THE SOCIAL MARKET ECONOMY REVISITED

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ABOUT THE AUTHOR

Lord Skidelsky is Emeritus Professor of Political Economy at the University of Warwick. His three volume biography of the economist John Maynard Keynes (1983, 1992, 2000) received numerous prizes, including the Lionel Gelber Prize for International Relations and the Council on Foreign Relations Prize for International Relations. He was made a life peer in 1991, and was elected Fellow of the British Academy in 1994.

Robert Skidelsky was born on 25 April 1939 in Harbin, Manchuria. From 1953 to 1958, he was a boarder at Brighton College (of which he is now chairman of the board of governors). He went on to read history at Jesus College, Oxford, and from 1961 to 1969, he was successively research student, senior student, and research fellow at Nuffield College, Oxford.

In 1978, he was appointed Professor of International Studies at the University of Warwick, where he has since remained, though joining the Economics Department as Professor of Political Economy in 1990.

In the 1980s, he began to take a more active interest in politics. He was a founder member of the Social Democratic Party (SDP) and remained in the party till its dissolution in 1992. In 1991, he became chairman of the Social Market Foundation, and the same year was made a life peer. Initially, he took the SDP whip but subsequently joined the Conservatives. He was made Chief Opposition Spokesman in the Lords, first for Culture, then for Treasury Affairs (1997-9), but he was sacked by the then Conservative party leader, William Hague, for publicly opposing Nato's bombing of Kosovo. In 2001, he left the Conservative Party for the cross benches.

He writes a monthly column for Project Syndicate, "Against the Current", which is syndicated in newspapers all over the world. His account of the current economic crisis, Keynes: The Return of the Master, was published by Penguin Allen Lane in September 2009. A short history of twentieth-century Britain was published by Random House in the volume A World by Itself: A History of the British Isles edited by Jonathan Clark in January 2010. He is currently working with Vijay Joshi, fellow at St John’s College, Oxford, on a book on globalization and international relations for Oxford University Press.
PART 1: KEYNESIANISM AND THE DILEMMA OF UNEMPLOYMENT

In my essay, The Social Market Economy, which launched the Social Market Foundation in 1989, I identified the inability to maintain continuous full employment as one of the failures of the market system, justifying government intervention. I pointed out, though, that there was no agreement among economists as to why heavy unemployment should develop and persist. Classical economics taught that efficient markets ‘always clear’. However, for markets to be efficient very strong conditions had to be satisfied, the chief of which were perfect competition and perfect information. Mass unemployment could develop if one or other of these conditions were not satisfied.

The Thatcher revolution tried to banish the spectre of mass unemployment by moving the market economy closer towards the competitive ideal. This is what was meant by ‘supply side policy’. Unemployment was blamed on monopoly pricing by trade unions, unemployment benefits set at too high levels and given under too easy conditions, minimum wage legislation, and so on. If unions were sufficiently weakened, unemployment and other benefits reduced in amount and scope, and minimum wages abolished, unemployment would recede to its ‘natural rate’ – that rate consistent with stable prices. To make labour and product markets more competitive was thus the object of Thatcher’s supply-side reforms. If supply-side reforms could deliver a tolerably satisfactory average rate of unemployment, the long-standing commitment by government to maintain full employment by expansionary fiscal and monetary policy could be safely abandoned. Macro-policy could be reduced to one single aim: to maintain stable prices.

This reorientation of economic policy was justified by a double failure of the hitherto dominant Keynesian school. The first was the failure of Keynesian policy to predict, and hence to control, the simultaneous rise of both unemployment and inflation in the 1970s. Milton Friedman had provided a plausible explanation of this. Powerful unions, he said, were pushing up wage costs and hence the ‘natural rate’ of unemployment. In their attempts to push unemployment below its natural rate by increasing the quantity of money governments were simply pushing
up the rate of inflation. Workers realising that their real wages had gone down demanded compensating increases in their money wages which rendered the unemployment reducing policies abortive.

