

DECODING J. M. KEYNES' WORKS: AN ANALYSIS OF THE INTERPRETATIONS OF KEYNESIAN ECONOMICS

MELINDA SIMONFFY

Senior Sophister

The publication of John Maynard Keynes' ground-breaking General Theory in 1936 sparked debate among economists, resulting in varied interpretations of his work. In this essay Melinda Simonffy concentrates on Fundamentalist Keynesianism, Hydraulic Keynesianism and Reconstituted Reductionism, comparing and contrasting these three different approaches. In conclusion she notes that it is the ever dynamic economic climate that results in the development of different perspectives on any economic theory.

Introduction

In the history of monetary thought, opinions about the role of money have often swung like a pendulum from one extreme to another (Hahn, 1947). Ever since John Maynard Keynes' attack on the body of theory that he designated as "Classical" in his famous *The General Theory of Employment, Interest and Money* (1936), academics and policymakers alike have debated the validity and the significance of the revolutionary ideas that were put forward in these writings (Coddington, 1983).

Keynes' suggestions, which he so presumptuously yet accurately believed "will largely revolutionize... the way the world thinks about economic problems" (Keynes as cited in Minsky, 1975:3), created a major shift in economic thought, but also much debate, confusion and controversy (Robinson, 1975). At the heart of this controversy lies a key question: What do Keynes' theories really mean? In order to find an answer to this question, a variety of researchers have attempted to provide appropriate explanations for Keynes' ideas. Three major interpretations of Keynesianism have emerged as a result; Fundamentalist Keynesianism, Hydraulic Keynesianism and Reconstituted Reductionism (Coddington, 1983). The objective of this paper is primarily to shed light on the aforementioned three interpretations with a particular focus on the *General Theory*, showing some of the shortcomings of each school of thought. To conclude, the Keynesian debate

will be re-examined, demonstrating its value to monetary thought.

The Interpretations of Keynes

The *General Theory* is considered disappointing when compared to his other works, renowned for their clarity and elegance in expression (Leijonhufvud, 1968). Thoroughly confusing, leaving "many gaping holes in his theory" (Gerrard, 1991:277), this work of genius (Samuelson, 1946) has been widely criticized as being vague, underdeveloped and "a very clumsy statement" (Minsky, 1975:12). In this context, it is not surprising that a variety of interpretations have sprung up as a response to disentangle this Keynesian "doctrinal fog" in order to discover the true essence of Keynesianism (Gerrard, 1991:276). Prior to this, the 'un-interpreted' theories of Keynes' *General Theory* will be presented.

The "Economics of Keynes"¹

The aim of the *General Theory* is to lay out "what determines at any time the national income of a given system and...the amount of its employment" (Keynes, 1936:247). He concluded that "national income depends on the volume of employment" and that the macroeconomic equilibrium is consistent with involuntary unemployment (Snowdon & Vane, 2005:58). It is said that Keynes did not consider it necessary to repeat his views on banking and money; since these were developed at great length in his *Treatise on Money* (1930), which is deemed a better guide on the latter two subjects (Leijonhufvud, 1968). The main innovation of the *General Theory* is the concept of effective demand, the principle whereby consumption can be stimulated through increasing the money supply, that is, "spending our way out of depression" through fiscal incentives (Garrison, 1996:166). A further uniqueness in his theory is the stress on quantity rather than price adjustments and the balancing role of output as opposed to prices (Snowdon & Vane, 2005).

In the *General Theory* Keynes redefined the fundamental propositions of the Quantity Theory of Money which holds that in equilibrium, money is neutral, where output, relative prices and incomes do not depend on the quantity of money. This position is in stark contrast to his previous works where he still maintained that, the Quantity Theory was valid although somewhat vague particularly in the short-run when disequilibrium

¹ Leijonhufvud (1968: 6)

occurs (Minsky, 1975). Keynes rejected the belief that a decentralized market system is inherently stable (*ibid*) since the intrinsic uncertainty of the future was spurred by investors' "animal spirits" (Keynes, 1936:161), making a centralized decision-making process more desirable than a decentralized one prevalent in market economies (Garrison, 1996).

Keynes expressed support for the "comprehensive socialization of investment" (Keynes, 1936:378) in order to achieve full employment. The interest rate that "rewards no genuine sacrifice" (Garrison, 1996:166) must in Keynes' view be kept low (or even driven to 0%) to hinder the short supply of capital and so create a more equitable economy (Minsky, 1975). Keynes thought that once the problem of scarcity had been tackled, future generations could abandon questions about economics in order to focus on a life full of aesthetic pleasures (Garrison, 1996). However, Keynes' predictions never materialized. Despite his philosophy, speculations about his writings on economics have never ceased. To gain further insight into these Keynesian movements, the three main interpretations outlined by Coddington (1983) will be discussed in greater detail.

