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**Paul Davidson, *Post Keynesian Theory and Policy: A Realistic Analysis of the Market Oriented Capitalist Economy*, Edward Elgar, 2015, 160 pp. \$99 Hardcover.**

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**Abstract.** In this book Davidson develops Post Keynesian strategies for full employment policies, targeting inflation and offers solutions for the problems of globalization. Davidson's message is clear: Markets cannot regulate by itself. Mainstream theories are all based on wrong assumptions like the neutrality of money, the predictability of the future (ergodic-axiom), the efficiency of markets, rational expectations, Say's Law and Walrasian Theory of equilibriums. In this book Davidson rejects all these assumptions and therefore offers Post-Keynesian solutions. From the viewpoint of Davidson these misleading assumptions of mainstream theories lead to a wrong economic policy resulting in high unemployment rates. He also criticizes Samuelson's neoclassical synthesis embedded in a Neo-Walrasian model, which Keynes clearly rejected. In an article (Neglected Prophets) written by Holt, Rosser, Wray (1998), Davidson is described as an economist who would have lost the discussion in the short run, but will win it in the long run (Holt et al., 1998:505). That sounds promising, but Davidson would not agree to this conclusion in the sense he would be a prophet. For a prophet the future is already pre-determined by the past, but in a non-ergodic world the future is open and not pre-determined. The future remains to be as not predictable.

**Keywords.** Post Keynesian Theory, Unemployment, Economic policy.

**JEL.** B50, B61, F62, H63.

## 1. Introduction: Against The Grain in Times of Confusion

Why did nobody notice it developing?", the Queen asked the director of research at the London School of Economics on a visit on November, 4<sup>th</sup>, 2008. The director told her: "At every stage someone was relying on somebody else and everyone thought they were doing the right thing." (Davidson, 2015:1). With these words Davidson starts the first chapter ("Did anyone notice the global financial crisis?") of his latest book "Post Keynesian Theory and Policy" and gives the right answer when he says that the prevailing economic theory has not been applicable to the real world. Before the crisis economists build on an illusion of efficient markets and equilibriums. The markets would always "know" better than anyone else and markets would be self-regulating. Even Davidson does not explicitly mention the "Washington Consensus", F. A. Hayek and for example Ben Bernanke in this context, these figures would be appropriate to be mentioned. The "Washington Consensus" became the leading paradigm of the world economy of today. Ben Bernanke believed in a complete illusion when he said before the

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crisis that the world economy would have reached the stage of the “Great Moderation”. Long before F. A. Hayek proclaimed “The Pretense of Knowledge” (Hayek, 1989) also alluding to Keynesian policy measures in his criticism. However, F. A. Hayek was not so simple minded that he just proclaimed “Efficient Markets”. He only said that competition would be a “discovery process” (Hayek, 2002). What we had discovered in 2007-09 was a complete disaster and the failure of the prevailing economic theory. Ironically, in this sense F. A. Hayek was right.

In the first chapter Davidson does not reject well organized financial markets in general, but he thinks that these markets are a double-edged sword. The good side is that financial markets can make things resp. investments or enterprises possible, which could not be realized without well-organized financial markets. The bad side is when investors loose confidence, try to sell these assets, but cannot find buyers due to increasing fears. Another aspect is that the accounting methods forces firms to value their assets “mark-to-market”, which means they have to value their assets in line with actual market prices. These methods leads to the result that the value of these assets fall into a deepening downward spiral in extreme market conditions.

These elements were the basis of the subprime loan crisis 2007-09. Securitized packages of mortgages were labeled with AAA-Rating and could be sold like cash due to its favorable ratings. These financial instruments became illiquid when first defaults occurred and investors began to loose confidence. Explaining the financial crisis Davidson focuses alone on economical aspects and neglects aspects of jurisdiction. From my point of view it was not the loss of confidence alone (even it may have had the decisive impact), but also the fact of fraud should be examined. It is very questionable that no decision maker was really unaware of the high risks she or he was taking. Also the rating agencies played a suspicious role in this complex, because they gave a AAA-rating to nothing else than junk. No one in the western banking system was prosecuted after the financial crisis. The only exception was Iceland, which prosecuted several bankers and put them to jail. For rating agencies the end was a happy end, because the jurisdiction said that these agencies could rely on “freedom of speech”. Davidson is an economist and not a lawyer, so that he is justified to rely only on economical aspects and not on views of jurisdiction. However, I believe that jurisdiction is very challenged in the light of future behavior of the financial sector and it seems that we need additional laws to protect the society. It is obvious that losses were socialized and profits had been privatized in the last financial crisis.