The theoretical failure of Keynesianism was, if anything, seen as more profound. The Keynesians were unable to provide a theoretical explanation for the widespread phenomenon of ‘sticky’ wages and prices. Why, when the economy suffered a shock – like the OPEC price shock of 1973-4 - did not producers adjust their wages and prices immediately to the new situation? The answer seemed to lie with external interferences with market adjustment by powerful trade unions, government subsidies for overmanned industries, and so on. So the way to get unemployment down was not to expand aggregate demand, which only pushed inflation higher, but to make labour markets more competitive.

The new doctrine was proclaimed by Nigel Lawson in his Mais lecture of 1984:

‘It is the conquest of inflation, and not the pursuit of growth and employment, which is or should be the objective of macroeconomic policy. And it is the creation of conditions conducive to growth and employment… which is or should be the objective of microeconomic policy’.1

However, economists were shocked by the huge unemployment cost of getting the inflation rate down in the 1980s. Despite sweeping supply-side reforms, unemployment in the UK went on rising for seven years, peaking at three million in 1986. It was in the light of this experience that a ‘new Keynesian’ school grew up. This concentrated attention on the second condition for efficient markets: perfect information. New Keynesians started to explain heavy and persistent unemployment in terms of ‘information failures’. Whereas the rational expectations theory of Chicago University assumed that market participants made efficient use of all relevant information, the new Keynesians identified blockages to the information flow

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sufficient to account for various forms of ‘market failure’. A favourite example was ‘asymmetric information’, which was used to explain failures in the market for private insurance. But as Paul Krugman later admitted, such information failures as identified by the New Keynesians were not up to the job of explaining the systemic crisis which hit the global economy in 2008. For this we need to turn to Keynes himself.
At the heart of Keynes’s economics is the distinction between risk and uncertainty. Risk is when probabilities can be measured; uncertainty exists when no such measure is possible. The financial system which crashed so spectacularly in 2008 used mathematical models which assumed that it was possible to measure risk and therefore insure or hedge against loss. Individuals could miscalculate the odds but, given the assumption of rationality, their mistakes would be randomised.

In his *Treatise on Probability* (1921), Keynes set out an alternative: the landscape of chance. First, there is cardinal or measurable probability, e.g. ‘There is a one in six chance of your house catching fire in the next year’. This frequency view of probability partly derives from games of chance, partly from invariable connections found in the natural, and some parts of the human, world. ‘In actual reasoning… exact measures [of this kind] will occur comparatively seldom’, Keynes wrote. Second, is ordinal probability, in which we have some evidential basis for believing that something is more or less likely to occur without being able to attach numbers to ‘more’ or ‘less’. Most risk assessments used by non-financial firms are based on this informal procedure. However, there is a residual category of ‘unknown probabilities’, in which our evidence is too scanty even to say that something is ‘more likely than not, or less likely than not, or as likely as not’. For Keynes, probability is the hypothesis on which it is reasonable for us to act in conditions of limited knowledge. There is no presumption that our knowledge will be sufficient to give us calculable probabilities.

Here is Keynes’s canonical statement, from a 1937 essay:

By ‘uncertain’ knowledge, let me explain, I do not mean merely to distinguish what is known for certain from what is only probable. The game of dice is not subject, in this sense to uncertainty; nor is the prospect of a Victory bond being drawn. Or again, the expectation of

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3 Ibid. viii, 32.
life is only slightly uncertain. Even the weather is only moderately uncertain. The sense in
which I am using the term is that in which the prospect of a European war is uncertain, or
the price of copper and the rate of interest twenty years hence, or the obsolescence of a
new invention, or the position of private wealth owners in the social system in 1970. About
these matters there is no scientific basis on which to form any calculable probability
whatever.\(^5\)

Keynes thought this category of ‘uncertain knowledge’ particularly relevant for the investment
process which is driven by the expectation of profit over time. The further we peer into the
future, the less we see.

