SECTION 2
MONETARY & FISCAL ECONOMICS

Chapter 4 A Review of J.M. Keynes

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"I believe myself to be writing a book on economic theory which will largely revolutionize...the way the world thinks about economic problems". (1)

J.M. Keynes

Keynes is the towering figure who has shaped and given direction to economics in the twentieth century. The upheavals of the early years of this century posed a serious threat to the survival of liberal capitalism. Keynes averted this threat by his relentless questioning of conventional patterns of thought and his replacement of them with new ones pertinent to the overriding issues of his time.

This dominance of Keynes arises for reasons other than the revolutionary impact of his General Theory. Keynes was a man of letters, an establishment figure; he played a major role in policy-making during and between the two World Wars; he gained fame for his prognostications concerning the Versailles settlement, his opposition to the return of the gold standard, his proposals for the financing of the Second World War, his part in the Bretton Woods agreement, his advocacy of a European free-trade area, his pioneering advocacy of national income accounting and econometric models; but most importantly his stature derives from his far-sighted genius. In the midst of the Great Depression Keynes foresaw the affluent society in which we now live.

Despite this dominance there is no consensus as to what view of the economy Keynes really espoused. The followers of Keynes may be classified as orthodox Keynesians, extreme Keynesians, fundamentalist Keynesians, or neo-Keynesians (to name but a few of the distinctions). These difficulties of interpretation arise because of inconsistencies between the General Theory and other of Keynes's works and because of lack of clarity within the General Theory itself. Such confusions were natural given Keynes's "long struggle to escape" from the conventions of his time but they have led to selective readings of Keynes by scholars eager to claim Keynesian approval for their own variety of economics. In this essay I shall treat of "The General Theory", then discuss the three dominant interpretations of it, and lastly I shall discuss the emergence of neo-Keynesian economics in response to the challenge of neo-classical economics.

In considering the General Theory we must outline the views of the 'classical economist' whom Keynes set up as a figure to inveigh (despite the fact that no single classical orthodoxy existed and despite the foundations of so-called Keynesian concepts in Pigou's work, e.g. the concept of national income, expectations, and the multiplier). Classical analysis was concerned with the efficient allocation of resources, a matter treated under the headings of price theory, value and distribution, and partial and general equilibrium. It was paralleled by the philosophies of individualism and utilitarianism. Coddington describes it as "reductionism", i.e. where the market reduces to individual choices. These choices are subject to the constraints of rationality and the condition of feasibility in the aggregate, i.e. market equilibrium occurs because the Walrasian auctioneer

brings about a vector of market-clearing prices by a process of tatonnement (or "groping").

Three markets were identified, those for labour, goods and money. Labour supply was a positive function of real wages, while labour demand (assuming that capital, technology, perfect competition and the aim of profit maximization are given) was a negative function of real wages. At equilibrium real wages equalled the marginal product of labour. Because prices adjusted immediately to shocks the economy was thought to be at full-employment equilibrium most of the time. Even if it were not, involuntary unemployment was not believed to exist.

The labour market alone was held to determine values of real variables - employment, output and real wages. Since, according to Mill, there was "nothing more insignificant than money", money was neutral in the classical theory. Under the assumptions that customs of payment were unchanging, demand for money was considered to be a function of money income. Supply of money was considered to be fixed by the authorities. Since money supply had to equal money demand, money alone determined the price level.

Finally, since expenditure and income were equal, savings and investment were brought into equilibrium by changes in the rate of interest.

Thus economic theory had a formal validity, i.e. it could claim logical consistency. However the microeconomic concepts upon which it was based were subjective and therefore untestable. Furthermore they seemed as much based upon social philosophies such as the virtues of thrift and fiscal propriety, the view of man as a utility maximizing pleasure machine, the value of individualism, the unquestioning acceptance that the pursuit of individual good leads to the general good and its corollary ,the acceptance of inequalities of wealth as a "good thing" since the rich were held to save more, as upon any mathematical truth.