Fundamentalist Keynesianism

Fundamentalist Keynesianism refers to a "frontal assault on the whole reductionist program"² (Coddington, 1983:217). The central tenet of the fundamentalist approach places an emphasis on Keynes' *The General Theory of Employment* (1937), which served as a response to criticisms on his *General Theory* and attempted to clarify some elements of the latter (Minsky, 1975).

Fundamentalist Keynesians include Hugh Townsend who was one of the earlier adopters of this position; G.L.S. Shackle who focused his studies on the unpredictability of human preferences; and Joan Robinson who maintained a "Neo-Ricardian" stance, which in Coddington's (1983:218) words reflected a "hybrid of Keynesianism with those aspects of Ricardo's work that were appropriated by Marx: Ricardo minus Say's law and the quantity theory of money."

The *General Theory of Employment* (1937), which serves as the main source of insights for the fundamentalist movement, is primarily an assault on the choice theory; one of the basic principles of the reductionist program. The paper discusses points such as the issue of uncertainty and the

² Reductionism is what Coddington (1983: 216) referred to as market theory where the "central idea is the reduction of market phenomena to (stylized) individual choices". See Coddington (1983) for further details.

intrinsic tendency for people to hoard and accumulate wealth due to "our distrust of our own calculations and conventions concerning the future" (ibid:216). This desire to hoard is ultimately determined by the level of interest. Keynes also elaborated on the notion of effective demand, which in his view includes two concepts; "investment-expenditure" and "consumption expenditure", which depended on the level of income, people's propensity to spend and expectations about the future as well as the interest rate (ibid:219). An increase in aggregate income has a positive effect on consumption expenditure; whereby the "amount that is consumed depends on the amount of income made up" by entrepreneurs that require investment for further generation of income (ibid:220).

The *General Theory of Employment* (1937:221) concludes with the notion that his theory can be summed by "saying that, given the psychology of the public, the level of output and employment as a whole depends on the amount of investment". However, factors which affect aggregate output (such as propensity to hoard, monetary policy, future expectations about the yield of capital assets, propensity to spend and other social issues influencing the money-wage) are "those which determine the rate of investment which are the most unreliable, since it is they which are influenced by our views of the future about which we know so little" (ibid). This supports Keynes' position on why output and employment are liable to fluctuation and why he rejects the orthodox assumption about existing information about the future.

Littleboy (1997:238) outlined some key points that characterize fundamentalist Keynesianism; the rejection of the Walrasian equilibrium; the fact that unstable expectations and flimsy conventions prevail; the pervasiveness of crowd behaviour that can "lose confidence and stampede or just huddle together for security"; the anti-mechanistic standpoint and the dismissal of what Robinson declared as "Bastard Keynesians" (1975:127); the focus on chronic instability; the uncertainty of the future and the belief that macro-instability is partly psychological and partly institutional.

Fundamentalists are also "accused of nihilism" which has been exemplified by both Robinson, who has revealed that "if the idea of equilibrium is pursued relentlessly, then as the concept becomes all-embracing it becomes paralyzed by its own logic: the equilibrium becomes a state of affairs that is, strictly, unapproachable; unless it already exists, there is no way of attaining it" (Coddington, 1983:219). Shackle supported a similar view, concluding that the use of comparative equilibriums to examine consequences of changing events is inadequate. Fundamentalists view the concept of the equilibrium as a distraction, for which the Keynesian model offers a refreshing alternative.

However, fundamentalist beliefs are not without flaws. In the final chapter of the *General Theory* it is outlined how classical theory holds if full employment is attained through the creation of the necessary aggregate volume of output to maintain this, contradicting fundamental Keynesian beliefs. Keynes (1936:378) stated that "there is no objection to be raised against the classical analysis of the manner in which private self-interest will determine what in particular is produced, in what proportions the factors of production will be combined to produce it, and how the value of the final produce will be distributed between them." Robinson (1935:581), however, maintains that "laissez-faire fails to maximise total utility, by failing to provide the ideal selection of commodities" and commented that "Keynes himself began the reconstruction of the orthodox scheme that he had shattered" (Robinson as cited in Coddington, 1983:221).

A further inconsistency in fundamentalist Keynesian thought is exemplified in the *General Theory of Employment* (1937). Here Keynes specifically expresses no objection to Hicks's formation of the IS/LM framework (or the income-expenditure model), clearly refuting fundamentalist principles (Coddington, 1983). In addition, the fundamentalist position does not offer a suitable alternative for the reductionist program; and is characterized by the conviction about the deep ambivalence of the functioning of the economy. Fundamentalist Keynesians, however, do agree on the proposition that "no model of this situation can be fully specified" (Coddington, 1983:222).

