THE ECONOMICS OF JOHN MAYNARD KEYNES

The Theory of a Monetary Economy

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To

LOUISA

My wife and colleague

Preface

THIS BOOK is an exposition of the economics of John Maynard Keynes. By any test, Keynes ranks as one of the great economists of all time and as the most influential economic thinker the twentieth century has so far produced. His book, *The General Theory of Employment, Interest and Money*, published in 1936, has already become one of the classics of economic thought. Unfortunately for the undergraduate and for the general reader, the *General Theory* is addressed to professional economists and is not very intelligible to others. However, the fundamental ideas underlying Keynes' work are relatively simple and can be understood by anyone who is acquainted with broad problems of economic policy such as unemployment and inflation.

The present discussion of the economics of Keynes focuses on the forces which determine the volume of effective demand, an insufficiency of which leads to unemployment, and an excess of which causes inflation. The plan has been to follow the outline of the *General Theory* and to bring in at appropriate points the other aspects of Keynes' work which contribute to his fundamental position. Restatements and modifications made by Keynes in articles after 1936 have been incorporated into his general theory, with the last statement being taken as definitive. The chapter on war and postwar inflation is based mainly on Keynes' *How to Pay for the War* (1940). In the concluding chapter, an interpretation is given of the meaning and significance of Keynes' entire contribution to economic theory and policy.

The subject matter of this book is the economics of Keynes rather than Keynesian economics. The distinction is important. In recent years the scientific, as well as the not-so-scientific, literature in economics has been filled with books and articles refining, enlarging, criticizing, and "refuting" what is now commonly referred to as "The New Economics." The positive contributions of others in this vast literature are important, but in a book of this size and type it is not possible to encompass the field of discussion and controversy. The basic idea behind this book is the need for a simple and thorough exposition of the ideas of the one man who stands out above all others as the chief architect of "The New Economics." The extent to which Keynes dominates recent developments in economics is indicated by the fact that "The Keynesian Revolution" is a synonym for "The New Economics." Occasionally in the text and in footnotes, some of the more important extensions and refinements of Keynes' work have been introduced, but there is no systematic attempt to survey the supplementary literature or to interpret the numerous debates which have centered around Keynes. For the benefit of readers who wish to pursue these issues further, a list of suggested readings is included for each chapter, as well as a bibliography of Keynes' own writings at the end of the book.

Perhaps the chief task which confronts a writer who attempts to simplify and clarify economic theory is to discover a method which will give concrete meaning to the abstract concepts which constitute the theory. Arithmetical examples, diagrams, and summaries are all useful, but they are not enough. From a pedagogical as well as from other points of view, I am thoroughly convinced that Keynes' theories are most easily understood when they are related to the policies with which they were associated in his thinking, especially since Keynes' ideas were always oriented toward positive policy. Keynes did not forge new tools of analysis just for the love of tool-making. His ideas are operationally significant and have been translated into action by statesmen. The meaning of his abstract theory is to be discovered on the solid ground of economic policy, that is, in terms of its consequences when put into practice. Hence, if there is anything distinctive about this presentation, it is the self-conscious manner in which I have attempted to explain the somewhat complicated and, in many respects, intrinsically difficult body of theory by linking it to the policies which Keynes advocated.

Although the Keynesian tools of analysis are now being incorporated into the new principles of economics, this does not involve an acceptance of Keynes' practical policy or social philosophy. The concepts developed by Keynes are not limited to the uses to which he put them. They have proven useful tools for others with different ideas about policy. Nevertheless, it should be recognized that in the larger sense, the tools of analysis which economists use are never divorced entirely from their preferences with respect to policy. People with widely differing social philosophies make use of quite different tools. Those who believe firmly in the laissez-faire premise that the economic system of private property is self-adjusting at full employment without inflation have no positive use for most of the tools of analysis forged by Keynes. Therefore, it seems safe to conclude that the widespread acceptance of Keynes' theory is an indication of a declining faith among economists and others in the automatic, self-adjusting nature of our economic system.