During the Great Depression conventional economics counselled further deflation, wage cuts and budgetary restraint. These remedies aggravated the malaise instead of relieving it because they had misdiagnosed the illness. The problem was not that real wages were too high but that aggregate demand (A.D.) was deficient and that the market lacked liquidity. The classical theory did not mention aggregate demand and its theory of interest rate determination (the loanable funds theory) did not consider the desirability of cash balances. With sinister appeals to communism and fascism gaining strength during the disillusionment of the inter-war years, the diagnosis according to Keynes of the principal economic ills of the time and his suggestion of a cure fell upon welcoming ears.

The substance of General Theory has been distilled into a few sentences by Spiegel:

"The national income equals expenditure for consumption and investment. A national income at less than full employment indicates that expenditures are deficient. Among expenditures for consumption and investment, those for consumption are more passive and tend to change in response to changes in income. Changes in income are generated by, and reflect in a magnified form, changes in investment. Investment expenditure is determined by the relationship between anticipated rates of return from investment and the rate of interest. The rate of interest reflects the public's preference for holding assets in the liquid form of cash. Expenditure that is deficient - inadequate to generate full employment - may be augmented by the stimulation of consumption and investment. Private investment may be supplemented by public investment, that is by the compensating spending of public authorities, with a resulting 'compensatory economy' and

the partial socialization of investment". (2).

The first Keynesian concept in this analysis is that of average and marginal propensities to consume, APC and MPC respectively. The observation of constant MPC and declining APC was derived from 'psychological law' and seemed to be verified in cross-sectional studies. This subject has been adequately treated in another article in this review.

The second concept is that of the multiplier. Given that Y=C+I, then dY=dI/(1-MPC), i.e. changes in income are a multiple of changes in investment. This simple equation has powerful implications. Firstly, it gave a theoretical underpinning to the role of government in economic stabilisation. Secondly, when extended to the open economy it provided a mode of analysing international trade. Thirdly, it showed the importance of investment and liquidity rather than thrift and deflation in times of recession. Lastly, it reversed the classical arguments in favour of inequalities of income on the grounds of the low marginal propensity to consume of the rich.

He postulated, contrary to his beliefs in the "Treatise on Money", that savings equals investment.

He introduced the marginal efficiency of capital as an explanation of the inducements to invest. Thus, while he accommodated the main body of micro-theory with the use of the maximization principle, he also underlined the volatile character of expectations which influence investment decisions.

In contrast to the classical loanable funds theory Keynes identified changes in the rate of interest as a response to changes in liquidity preference. He ascribed three motives to the demand for money: the transactions, precautionary and speculative motives.

Apart from the body of the "General Theory" Keynes also added some philosophical notes. In these he advocated a role for government in *management* of the economy but he specifically rejected the notion of state socialism. Rather the government should try to keep the economy at a stable level of full employment. By keeping the rate of interest low investment would be encouraged and liquidity of the market guaranteed. This would also bring about "the euthanasia of the rentier", i.e. it would no longer be possible to derive an income from the ownership of capital. He saw this management as an essential safeguard for individualism and liberal capitalism.

Moreover, once full employment was reached "the classical theory comes into its own again from this point onwards". (3). This unambiguous statement is remarkable in its acceptance of the possibility of equilibrium and its acknowledgement of the virtues of the classical system (efficiency and personal liberty). It would seem to remove the emphasis on disequilibrium trading which so many followers have emphasized. I shall now discuss the three interpretations of Keynes.

The first is termed "fundamentalist Keynesianism" by Coddington. This view regards Keynes's work as a frontal assault upon the reductionist programme. Joan Robinson, one of its foremost exponents, explicitly rejected Keynes's "equilibrium" statement; the fundamentalists saw Keynes's 1937 Quarterly Journal of Economics article as representative of what was central in his works; the volatility of expectations and therefore the inherent instability of the market system. Hugh Townsend argued that since prices are set in money they cannot be separated from the expectational elements which characterize Keynes's rate of interest.

Shackle, in parallel with Keynes's work on probability in which he rejected frequency theory, developed an ingenious theory of decision-making under uncertainty. Each managerial decision is a unique event, he posited, and this calls the choice-theoretic basis of reductionism into question. Without a stable basis in choice logic the concept of market equilibrium collapses.