In chapter 2 (“Alternative theories of the operation of a capitalist economy”) Davidson raises the question which theory could provide an explanation for the crisis. Davidson distinguishes between two fundamental economic theories. The first one can be subordinated into a class of theories which has its origins in the first part of the 18<sup>th</sup> century. They are all named differently but they are all based on the same axiomatic foundations, which are efficient market theory, Walrasian theory, general equilibrium theory, dynamic general equilibrium theory, Austrian theory and mainstream Keynesian theory according to the neoclassical synthesis developed by Samuelson. There is to add on the New Keynesian Theory developed by students of Samuelson. These theories differ in details, but they all have in common that free markets, flexible product prices and wages will shift the economy into an equilibrium of full employment and most efficient usage of resources. The second one is the Post Keynesian theory which rejects the axioms of the standard theories. Interventions by the state in cooperation with private household and private industry should enable the economy to full employment. In addition Davidson describes the classical economy embedded within Say’s theorem. Davidson outlines many arguments why this theory is not applicable to the real world and finally rejects it by the Post Keynesian approach.

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Chapter 3 (“Unemployment and the classical theory’s axioms”) explains the difference of classical theory vs. Keynesian theory regarding the appearance of unemployment in a capitalist society. While the classical theory assumes that wages are too high in phases of unemployment and wages have to decrease to reach full employment due to the assumption that markets would be efficient, Keynes rejects this theory, because he does not assume that markets would be efficient. According to Davidson Keynes overthrew three classical axioms: 1<sup>st</sup>, the ergodic axiom, 2<sup>nd</sup>, the neutral money axiom and 3<sup>rd</sup> the gross substitution axiom. The ergodic axiom says that the future is pre-determined by the data of the past. All different outcomes could be reduced quantifiable, objective results. The idea of rational expectations was born which simply assumes that all agents would have realized that and their subjective probabilities of the future would fit with all objective probabilities. Davidson sets in contrast the non-ergodic axiom which means that the future is fundamentally uncertain in the sense that data of the past have no meaning for the future. Davidson subsumes all Classical Theorists, Monetarists, Neoclassical Synthesis Keynesians and New Keynesians to the ergodic axiom. So, in the result, even self-proclaimed Keynesian would be Classical Theorists, because they would not have understood the non-ergodic axiom. By assuming the ergodic-axiom money is neutral, because the economic system is pre-determined and immutable. An increasing quantity of money would simply increase price levels immediately and could have no influence on the distribution of income or effective demand, because the higher quantity of money would just express higher prices and wages while the relation of prices, goods and wages would remain constant. According to Keynes changes in the quantity of money can have influence on output and employment. Full employment could not be reached by entrepreneurial activities solely, fiscal policy and government spending should correct the failure of markets and provide full employment. The gross substitution axiom says that price changes for a specific good would effect changes in demand for other substitute goods. In other words, if for example the price for coffee increases, the demand for coffee will decrease and therefore the demand for tea as substitute for coffee would increase by assuming a constant income. Due to this effect prices will adjust between these two goods and will slip into a new (Walrasian) equilibrium. Keynes also rejects the gross substitution axiom, because today’s savings would not be used to buy daily products and services over time. Producible durable goods would not be used for savings, but liquid assets including money. So, durable goods are not gross substitutes for storing savings.

Chapter 4 (“Keynes-Post Keynesian theory: money and money contracts”) describes the difference between the Classical Theory of savings and the liquidity preference theorem from the precautionary motive in Keynesian terms. According to the Classical Theory savings only express the time preference for purchasing goods in the future. In this paradigm the future is known or known in the sense of rational expectations. Say’s law requires that all income is determined for the consumption of goods in the present. Savings are only necessary for future consumption (time preference). In this model the production of goods creates its own demand. In this equilibrium model the supply of goods equals the demand in money terms and provides full employment.