Hydraulic Keynesianism

The hydraulic interpretation of Keynesianism originates in Hicks' (1937) famous paper *Mr Keynes and the Classics – A Suggested Interpretation* (Cardim De Carvalho, 1992). Among the hydraulic interpreters of Keynesian economics are Modigliani (1944), who supported the view that the essence of Keynesianism was the "economics of wage and price rigidities", Samuelson (1946) who developed the 45° Keynesian cross diagram, Klein (1947) and Hansen (1953) (Snowdon & Vane, 2005).

Hydraulic Keynesianism holds the idea that the economy at the aggregate level contains "disembodied and homogenous flows" which rely on stable relationships between these (Coddington, 1983:224). Recurring themes of the hydraulic approach evolve around a focus on fiscalism which is characterized by a steep IS curve and a flat LM curve; fixed prices and rigid wages as represented by a flat AS curve; the importance of the liquidity trap and the "discretionary fine-tuning by technocrats"; a view of lethargic

capitalism which lacks "animal spirits" and the support for state intervention in a mixed economy yet avoiding dogmas such as Marxism and fascism (Littleboy, 1997:326).

The backbone of the hydraulic theory is the IS/LM framework (Snowdon & Vane, 2005), which has become "the conventional wisdom in modern macroeconomics" (Cardim De Carvalho, 1992:5). Hicks defined three models in his interpretation; (i) the Classic, (ii) the special Keynesian and, (iii) the Keynesian:

Table 1: Hicks' Keynesian Models

Classic	Special Keynesian	Keynesian
$I = S(I, Y)$	$I = S(Y)$	$I = S(Y)$
$I = I(i)$	$I = I(i)$	$I = I(i)$
$M = k Y$	$M = L I$	$M = L(i, Y)$

where

I	= investment
S	= saving
Y	= income
i	= the interest rate
M	= money.

Models (i) and (ii) construct the IS curve, and the third identifies the LM curve. The two endogenous variables are i and Y . The distinction between the first two models lies in the savings function and in the demand for money (Cardim De Carvalho, 1992). In Hicks' approach, the demand for money is stressed and the importance of the savings function mitigated, thereby juxtaposing the Cambridge Quantity Equation to Keynes' Liquidity preference. However:

...even this difference is not as important as it may seem at first sight, because even though Keynes emphasizes the role of interest rates in the determination of the demand for money (through the speculative motive to demand money), when one considers Keynes' transactions demand for money the model to be used is not model II but model III, which represents, according to Hicks, 'a big step back to Marshallian orthodoxy', making 'his theory... hard to distinguish from the revised and qualified Marshallian theories...' (Hicks as cited in Cardim De Carvalho, 1992:5).

The validity of the IS/LM model as a reflection of the *General Theory* is greatly debated on a number of grounds. Hicks himself cautioned against using his "skeleton apparatus" without the use of a critical eye since his methodology "remains terribly rough and ready sort of affair" (Hicks as cited in Leijonhufvud, 1968:4). Cardim De Carvalho (1992) points out that the IS/LM model fails to attain its objective to satisfactorily compare Classic theory with Keynesianism. Also, Hicks's approach establishes simplistic rationalizations as a matter of econometric convenience which has no theoretical significance, ignoring variables held constant in the equations. Coddington (1983) stated that since the paper was published, 30 years of experience in demand management policies have highlighted the intellectual problem of scope, which led to Hicks' reappraisal of his own theories on Keynesian economics. The reconstituted reductionist school of thought also attempted to address this question of scope, as will be elaborated in the following section.

Reconstituted Reductionism

The reconstituted reductionist school of thought was first developed by Patinkin (1956), who proposed that the essence of Keynesianism is the "economics of unemployment disequilibrium and that involuntary unemployment should be viewed as a problem of dynamic disequilibrium (Snowdon & Vane, 2005:71). Patinkin focused on analysing the existence of involuntary unemployment in perfect competition with flexible prices and wages, which he concluded may occur in this situation. In Patinkin's evaluation, particular attention is paid to the pace with which markets can correct and absorb shocks. This diverted the focal point of his analysis from the degree of wage and price flexibility to the issue of coordination.

The main characteristics of this school of thought have been described as the following: the belief that the mechanism out of equilibrium behaves irrationally when left to its own devices; the proposition that agents must fend for themselves yet the "members of the crowd push each other further away from full employment"; that the auctioneer is fictional; that in disequilibrium false prices, signals and trades occur; the issue of co-ordination breakdown; that "dynamics depend on effective (money-backed or credit-backed) demand not (Walrasian) notional demand"; how exchanges are affected by money; the deviation-amplification due to the multiplier and how long-run recovery is problematic (Littleboy, 1997:334).