Business cycle theory evolved from Keynes's observations of vague, uncertain and shifting expectations. Joan Robinson argued that equilibrium was unapproachable and therefore unattainable if not in existence. In short, the fundamentalists saw Keynes's General Theory merely as a first step in the wholesale revision of economic theory. Their nihilism, however valid in itself, is, however, in contrast with Keynes's eclecticism.

"Hydraulic Keynesianism"evolved as other writers attempted to clarify the central tenets of the General Theory for the lay reader. This interpretation views the economy at an aggregate level in terms of disembodied and homogeneous flaws, such as income, expenditure and output. The central characteristic of hydraulic Keynesianism is the belief in the stable relationship between these flows at an aggregate level. Thus it is inconsistent with reductionism, which places its emphasis on prices. hydraulic Keynesianism analyses a situation in which prices are failing both as disseminators of information about relative scarcities and in the provision of incentives to act upon information. It embodies the view that employment is more a matter of demand for output than of real wages. There is only one agency making deliberate acts of choice, the government. The most widely accepted orthodox interpretation was Sir John Hicks's income-expenditure model. It followed Keynes in its assumption of wage and price rigidities and in showing, in a more elegant way than Keynes' diagrams of his four interdependent markets, the simultaneous determination of interest rates and incomes. Specific Keynesian assumptions regarding the slope and position of IS and LM curves and the assertion that the liquidity trap and low interest elasticity of investment placed the efficacy of monetary policy in doubt led to the championing of 'fiscalism'.

IS/LM became widely accepted, firstly because of its ingenious simplicity as an expository device and its ease of adaptation to an open economy setting, and secondly because it bristled with policy prescription at a time when policy prescription was greatly needed. During the 1940's, 1950's and 1960's, Keynesianism was incorporated into every manifesto as the idea of how a largely decentralized economy may be subject to broad central control through the instrument of the budget became popularized. Again social considerations were never far away. This theoretical justification for government intervention was seized upon by those rebuilding their infrastructure after the ravages of war and by those who saw a role for government in the pursuit of goals other than full employment, such as urban renewal, cleaner air and water, and the alleviation of poverty. Lastly, policies based upon hydraulic Keynesianism have had different effects, leading one to question its scope.

These policy conclusions were seen by many as a vulgarization of Keynes. Firstly, conclusions about the efficacy of monetary or fiscal policy depend upon initial assumptions regarding the IS and LM curves and are not inherent in the model. More importantly, the IS/LM framework itself has been criticised. It is mechanistic - it assumes that fiscal and monetary policies are independent and thus ignores feedback effects. Prices do not enter the analysis. It is inherently an equilibrium approach and overemphasizes Keynesian theory in terms of comparative statics while not treating disequilibrium dynamics. It is of note that in a

revision of Keynesian economics Hicks dropped IS/LM. He has expressed unease about how widely it has become used in recent years.

In the 1950's the 'neo-classical synthesis' emerged. Its central tenet was that a Keynesian recession is a special case of the classical system. One of its foremost exponents was Patinkin who developed Pigou's idea of a real balance effect. As such he was both trying to introduce an equilibrating role performed by relative price changes into the Keynesian model and also to supplement the Walrasian system in which prices are indeterminate at equilibrium with the real-balance effect.

Clower and Leijonhufvud emerged in the 1960's decrying orthodox Keynesianism and reaffirming that there was to be no synthesis between Keynesian economics and its alternatives. Both economists offered differing analyses, both of which bear a resemblance to Keynes's economics but which also contain their own ideas. Coddington termed their work "reconstituted reductionism". They advocated the abandonment of the concept of equilibrium and its replacement by disequilibrium prices and its underlying choice logic. Thus they emphasized the interdependence of markets in the Keynesian model in contrast with the independence postulated by classicists.

Clower's contribution was his dual decision-hypothesis which explained how consumer spending depends upon current income. (A full discussion of how he treats the micro behaviour while at a macro disequilibrium may be found in the Student Economic Review, Volume 1, J. Fingleton).