Despite the widespread acceptance of his ideas, Keynes was and remains a controversial figure. In so far as matters of controversy touch the present volume, it is what would probably be called "sympathetic" to Keynes. In my judgment, a good exposition of any economist's work should be sympathetic in order to be understanding and illuminating. However, I am not unaware of Keynes' shortcomings as an expounder of the ideas of people of whom he was critical and of his impatience for detail. Keynes was an original thinker in the sense that he arrived at his ideas in his own way. The ideas he advanced were his own even though someone else may have expounded the same or similar ideas at an earlier date. For this as well as for other reasons, no attempt is made to trace the antecedents of Keynes' ideas either as they relate to heterodox predecessors on the principle of effective demand or to the more contemporary Anglo-Saxon and Swedish writers on monetary theory. Much more important than the influence of other people was the influence of historical circumstances in leading Keynes to his new theory. To explain this is one of the main purposes of the final chapter. In connection with Keynes' criticisms of what he called "classical" economics, especially the work of Professor Pigou, it should be observed that Keynes was prone to state his case strongly in order to lend clarity and persuasiveness to his position.

My concentrated attention was first directed to Keynes by the late Professor Leo Rogin of the University of California, who from the beginning recognized the revolutionary significance of the *General Theory*. Professor Rogin's untimely death is an irreparable loss to the economics profession, which has been deprived of one of its great minds.

The present volume was written at the suggestion of Dr. E. A. J. Johnson of New York University and editor of the Prentice-Hall Economics Series.

I wish to express my sincere gratitude to all who have assisted in the preparation of this book. Dr. Allan G. Gruchy of the University of Maryland, Dr. H. Gordon Hayes of Ohio State University, Dr. Everett E. Hagen formerly of the Bureau of the Budget and now of the University of Illinois, and Dr. Paul A. Samuelson of the Massachusetts Institute of Technology have read the manuscript and made valuable suggestions for its improvement. Special acknowledgment is made to Dr. Gruchy for his keen criticisms and stimulating counsel throughout the entire period of preparation of this book. His generous assistance and valuable suggestions are deeply appreciated. I am grateful to Willard O. Ash of the University of Maryland for helpful suggestions regarding Chapter 5. Most of all, I am indebted to my wife, Louisa Gardner Dillard, for invaluable assistance at every stage in every detail in organizing, writing, typing, checking footnotes, preparing bibliography, and reading proof. As a small token of my

appreciation for all she has done, this book is dedicated to her.

Harcourt, Brace and Company, the American publishers of Keynes' works, have kindly granted permission for use of quotations, especially from *The General Theory of Employment, Interest and Money*. The page numbers inserted parenthetically in the text refer to the *General Theory* unless otherwise indicated by the context. Appreciation is expressed to *The Journal of Economic History* for the use of part of my article, "The Pragmatic Bases of Keynes' Political Economy."

Dudley Dillard

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CHAPTER 1

Introduction and Fundamental Ideas

> I am more attached to the comparatively simple fundamental ideas which underlie my theory than to the particular forms in which I have embodied them . . . .
>
> J. M. Keynes, *The Quarterly Journal of Economics*, February, 1937, page 211.

WITHIN the first dozen years following its publication, John Maynard Keynes' *The General Theory of Employment, Interest and Money* (1936) has had more influence upon the thinking of professional economists and public policy makers than any other book in the whole history of economic thought in a comparable number of years. Like Adam Smith's *Wealth of Nations* in the eighteenth century and Karl Marx's *Capital* in the nineteenth century, Keynes' *General Theory* has been the center of controversy among both professional and nonprofessional writers. Smith's book is a ringing challenge to mercantilism, Marx's book is a searching criticism of capitalism, and Keynes' book is a repudiation of the foundations of laissez-faire. Many economists who were at first highly critical of Keynes have deserted their old position for the Keynesian camp. In book after book, leading economists acknowledge a heavy debt to the stimulating thought of Lord Keynes.

If the influence of Lord Keynes were limited to the field of technical economic doctrine, it would be of little interest to the world at large. However, practical economic policy bears even more deeply than economic theory the imprint of Keynes' thought. A few examples of the wide and growing acceptance of Keynes' philosophy of governmental intervention, public investment, and other forms of economic policy designed to fill the gaps in the private enterprise economy are: the economic policies of the New Deal, the special economic message of President Truman to Congress at the close of the second world war, the English, Canadian, and Australian "White Papers" on unemployment policy, the Murray Full Employment Bill of 1945 and the Employment Act of 1946 in the United States, the provision in the new French Constitution which requires an annual employment budget, the newer thinking in the field of fiscal policy, the International Monetary Fund, and the International Bank for Reconstruction and Development. It appears that the trend in economic policy in those countries where private enterprise is still vigorous will be in the direction which Lord Keynes charted. Many of his ideas and most of his theoretical apparatus can be useful in socialist economies even though his fundamental social philosophy is anti-Marxian.

