----------------------- EPA1223 *Macro-Economics for Policy Analysis* -----------------------

**A Brief Study Guide to:**

James Crotty (1994)

“Are Keynesian uncertainty and macrotheory compatible?

Conventional decision making, institutional structures, and conditional stability

in Keynesian macromodels”

Crotty presents an important interpretation of Keynes’ *General Theory* and where and how this theory is different from the neoclassical model. The paper is densely written and not easy to read. To help you understand Crotty’s argument, this study guide has summarized Crotty’s paper in (what we hope to be) an easier-to-digest manner.

*Crotty’s first point* (pp. 1-11, “Keynes versus the New Classicists and Neoclassicists ….”) concerns the modeling of individual (agent’s) decision making. Crotty’s focus is on the decision to invest by firms, which is a ‘crucial’, non-repeatable, or ‘momentous’ decision which involves some assessment of the expected future returns of the investment.

In the **neoclassical model**, it is assumed that individuals are rational optimizers who choose the ‘optimal’ investment option out of a given ‘portfolio’ of all possible future states (with each ‘state’ having a numerical probability attached to it). These probabilities can either be ‘subjective’ or ‘objective’, but in Crotty’s view the difference is a minor issue. Much more important is the assumption is that the rational investor does construct a complete probability distribution of expected returns, which means that the probabilities add up to unity (1). The future, in other words, is already fully known and exogenous (sic!), because the decision of the investor does not have an impact on any of these future states. Thus, Crotty writes (p. 4), “the neoclassical theory of agent choice is restricted to a world in which agents’ decisions do not “create” the future.” The future is pre-given and does not depend upon agent choice. The problem with this assumption is that the future is uncertain and unknowable in principle. “Rational agents would always be conscious of their lack of complete knowledge of the future,” writes Crotty (p. 8).

**Keynes** argued differently: investors are ‘rational’ because they know that they don’t know. They also understand that their investment decisions, and also their expectations, will shape future outcomes – the future is not pre-given. How do firms decide on investment under uncertainty? Keynes’s answer is that what is important is the “**confidence**” of investors in the meaningfulness of their forecasts. Confidence concerns the degree to which investors believe in the (subjective) probabilities assigned to possible future states. Changes in the degree of confidence ‘will shift the investment function even if our hypothetical subjective probability distribution is held constant.” (p. 9). Investment is therefore based on the “flimsy” foundation of “investors’ confidence”. If this is so, then it is remarkable that market economies exhibit stability and continuity for long periods of time, rather than being unstable and disorderly all the time. How can market economies be stable when investment decisions are based on such flimsy foundations? This leads us to Crotty’s next point.

*Crotty’s second point* (pp. 11-23, “Human agency and conventional decision making”) provides the answer to the question why market economies are stable when investor confidence may fluctuate widely. “We do not know what the future holds,” wrote Keynes (p. 12), “Nevertheless, as living and moving beings, we are forced to act.” How do we decide in the face of uncertainty? Keynes’s answer is psychological: we behave **as if** we are rational, or we have a human need to “behave in manner in which saves our faces as rational, economic men.” In other words, we **rationalize**. To calm our nerves, we revert to **conventional decision making** based on custom, habit, tradition, authority or instinct (pp. 14-15). For example, when the collective wisdom of Wall Street and the business press is unanimous in predicting a rising stock market, it is not unreasonable for an individual investor to invest in shares. Or when the IMF is predicting a recovery of global growth, it may be rational for firms to consider new investment projects. Conventions (e.g. to rely on Wall Street or IMF expertise) help to create confidence in the meaningfulness of our forecasts. Conventional decision making is **institutionally specific,** historically contingent and also **socially constructed** (p. 21). The social context is crucial: investors need to divine where other agents think the market is headed. This is comparable to betting on horse races or trying to pick the winner in the Eurovision song contest. The point is not to pick the song you yourself like most, the main task is to predict the song chosen by the majority of the other agents. But the other agents are doing the same thing: predicting what you and the others will do. The only way to stabilize this process is by introducing shared conventions.

Stable conventions, in turn, create **conditional stability** in the economy (p. 16), because these conventions, leading to a widely shared outlook, make economic life predictable and create an illusion of continuity. (In a way, this is an example of a self-fulfilling prophecy …..) The key insight of Keynes here is that social conventions are “fragile” and “subject to sudden and violent changes” (p. 18) as sentiments change. Hence, the market will be subject to waves of optimistic and pessimistic sentiment, as reflected in the **business cycle**. The confidence in the meaningfulness of the conventional outlook can be destroyed very suddenly, and this leads to crisis and instability. In Keynes’s view, investors are not irrational, but rational – the adoption of conventional decision making is a rational response to uncertainty. It helps create temporary stability, but cannot avoid crisis.

*Crotty’s third point* (pp. 23-27, “The institutional foundation of conditional stability”) is to explain how society’s basic institutions help to create temporarily stable conventions – which in turn generate macroeconomic stability (and the orderly reproduction of investment each year). Government regulation of the macro-economy (via **fiscal stabilization policy**) is an example of such an institution. In this context, Keynes stressed the fact that “money” is an institution which helps to calm nerves and to impart stability. How does this work (see p. 24)? **Money** (or “**cash**” or “**liquidity**”) provides the owner with the ability to postpone risky or irreversible commitments in times of uncertainty. Money gives the owner flexibility: you can just sit on the cash and wait for better times. But while money can help to stabilize the economy, it can also de-stabilize it. When uncertainty increases and the sentiment of investors turns negative, it is – at the individual level – rational to postpone spending and keep to your liquidity. But what is rational at the micro level is not rational at the macro level: because people hold on to their cash (and don not spend), aggregate demand goes down. This slows down growth, increases unemployment and raises uncertainty further. If the sentiment becomes even more pessimistic, the crisis deepens – and becomes self-reinforcing. Money (as an institution) has two faces: it can impart stability or lead to instability, depending on sentiment and on actions of the government.

Note: the concepts in **bold-face** are key concepts, the meaning of which should be clear.