For Keynes the future is fundamentally uncertain and therefore agents save liquidity in order to keep the ability to fulfill future contracts which were not foreseen. In addition companies and households arrange money contracts to diminish uncertainty. In the result due to a fundamental uncertain future some potential money for demand flows out of the circle for effective demand and releases a gap for consumption so that not all produced goods will find enough

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buyers. The production must be adjusted to the lagging demand and therefore workers lose their jobs. This downward spiral can only be interrupted and reversed by additional government spending in order to fill the gap of effective demand.

At the end of this chapter Davidson mentions Friedman who recognized the problem that Say's Law can only be kept when the complete income will be spent for consumption. Friedman tried to bypass the problem by defining savings as a purchase of durable goods, because such goods cannot be consumed completely in one day of the purchase. So, consumption of durable goods according to Friedman is defined as the portion of consumption of a durable good within an accounting period for depreciation. To buy durable goods means in the sense of Friedman savings out of current income minus the amount of depreciation. While for Friedman to buy a durable good first means "savings", for Keynes it is "consumption". Due to the redefining of "consumption" as "savings in the neoclassical sense of time preference" and the lack of any concept of the classical model Friedman implies that no government spending is necessary to assure full employment, because by this redefinition Say's Theorem can be saved.

Davidson sets both models (Friedman vs. Keynes) in contrast, however I missed a practical example that could reject Friedman's theory, even the last financial crisis gives a good example that Friedman is wrong. I want to explain my own theory why Friedman was wrong and I believe Davidson probably would agree:

Before the financial crisis real estate prices in the US increased relatively steadily since the beginning of the Fifties and therefore consumers "saved" their money for houses, because they could anticipate an increasing value of their home in the future. The future was some kind "certain" because households anticipated this trend. These expectations implied that a trend prevailing more than 50 years would not be interrupted. Following these "rational expectations" households constantly checked the value of their houses and in times of increasing value of their houses they increased their indebtedness covered by the estimated value of the real estate. With this additional money they usually "saved" their money in solid cars, like SUVs. From their point of view buying a car was a "saving" resp. "savings" in the sense of Friedman, because houses and expensive cars are durable goods. When the real estate bubble, or better expressed the credit bubble, busted, the whole construction collapsed like a house of cards. The belief of "savings" was based on wrong definitions and a misleading understanding of an economy which led to this mis-behavior which was initially defined by Milton Friedman. Maybe that Friedman's view has influenced the view of the common people or that Friedman already shared the view of common people. This example shows that Friedman is fundamentally wrong. I would go so far that Friedman created an illusion and Keynes explained the reality. The future is uncertain and there are no rational expectations applicable. The data of the past can give no advice for the future. In the result liquidity preference from the precautionary motive is necessary in order to meet unexpected demands. That also means that Say's law is invalid and involuntary unemployment is possible without governmental interventions.

Chapter 5 ("Why traditional mainstream Keynesian theory is not Keynes's theory") Davidson outlines the difference of Post Keynesian Theory in comparison to 'traditional mainstream Keynesian theory' such as the neoclassical synthesis founded by Samuelson. Samuelson began to modify the General theory by the erasure of fundamental axioms of Keynes's theory and embedded it into a Walrasian model.

When Keynes published his "General Theory" in 1936, Davidson outlines, Keynes wrote in his foreword of the German translation. "This is one of the reasons which justify my calling my theory a *general* theory. Since it is *based on*

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*fewer restrictive assumptions* [“weniger enge Voraussetzungen”] than the orthodox theory, it is also more easily adopted to a large area of different circumstances.” (Keynes, 1936:ix).