During his lifetime Keynes wrote numerous books, many of which are outstanding contributions to special fields of economics. Clearly, however, *The General Theory of Employment, Interest and Money* contains the essence of his contribution to general economic theory. This work, published when he was fifty-two years of age (he lived to be sixty-two), is a product of his mature thought. It seems appropriate that a book on the economics of Keynes should begin with a discussion of the fundamentals of his thinking as outlined in the *General Theory*. The fundamental ideas are to be distinguished from the form in which these ideas are expressed. In the first restatement of his position after publication of the *General Theory*, Keynes wrote: "I am more attached to the comparatively simple fundamental ideas which underlie my theory than to the particular forms in which I have embodied them . . ."[1] The theory stands or falls on these basic ideas. The forms in which the ideas are presented, on the other hand, allow for compromise. It is mainly these forms which have been the subject of debate subsequent to the publication of the *General Theory*. Once the fundamental ideas are clear, the rest falls easily into place. A full statement of the underlying ideas involves, of course, an explanation of the framework upon which they are built, but for the purpose of a general introduction the framework can be temporarily neglected. These fundamental ideas center around the following: (1) the *general* nature of Keynes' theory, (2) the role of money, (3) the relation of interest to money, (4) investment, and (5) uncertainty about the future.

(1) *A General Theory:* In the title of his book *The General Theory of Employment, Interest and Money*,[2] Keynes' emphasis is on the word *general*. His theory deals with *all* levels of employment in contrast with what he calls "classical" economics, which is concerned with the special case of full employment. The purpose of Keynes' general theory is to explain what determines the volume of employment at any given time, whether it happens to be full employment, widespread unemployment, or some intermediate level. For reasons to be explained in the following chapter, the classical school assumes there is a tendency for the economic system based on private property in the means of production to be self-adjusting at full employment. Keynes challenges this assumption and calls the classical theory which is based on it a *special* theory, applicable only to one of the limiting cases of his *general* theory. Keynes attempts to show that the normal situation under laissez-faire capitalism in its present stage of development is a fluctuating state of economic activity which may range all the way from full employment to widespread unemployment, with the characteristic level far

1. "The General Theory of Employment," *The Quarterly Journal of Economics*, February, 1937, Vol. LI, No. 2, page 211.

2. Keynes, J. M., *The General Theory of Employment, Interest and Money*. New York: Harcourt, Brace and Co., Inc., 1936.

short of full employment. Although unemployment is characteristic, it is by no means inevitable. Another "general" aspect of the general theory is that it explains inflation as readily as it does unemployment since both are primarily a matter of the volume of effective demand. When demand is deficient, unemployment results, and when demand is excessive, inflation results. If Keynes' more general theory is correct, then the special theory is at fault not only in being the theory of a limiting case, but also in being largely irrelevant to the actual world in which unemployment is obviously one of the gravest problems. Most of the significant differences between the classical theory and Keynes' theory stem from the difference between the assumption that full employment is normal and the assumption that less than full employment is normal. The one is a theory of a stationary equilibrium and the other a theory of a shifting equilibrium.

There is another equally important meaning associated with the term "general" as it appears in the title of Keynes' book. His theory relates to changes in employment and output in the *economic system as a whole* in contrast with traditional theory which relates primarily, but not entirely, to the economics of the individual business firm and the individual industry. The basic concepts of Keynes' over-all theory are the aggregates of employment, national income, national output, aggregate supply, aggregate demand, total social consumption, total social investment, and total social savings. The relationships between individual commodities expressed in terms of individual prices and values, which constitute the chief subject matter of traditional economics, are important in Keynes' general theory, but they are subsidiary to the aggregate or over-all concepts of employment, income, et cetera. A little reflection will reveal that conclusions which are valid for the individual unit may not be valid when applied to the economic system as a whole. For example, some people may get rich by stealing from others, but obviously a whole community cannot enrich itself merely by its members plundering each other.