Two economists associated with the reconstituted reductionism proposition, R.W. Clower and A. Leijonhufvud, followed a similar approach

to Patinkin, creating a "modified general equilibrium" model along Walrasian lines as a response to overcome the aforementioned coordination problem (Snowdon & Vane, 2005). However, Clower and Leijonhufvud differed in their interpretation of Keynes' work, which materialized in a 'family quarrel' about 'the expandability of the concept of equilibrium' (Coddington, 1983:226). Clower on one hand came up with the so-called 'dual decision hypothesis' which relies on the principle that current income affects consumer spending. He believed that Keynes had the concept of dual-decision hypothesis and the household behaviour theory "at the back of his mind when he wrote the *General Theory*" otherwise "most of the General Theory is theoretical nonsense" (Clower as cited in Coddington, 1983:226). The assumption that Clower presented here was that Keynes had a variety of ideas that he did not include in the writing of the *General Theory*, raising speculation regarding what these omitted ideas were. However, Coddington points out that this "is a problem of reading not so much between the lines as off the edge of the page"; indicating that Clower's assumptions may have been at times ambiguous in their nature (ibid).

Leijonhufvud, in his famous *On Keynesian Economics and the Economics of Keynes* (1968) tried to prove that Keynes' theory is quite distinct from the Keynesian income-expenditure theory and tried to provide a fresh perspective from which the income-expenditure theory may be reconsidered. He attempted this by undertaking a thorough analysis of Keynes' ideas such as the role of money, the role of the interest rate, the relationship between the *Treatise* and the *General Theory*; relative prices; the importance of money and by looking at the Keynesian revolution. Leijonhufvud's exposition has been praised for its great detail in presenting logical requirements of the Keynesian system; patiently disentangling the misunderstanding in the neo-classical scheme and shedding light on some controversies such as the Pigou effect (Robinson, 1969).

Leijonhufvud built upon Clower's theme providing a neo-Walrasian interpretation that stresses the importance of processes and implications of disequilibrium trading and coordination failure (Snowdon & Vane, 2005). He outlines how the concept of 'involuntary unemployment' arises from this disequilibrium and offers an explanation on how a competitive market economy behaves in the short-run to aggregate demand shocks when "wage and price adjustments are less than perfectly flexible", criticising the neoclassical synthesis (Snowdon & Vane, 2005:73).

However, Leijonhufvud's work is not immune to criticism. Coddington (1983:228) commented that in Leijonhufvud's attempts to hunt for authenticity in the *General Theory* he falls back into "the realms of mind-reading", and "fails to distinguish between the past and the future, and treats rentiers, workers and entrepreneurs all alike as 'transactors' and 'asset

holders" in his juxtaposition with the neo-classical model that eliminates money prices (Robinson, 1969:582). Furthermore, Leijonhufvud's theories have been criticized as "unfaithful to Keynes' writings" that "misrepresents Keynes on a number of issues" such as on the questions of "the theory of unemployment, the causes and consequences of wage rigidity, the liquidity trap, and the behaviour of commodity prices" (Jackman, 1983:31-43).

In their search for innovative approaches, both Clower and Leijonhufvud tried to set themselves the task of "constructing a framework that would provide room or scope for Keynesian ideas" (Coddington, 1983:228), which led them to the conclusion that in order to accommodate these ideas, the process of disequilibrium trading must be embraced and the concept of equilibrium theorizing deserted. In Clower and Leijonhufvud's reconstituted reductionism, it is evident that they were attempting to explain the problem of attaining equilibrium rather than the state of it, yet it does not provide any practical solutions such as the hydraulic Keynesians did (Coddington, 1983). Accordingly, Leijonhufvud's book is "not so much about the economics of Keynes as about the scope of the economics of Keynes" leaving many questions unanswered (ibid:231).

Conclusion

In this discussion, some interpretations of Keynes' *General Theory* have been considered. The fundamentalist approach advocates the rejection of the choice theory; the 'old-fashioned' hydraulic view shuns formal choice theory foundations while the reductionist Keynesians try to "make room for Keynesian ideas... by refocusing the market theory on disequilibrium states whilst retaining the standard choice-theoretic foundations" (Coddington, 1983:231).

In the field of economics, particularly macroeconomics, it is only natural that with changes in experience and within the economic climate, debates surrounding economic theories alter dynamically with time and will continue to do so in future. The era in which the *General Theory* was written was a completely different world from the current one; creating a further divide between what Keynes tried to express and the point of view and methodologies that economists living in the 21st century apply when reading those 'Classic' works. This leads to the development of a continual stream of new perspectives. Multiple interpretations of the "Economics of Keynes" provide a great platform for discussion, foster progress and diversify macroeconomic thinking, much to the benefit of the field; for there is

nothing more stimulating to the mind than insights gained from intellectually challenging debates.

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