To illustrate why he thought the future will necessarily be opaque to us, Keynes gave the
example of an apple endowed with ‘human’ characteristics. ‘It is as though the fall of the apple
to the ground depended on the apple’s motives, on whether it is worthwhile falling to the
ground, and whether the ground wanted the apple to fall, and on mistaken calculations on the
part of the apple on how far it was from the centre of the earth’.\(^6\)

Some part of the uncertainty attaching to the velocity of the apple’s flight can be put down to
the apple’s miscalculation. However, the main ‘human’ characteristic with which Keynes
equips his apple is ‘motives’ and ‘intentions’. It is these which break the link between past and
future, between economics and physics. Keynes’s point is that economics ‘deals with
introspection and values… with motives, expectations, psychological uncertainties’. The future
can’t be predicted, because it is what we choose to make it. This view implies a large restriction
on the applicability of econometrics. Basically Keynes believed it could be applied only to
those fields in which risk is measurable. This excluded nearly all the risks incurred in investment
markets.

\(^5\) CW, xiv, 113-4.
\(^6\) xiv, 300.
Human beings, though, can stand only a limited amount of uncertainty. Keynes’s economics is about the behavioural strategies we use to rob uncertainty of its sting. The main one is to transform uncertainty into calculable risk by giving it numbers. The best known technique for this purpose is Bayes’s theorem. Bayes divided probability into prior and posterior probabilities. This division enables subjective beliefs to be construed as bets. The rationality of the bets is satisfied if they are such that no clever gambler can make a profit against the better whatever happens – that is, when no bookie can run a Dutch book on the better. As the number of observations grows, the starting odds come to reflect the objective merit of the horses.

Keynes would have agreed that we do form our expectations by some such process. What he denied was that in investment and other future-oriented markets there exists an objective reality with which our subjective bets are aligned by a learning process. While repeated betting on horses allows you to update your ‘priors’ to match the ‘true’ merits of the horses, no amount of data on past financial crises or armed conflicts brings you any closer to their true probabilities in the future because they are by their nature singular events. Analysis of the 2008 crisis will not give you a probability of a crisis occurring in say 2013. What we do is to use mathematics to invent a world of calculable probabilities which we take to be an accurate reflection of the real world.

Keynes put uncertainty to work to explain two leading features of modern economic life: the frequent breakdowns in the investment machine, and the persistence of heavy unemployment following a collapse in investment.

Why, in Keynes’s view, does investment break down? His answer is that the technique for transforming uncertainty into calculable risk is based on nothing more than a convention, the convention being that ‘the existing state of affairs will continue indefinitely, except in so far as we have specific reasons to expect a change we are assuming, in effect that the existing market valuation, however arrived at, is uniquely correct in relation to our existing knowledge,
and that it will only change in proportion to changes in this knowledge’. This convention is philosophically flawed, ‘since our existing knowledge does not provide a sufficient basis for a calculated mathematical expectation’. Nevertheless, it is compatible with ‘a considerable measure of continuity and stability…so long as we can rely on the maintenance of the convention’. [italics in original] For by using the convention the investor can ‘legitimately encourage himself with the idea that the only risk he runs is that of a genuine change in the news over the near future’, which is unlikely to be very large. Thus investment becomes reasonably ‘safe’ for the individual investor over short periods, and hence over a succession of short periods… if he can fairly rely on there being no breakdown in the convention.8

But expectations so precariously based, are liable to be swept away, because, as Keynes says, ‘there is no firm basis of conviction to hold them steady’ – that is, to be able to distinguish between new relevant information and ‘noise’. Suddenly every one starts revising their bets. The existence of liquid markets for securities enables investors to do this. Everyone tries to become liquid. But, as Keynes notes, ‘there is no liquidity for the community as a whole’.9

‘The practice of calmness and immobility, of certainty and security, suddenly breaks down. New fears and hopes will, without warning take charge of human conduct. The forces of disillusion may suddenly impose a new conventional basis of valuation. All these pretty, polite techniques, made for a well-panelled boardroom and a nicely regulated market, are liable to collapse’.9

This is as good a theoretical explanation for what happened last autumn as I have come across. There was no ‘under-pricing of risk world-wide’ as Alan Greenspan claimed. There was a breakdown of the convention that risks were being correctly priced.