Leijonhufvud set himself the task of finding "a fresh perspective" from which to consider income-expenditure theory. He and Clower both reject the Marshallian partial equilibrium analysis, the alleged independence of markets, and the impossibility of false trading. Rather they posit quantity rather than price adjustments, an absence of liquidity, false trading, the interdependence of markets and associated spillover effects derived from a neo-Walrasian view of General Theory and the "Treatise on Money" combined. Barro and Grossman later coined a phrase for the knock-on effects the multiplier would induce following a fall in aggregate demand - "deviation-amplifying feedbacks", which aggravate rather than stabilize an initial disequilibrium.

While Clower and Leijonhufvud hold claims regarding their particular insights into what Keynes really said, their disequilibrium analysis may well have a role to play in analysing real effects of policy measures (such as those proposed by hydraulic Keynesianism) where prices, being slow to adjust, provide incentives, but the wrong ones.

Keynesian economics became discredited in the 1960's and early 1970's as demand management policies were misapplied in situations of full employment leading to inflation and budget deficits. Friedman and Phelps became recognized in the 1970's as supply shocks and inflation plunged the world into a recession which they had predicted. Friedman's restatement of the quantity theory of money spawned monetarism. Neo-classical economics emerged to focus attention upon the micro foundations of macro theory, or supply-side economics. That school of thought is now in the ascendence, but there are still neo-Keynesians who remain unpersuaded. Barro and Grossman, for example, emphasize how slow the economy is to respond to changes and hence claim that the economy, once disturbed from equilibrium, will be slow to revert to it. Although they believe in the concept of equilibrium, they question "obsolete Keynesianism" for its use of the Keynesian consumption function along with the neo-classical labour demand

function, which they believe to be mutually incompatible. They argue that in a Keynesian recession, we are off the neo-classical labour demand function and hence use of AS/AD is invalid. Moreover, they posit that IS/LM is an equilibrium analysis in which spillover effects implicitly run in one direction only, i.e. from the labour to goods market. They argue that, because of interdependence, spillover effects run both ways. Bruno and Sachs, in an analysis of the O.E.C.D. economies, classify recessions and booms into their classical and Keynesian components. They recognize that in practice the difference is not so stark as in theory. The neo-Keynesians and neo-classicals both have assimilated parts of standard classical and Keynesian theory into their models, illustrating the lasting contributions of both schools.

Keynes's economics has its limitations. It is of relevance in conditions of less than full employment; the use of the multiplier at full employment leads to monetary, not real, changes. His treatment of economic aggregates ignored environmental issues which have assumed importance now. Because of his view that "in the long-run we are all dead" his variables did not have a time dimension and his assumption of price and wage rigidities were not always valid. Most importantly, by concentrating on the relationship between employment and output he ignored productivity and a host of other institutional factors on the supply side.

However, Keynes did revolutionize the way people think about economic problems. His theory of consumption has been refined by Friedman and Modigliani. Although he did not discuss distribution, Kaldor's theory started from Keynes's analysis. The multiplier concept has applications in the field of international economics and induced the acceleration principle and the steady growth theories of Harrod and Domar. The importance he assigned to aggregates and his writing on econometrics (which underwent a revolution of its own in the inter-war years) stimulated both national income accounting and dynamic econometric models. Unlike the subjective notions of classical economics, Keynes's postulates were subject to empirical testing - he reinvigorated the debate concerning the neutrality of money by his assertion that variation in cash balances are associated with changes in the rate of interest.

While responding to the burning issues of his time, Keynes yet provided a commanding structure which was abstract and general. It is more likely that it is its richness in its provision of ample food for thought rather than its inconsistencies which leads to a reinterpretation of Keynes every twenty years. The greatest testimony to his lasting stature was, perhaps, the acknowledgement by Friedman that, "we are all Keynesians now". (4).

Footnotes

1. Moggridge, "Collected Writings of J.M. Keynes", Royal Economic Society, 1973, vol XIII, p.492.
2. Spiegel, "The Growth of Economic Thought", p.608.
3. J.M. Keynes, "The General Theory of Employment, Interest and Money", p.378.
4. Milton Friedman, quoted in P.A. Samuelson's "Economics", 8th edition.