From Davidson’s point of view Keynes contributed a more general approach than the Walrasian theory and attacks Samuelson who added restrictive axioms to the General Theory. By implementing the Walrasian paradigm to the General theory Samuelson robbed Keynes’s theoretical foundations. According to Davidson the neoclassical synthesis of Keynesian theory was not only wrong – but also encouraged a laissez-fair-policy with significant high unemployment rates. Davidson claims Samuelson’s arrogance when Samuelson described Robinson’s and Weintraub’s version of Keynesian-ism as “unreconstructed Keynesians” while Samuelson defines his synthesis as “reconstructed Keynesians” who kept Keynesians insights and the principle of effective demand based on Walras as the only true interpretation. Davidson believes that Samuelson saved the term “Keynesian” in the McCarthy era, however the price paid for this rescue was very high. In Samuelson’s book “Foundations of Economic Analysis” (1947) the classical axioms foundation of the neoclassical synthesis were laid. Samuelson noted that holding cash would make no sense and money would be neutral. This is clearly the opposite of Keynes’s axioms in the General Theory (1936). Furthermore, in an article published in (1969:184) Samuelson implemented the “ergodic axiom” in order to make economics to a “hard science”. Exactly at this point Davidson criticizes Samuelson fundamentally and sets the “non-ergodic-hypothesis” against Samuelson’s “ergodic axiom”. Non-ergodicity means that a sample of information of the past can give no information or quantifiable probabilities for the future. In an ergodic world the future is pre-determined by the past, it is only a shadow of the past, a theory which fits in with the Walrasian paradigm. It is an immutable system in which any interventions can have no influence, because the future is already pre-determined by the past. According to Davidson, post Keynesian-ism means that the future is not pre-determined and that the economy is transmutable. Due to fundamental uncertainty, liquidity preference is, among other reasons, due to the cautiousness motive not neutral. The demand for liquidity increases, when uncertainty is also increasing. In the result money is not neutral.

The Post Keynesian interpretation stands in full contrast to the neoclassical synthesis. Davidson believes if policy makers would have adopted the Post Keynesian approach instead of the neoclassical synthesis or later the monetarism founded by Friedman, the world of today would look much better. The rejection of austerity measures, decreasing wages and laissez-fair-policy would be a necessary condition to create a capitalist society of full employment and more social welfare.

In the following chapters Davidson enrolls a whole architecture of measures which should improve and civilize a capitalistic society. It starts with chapter 6 (“Creating full employment”) in which Davidson describes the cause of persistent unemployment as a shortage of demand for all supplied goods and services. In order to fulfill the lack of effective demand Davidson discusses several options which could be sufficient to maintain enough effective demand. The first option would be to reduce taxes. However under the Ricardian equivalence thesis households would anticipate higher budget deficits and also would anticipate the government would have to increase taxes in later periods. Therefore, households would save the extra money for later payments for expected additional taxes. From a Keynesian perspective households would save a specific amount in liquid assets due to an uncertain environment. In the result tax reliefs would have no or a less impact. The government or central banks could set incentives for entrepreneurs to borrow more money in order to increase investments. This can only work when the

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entrepreneurs have expectations that their additional investments would pay off. Consumers could also be offered easy credits for consuming, but it should become a major problem when these debts cannot be repaid anymore and would default. At least if the government would directly spend the money it otherwise would have paid to the people by tax reductions this would have the optimal effect, because the total amount of money directly would flow into additional effective demand. The other question is in how far rising deficits would be a harm for society. Davidson explains that a private household is something different than a state budget. If a budget would be managed like a private household this would have a counterproductive effect due to the lack of demand if a government does not spend more money but cuts spending. But how deep can deficits run without negative effects to the economy? Davidson gives the examples of the WW II period when the government increased debts sharply in order to win the war or the Nixon-period when the moon landing program and the Vietnam war caused high budget deficits. In all of these periods of high governmental expenditures the economy reached high output levels and nearly full employment. Davidson argues a war would not be necessary to justify high deficit spendings, because the economy will run well due to the additional effective demand by deficit spending which otherwise could not fill the gap of effective demand and therefore recessions and high unemployment rates would appear.

In chapter 7 (“Inflation policy”) Davidson evaluates Keynes’s inflation theory vs. inflation theory of classical economics. The classical theory sees a direct link between the quantity of money and inflation. Rising quantities of money would increase inflation and vice versa. According to Keynes money is not neutral and inflation can have different causes, commodity inflation/deflation and/or incomes inflation/deflation. In cases of commodity inflation spot prices rise or fall due to changes of demand or changing quantities for a good. Government policies could flatten the volatility of spot prices if an authority keeps buffer stocks in case of supply shortages. Another reason for inflation would be if wages rise more than labor productivity gains. To avoid such developments a policy must be implemented to keep inflation low. Davidson mentions Marx’s theory of the ‘industrial reserve army’ which would appear in free market societies in which a reserve army of people without jobs keep pressure on wages. Employers take advantage by low wages of workers. Davidson outlines that due to the globalization another reserve army of unskilled labor has been build up in foreign countries with low labor costs. Monetary policy is targeting inflation by rising interest rates or decreasing money supply. This has a contractive impact on wages and employment. The alternative approach in Keynesian terms is to stimulate the economy by low interest rates and government spending to reach full employment. If unemployment rates are low the danger rises that wages would increase above the level of productivity gains. In order to avoid such kind of inflation Davidson suggests Weintraub’s idea of a tax-based income policy (TIP), which should raise additional taxes on companies which increase wages more than the increase of labor productivity. Due to the fact that a Post Keynesian policy never was implemented double-digit unemployment rates would have become the norm in many Western European countries.