Money plays a key part in the narrative of investment breakdown. Holding money is an alternative to buying investments. The collapse of investment is simultaneously a flight into

7 Ibid. vii, 152.
8 Ibid. vii, 152.
9 Ibid. xiv, 114-5.
money. The function of money as a store of value can only be explained, Keynes felt, by the existence of uncertainty. Since the crisis struck last year there has been a big increase in hoarding money – as the phrase is, we are suffering from a liquidity crisis. Banks are reluctant to lend, and investors reluctant to borrow. They both sit on enlarged cash balances.

Uncertainty also lies at the heart of Keynes’s theory of persisting unemployment. The classical theory, like its new classical successor, assumed optimally self-regulating markets. It assumed, that is, the rapid adjustment of relative wages and prices to shocks – monetary shocks, technology shocks, and so on. What most normal people call unemployment is for Chicago economics a voluntary choice for leisure.

Keynes offers an explanation of why wages and prices remain ‘sticky’. A shock to investment creates a new situation in which the old vector of wages and prices becomes unviable. But market participants have no knowledge of what the new viable vector is. They are forced to trade at disequilibrium prices. In the graphic phrase of Axel Leijonhufvud there is no auctioneer to call out prices before the new round of trading starts. So market participants hold off investing or offering labour services long enough for output losses to develop. Once output starts falling its fall is cumulative, as aggregate spending falls in a multiplied way till an under-employment equilibrium emerges. Wage costs, that is, are adjusted to the ‘shock’ mainly through a fall in output and employment which automatically reduces the wage bill.\(^{10}\)

The chief ‘sticky price’ in Keynes’s system, however, is not wages, but the rate of interest. Contemporary monetary theory – as in Keynes’s day – suggests that a fall in investment relative to saving would bring about an automatic fall in the rate of interest. But Keynes, as we have seen, thought that a great deal of saving was done not to invest but to hoard money, and that this ‘liquidity preference’ rose during a financial crisis. So the rate of interest in his scheme was the price of ‘not hoarding’; as he put it ‘the price which adjusts at the margin the demand for hoards to the supply of hoards’. This price might easily stay too high to bring about a

\(^{10}\) Axel Leijonhufvud, *Keynes and the Classics*, 1969, Institute of Economic Affairs.
recovery of investment. I quote: 'When a more pessimistic view is taken about future [yields] of investment there is no reason why there should be a diminished propensity to hoard. Indeed, the conditions which aggravate the one factor tend, as a rule, to aggravate the other. For the same circumstances which lead to pessimistic views about future yields are apt to increase the propensity to hoard'.

Uncertainty may cause the long term rate of interest to remain for years above the rate needed to restore a full employment volume of investment. This removes the main ‘self-adjusting’ element in the economic system. The listing ship does not automatically right itself. This is Keynes’s main argument for a ‘stimulus’. In a situation of rapid economic decline, it is the government’s duty to provide an external source of spending to replace the shortfall in private spending. This usually means running a budget deficit. The extra spending created by government will reverse the initial fall in aggregate demand. As aggregate spending increases, the budget deficit will automatically shrink, since government revenues rise faster than national income. If the economy starts growing again at its old rate, then provided budgets return to balance, the national debt will also start coming down automatically.

The theory of the stimulus is not rocket science. How large it should be and what its effects will be are subject to uncertainty. A large part of the effect will depend on confidence in the government’s policy and in the sustainability of its finances. In the UK the political parties have been arguing about the size of the government’s ‘structural’ (that is, pre-recession) deficit, and therefore about how much public spending will have to come down or taxes go up to rebalance the budget, and how soon this should happen. In present conditions, Keynes would, I think, have been in favour of putting extra money directly in the pockets of the poorest section of the population, those with the lowest propensity to save.

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11 Ibid. xiv, 118.
PART 3: TOWARD A SOCIAL MARKET ECONOMICS

Although I identified persisting unemployment as one of the main issues a social market economy needed to address, I did not in fact address it in my SMF pamphlet of 1989. Had I done so I would have discovered a more extensive field for government intervention than I, or other social market theorists of the time, would have allowed.

