Financial Systems and Economic Development in the 21st Century: Are We All Keynesians Yet?

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Abstract

This paper explores the contribution of Keynesian economics to the matter of finance and development. It does so in several steps. First, the paper presents an account of the mainstream neoclassical approach to finance and development and traces through its historical evolution since the early 1970s. Second, the paper demonstrates that the failure of the neoclassical approach to finance and development stems from a variety of immutable theoretical and empirical problems with this approach. Third, the paper considers a range of Keynesian contributions to the debate over finance and development that have emerged in the wake of the repeated and consequential failures of the financial liberalization prescription and the related early warning models of financial crisis in developing countries that have been so important to neoclassical theorists. Fourth, the paper considers the kinds of commitments and broad approaches to financial policy in the developing world that are consonant with Keynesianism. Finally, the paper concludes with some speculations on the possibilities that the current global financial turmoil will create intellectual and policy space for Keynesianism to be taken more seriously as part of a sustained intellectual revival of the paradigm.

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1. Introduction

The current global financial and economic crisis seems to have reminded the economics profession of Keynes’s relevance. Even unreconstructed libertarians, most notably former Federal Reserve Chair, Alan Greenspan, have acknowledged the limitations of neoclassical theory and appear to be recalling some of the insights of Keynes. During the April 2009 Group of Twenty meeting in London, British Prime Minister Gordon Brown and US President Barack Obama seemed to be channeling the spirit of Keynes. This state of affairs is heartening to Keynesian economists, a group that has largely labored in the professional margins since the 1970s. Whether the rediscovery of Keynes will ultimately have a lasting effect on the profession and the policy world is unknown at this point. It is at least possible that Keynesianism may come to be seen (as it was from the vantage point of the 1970s) as the theory to be invoked only during each century’s great economic crisis. Once the current turmoil subsides, it may be that the profession could return to its neoclassical center of gravity (as some have suggested, see Cohen, 2009).

A return to neoclassicism would be most unfortunate since Keynesianism is ever more relevant now as we seek to understand the economic challenges of the 21st century, challenges that neoclassical theory is ill-equipped to address. Moreover, in my view, Keynesianism has always had particular salience for the field of finance and economic development, a salience that the neoclassical theorists who dominate this area have been loath to acknowledge. Indeed, over the past several decades, neoclassical economic theorists and policy entrepreneurs have presented an unambiguous and even simplistic account of the means by which financial flows can be put in service of development. The general contours of this prescription, which entails a rather steadfast commitment to “financial liberalization,” are fairly well known. But this prescription has met with repeated failures across the developing world, and among the post-Communist economies. As a consequence, the prescription has been amended repeatedly in order to account for these failures without sacrificing the economic science that founds the prescription, or its most central features.