I only can confirm Davidson’s conclusion from my own experience. I can recall the day when in West-Germany the number of unemployed rose over one million people in the beginning of the 80s. That was a big shock-wave in Germany, because unemployment was a completely neglected theme before. In the 60s Germany had full employment and in the 70s the number of unemployed people remained relatively low. After this shock people were still concerned but got accustomed with the idea to live with high unemployment rates. Today when the

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official number of unemployed people falls below 2.6m people the government and all leading economic institutions in Germany promote this figure as a “success” and people believe it would be so due to the brainwashing reporting by the media. Needless to say that millions of people in Germany do not have full time jobs or they have fixed-term labor contracts only or have precarious working conditions. A look to southern European countries is even worse. High double-digit unemployment rates for young people are the norm. In Greece additional austerity measures for keeping the Euro lead to decreasing wages, lower pensions, high unemployment rates and last but not least a very weak economy in general due to the lack of effective demand.

Chapter 8 (“Securitization, liquidity and market failure”) is an analysis of the financial crisis and Davidson gives advice for better regulations of the financial sector in general. The reason why financial markets collapsed in 2008 was from Davidson’s viewpoint the belief in efficient markets (EM) and the fact that economists had forgotten Keynes’s liquidity preference theory (LPT). In a nonergodic world the future is fundamentally uncertain and future events cannot be probabilistically quantified. However, the prevailing theory assumes that the economy is ergodic. So, for example AIG covered all its risks by derivatives which replaced the liquidity an insurance company would have needed to cover its risks. Because these models were built upon wrong assumptions AIG was one of several other companies in the financial sector which failed first and pushed a domino-effect through the whole world financial system. If the Fed and other central banks would have not intervened heavily and immediately the global financial system would have collapsed. Davidson criticizes that many exotic financial markets were not provided with a sufficient market maker and customers misguided believed they would hold liquid assets. Davidson believes that also the SEC did not meet its obligations, because they behaved much too lax. According to Davidson the legal framework for financial institutions should be regulated as follows: 1<sup>st</sup> A public notice for financial products that could become quickly illiquid due to the lack of a market maker. 2<sup>nd</sup> To forbid securitizations for transforming illiquid private financial contracts to liquid assets on public markets, which would be illiquid if sold privately as single contracts. 3<sup>rd</sup> A new legislation of a 21<sup>st</sup> century version of the Glass-Steagall Act. It should be noted that the Glass-Steagall Act was introduced in 1933 in order to separate credit business from brokerage business from the experience of 1929 where banks played a major role for creating the stock market bubble fueled by banks which contracted customers who wanted to participate in the stock market boom by leveraging their engagements with additional loan credits. In 1999 this act was completely abolished by the Clinton-Administration. The consequence was that banks and brokerage firms could merge their businesses again which was a first foundation for the financial crisis to come around 9 years later. In this book Davidson gives a fundamental advice for the legal framework of a new regulation of financial markets by three bullet points only which should solve the most severe problems of today. However, in the last few years thousands of new legal acts have been introduced which no one really can overview (and probably not understand) anymore and it is very questionable whether this high volume of regulations will really meet its targets or if lawmakers should have been better advised by implementing less complex three rules Davidson suggested.