The most notable omission in my pamphlet was any discussion of the financial system. Its capacity for self-regulation was simply taken for granted. This assumption has been blown sky high. Everyone now accepts that it needs to be reformed, but there is considerable debate about the kind of reform needed. If, as most people now agree, banking services need to be made less risky for most of their users, how can this be done without chilling the spirit of financial innovation? The short answer is that financial innovation is not always a benefit. It was Warren Buffet who described derivatives as potential financial weapons of mass destruction. I would limit the scope of financial innovation to those areas where people can be left free to gamble without endangering the system as a whole. This points to restoring the fire walls between different types of banks swept away in the de-regulation movement of the 1980s and 1990s. The basic cause of the financial crisis was not that retail banks over-lent mortgages, it was that the investment departments of retail banks used depositors’ money to gamble in derivatives. If it is true, as John Kay contends, that retail banks had become ‘utilities with casinos attached to them’, the logical solution is to separate the utility from the casino, i.e., a return to Glass-Steagalsm.

A banking reform along these lines would automatically reduce the scope for securitization. In Keynes's terms it would protect the main part of the banking system from the quants who claim to turn uncertainty into calculable probability.

Secondly, Keynes suggested two measures to counter the inherent instability of the private investment machine. The first was to have a larger share of investment done by the state: 'I
expect to see the State, which is in a position to calculate the marginal efficiency of capital-goods on long views and on the basis of the general social advantage, taking an ever greater responsibility for directly organising investment’. The reason he gave was that fluctuations in private investment demand were likely to be too great to be offset by any practicable changes in the rate of interest.  

The idea of a greater role for public investment to ‘steady the economy’ will raise howls of execration from all those who regard the state as the problem, not the solution. But what we always have to do is to balance the waste inherent in state activity against the waste of prolonged bouts of heavy unemployment. A crucial task for any updated version of the social market economy is to rehabilitate the state as a potentially beneficial economic actor.

Keynes’s second proposal was to redistribute incomes so as to raise the propensity to consume, since an ‘increase in the habitual propensity to consume will in general [i.e. except in conditions of full employment] serve to increase the inducement to invest’.

The following passage from Marriner Eccles, chairman of the US Federal Reserve Board from 1934-1948, spells out the logic of this position in terms completely applicable today:

A mass production has to be accompanied by mass consumption. Mass consumption in turn implies a distribution of wealth to provide men with buying power. Instead of achieving that kind of distribution, a giant suction pump had by 1929 drawn into a few hands an increasing proportion of currently produced wealth. This served them as capital accumulations. But by taking purchasing power out of the hands of mass consumers, the savers denied to themselves the kind of effective demand for their products that would justify a reinvestment of their capital accumulations in new plants. In consequence, as in a

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13 Ibid. vii, 373.
poker game where the chips were concentrated in fewer and fewer hands, the other fellows could stay in the game only by borrowing. When their credit ran out, the game stopped.\textsuperscript{14}

Finally, it would be worth the SMF giving serious thought to the question of what kind of economics could best support the idea of a modernised social market economy. What would an economics look like which allowed for the possibility of unpredictable events with large consequences? Its basic axiom, I suggest, cannot be rational expectations as defined by the still dominant Chicago school. It would need to recognize the role of conventions in shaping the behaviour and expectations of individuals in an environment which lacks the clairvoyant signals about future events assumed by orthodox economics. It would need to understand why conventions thus formed are liable to periodic breakdowns, and would seek to create institutions which limited the ravages of unpredictable events. It would seek to rebalance our prevailing views about the role of state and markets. The great achievement of the Institute of Economic Affairs in its heyday was that by asking fundamental questions about economics it prepared the ground for new thinking about policy. This is something the SMF should try to do today.

\textsuperscript{14} Eccles Q, Reforming the City, ed. Sam Whimster, 2010, p.98.
In *The Social Market Economy Revisited*, former Chairman of the SMF, Lord Skidelsky, returns to the themes of his seminal 1989 essay that marked launched the Foundation. In the wake of the biggest financial crisis in history, he examines how markets address different types of uncertainty, the role of convention in determining economic behaviour and the limits to the use of econometric analysis in forecasting the future. Arguing that financial systems cannot self-regulate, he calls for a renewed examination of the state as a potentially beneficial economic actor, and for a new kind of economics to support the social market economy.