Title: A Keynesian Critique of Recent Applications of Risk-Sensitive Control Theory in Macroeconomics

Author: James Juniper

Abstract

Abstract: In Book Five of the General Theory, Keynes argued, in opposition to the Treasury position at the time, that wage and price flexibility would not suffice to overcome the problem of involuntary unemployment. In this section of his text, Keynes linked together his earlier analysis of liquidity preference and the speculative demand for money, with his discussion of factors influencing both the marginal propensity to consume and the marginal efficiency of investment schedule to suggest that price deflation would have an adverse impact on each of these behavioural relations. In this paper I examine the similarities and differences between Keynesian notions of liquidity preference and recent theories of decision-making under uncertainty aversion, which have allowed researchers to identify the presence of uncertainty-premia, and distinguish between risk- and uncertainty-premia in asset markets.

However, I contend that a rigorously Keynesian understanding of liquidity preference can only raises serious doubts about the validity of applying these stochastic control and filtering techniques in a macroeconomic or general equilibrium context. I argue that these doubts have less to do with the usual heterodox concerns about agent heterogeneity or coordination failure and more to do with the impossibility of isolating changes in uncertainty aversion from the state of the economic system that agents are attempting to control. It can be seen that my arguments, despite their formalism, have notable affinities with those of Paul Davidson, who has emphasized the non-ergodic characteristics of real-world macroeconomies.