In chapter 9 Davidson explains the difficulties of foreign trades. Export surpluses of one country lead to trade surpluses of the exporting nation, which simultaneously lead to trade deficits in other countries. Classical theory says due to the exchange rate mechanisms between the trading countries these imbalances would become equalized in the long run. Keynes doubted this efficiency of

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currency markets and suggested a World Bank with one global currency which could directly re-balance appearing trade in-equilibriums between different nations. Keynes could not realize his idea, because it was vetoed by the US. Instead the White Plan was accepted which set up the IMF and the World Bank (Bretton Woods). The IMF and the World Bank should finance the trade deficits of the war destructed European countries who had to import goods from the USA. However, these banks were unable to finance enough credit volume to enable these countries to buy enough goods from abroad. In 1948 the Marshall Plan was introduced which had a total volume of 13bn dollars (equivalent to around 160bn dollars in 2014). Davidson outlines that the money needed not to be repaid and so did not demand a “belt tightening”. This plan put both sides into a win-win position and let the economies in Europe and the USA prosper. The political implication of this plan was to get West-Germany and all other Western European countries on the “right side” and to prevent these nations from a further spread of communism. A similar situation appeared when the USA went into war and therefore could justify high deficit spendings which stimulated the economy to full employment. The question which arises is why a war or an enemy is needed to justify and implement a sound economic policy. Presenting a “gift” or increasing deficits always need a justification, because otherwise politicians would not be elected. There should be found a better strategy. In the 50s and 60s Western European countries recovered strongly and turned from deficit countries to surplus countries. These countries exchanged their surpluses to gold and the US had to export high amounts of gold. During a long period of mutual prosperity in 1971 President Nixon closed the gold window. This was, from Davidson’s view, the unilaterally withdrawn from the Bretton Woods system. The countries would have forgotten their obligations to correct persistent trade imbalances. Davidson believes that a great opportunity was missed in 1944 when Keynes’s Plan was rejected. Therefore Davidson suggests a similar plan for the 21<sup>st</sup> century. Instead of a World Bank an “International Monetary Clearing Union” (IMCU) should be established as an institution that clears all international capital and money movements around the world. It should be an intermediate control institution of all central banks and foreign exchanges. The major task of this institution should be to re-balance persistent trade imbalances between different countries. This institution could also clear illegal transactions of organized crime, tax fraud and terror finance, if no one can bypass this institution for any transaction. Davidson points out that nowadays such an institution would have a better political chance than Keynes’s idea of a World Central Bank. However, I think actually it would also have a lesser chance today until the differences between Russia and the Western World have not been solved. The reason why Keynes’s Plan was rejected in 1944 was that the USA had replaced Great Britain as the leading super power and it wanted to show where the action will be taken.

In chapter 10 (“Is international free trade always beneficial”) Davidson rejects the classical 'comparative advantage' by the argument that free trade in our times, often defined as 'Globalization', is based on the cost advantage of wages of skilled and unskilled labor in developing countries. In the sum neither the poor countries nor the rich countries are really profiting from this relation in general, because the industrialized countries loose their manufacturing jobs and the poorer countries have to accept inhuman working conditions.

Chapter 11 (“Policies to assure a civilized capitalist economic system”) shows the history of first attempts to realize Keynes’s policy for example by Franklin D. Roosevelt. Later the Marshall Plan also had a positive impact on the economies in the USA and Europe and provided a long period of full employment. The first sin was the neoclassical synthesis by Samuelson and later the second (most severe) sin

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was Paul Volcker's high interest rate policy beginning in 1979. Davidson attacks this policy heavily because it pushed the world economy into a deep recession, destructed formerly well operating firms and its working places. It also marginalized the power of labor unions, which had to accept lower wages in order to keep the remaining jobs. High unemployment rates became a norm in the Western World. To reach the goal of a civilized society Davidson promotes a Post Keynesian policy for the 21<sup>st</sup> century, which could provide full employment, better education, an improved infrastructure and last but not least a social health care system.

### 2. Conclusion

Davidson offers a deep analysis of crises and unemployment in capitalism. Say's Law, the neutrality of money and the foresee-ability of the future (ergodic-axiom) are clearly rejected. A new, Post-Keynesian policy would be needed in order to lower high unemployment rates and to re-balance the imbalances of foreign trade. There still remain some open questions. For example if there is a limit for deficit spending and how high this limit could be. The dollar is the leading world reserve currency with which all important commodities are converted and this advantage gives the US government more space for deficits than other countries. So, it is also questionable that the US government would marginalize this advantage by implementing an IMCU.

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