

# A Guide to Keynes

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## A GUIDE TO KEYNES

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*Readers are asked to note that the page references to Lord Keynes's  
THE GENERAL THEORY OF EMPLOYMENT,  
INTEREST, AND MONEY quoted in this book, refer also  
to the edition published by Macmillan and Company Limited of London.*

## Preface

This book is intended primarily for students majoring in economics and for first-year graduate students. Its aim is to assist, and induce, the student to read the *General Theory*.<sup>1</sup> Too often nowadays the student reads a good deal of the literature *about* Keynes but little in the *General Theory* itself.

It is my experience that very many students find the *General Theory* a difficult book. It is the purpose of this volume to serve, so to speak, as a tutorial guide. The student is advised to read and reread the relevant sections in the *General Theory* in conjunction with the present volume.

There is available, by now, a number of books which offer the student a "short cut" to Keynes. The present volume does not belong to this category. It is not a substitute for Keynes. The short cuts are not likely to help the student to read the difficult parts in the *General Theory*. By attempting to "make Keynes easy" they are indeed likely to leave the student, quite unintentionally no doubt, with wrong ideas about what Keynes really said.

I have tried in this volume to face the difficult parts in the *General Theory* head on. And especially I have tried to underscore precisely what Keynes said on controversial issues. In considerable measure (but not always) the controversy vanishes once it becomes clear what Keynes *did* say.

No one can reread Keynes without being impressed with the fact that he succeeded, to an astonishing degree, in

<sup>1</sup> Throughout this volume the commonly used shorter title, *The General Theory*, is used instead of the full title of Keynes's great work, *The General Theory of Employment, Interest and Money*, Harcourt, Brace and Company, Inc., 1936.

anticipating his critics. But he was not always right, and where this is the case I have endeavored to point it out. On the other hand, I have set phrases, which taken by themselves alone are likely to be misinterpreted, against the larger background of the book as a whole. A debater may look for points but scholarship demands that we take a look at the whole.

No doubt practiced readers will find, here and there, that I am quite wrong in what I say. It would be foolish to claim the final word on so difficult a subject, and I have no illusions on that score. But throughout this volume I have constantly tried to cite chapter and verse so that the reader who may question my interpretation of any particular point can readily refer back to Keynes himself.

I wish to express my appreciation for the facilities for research made available by the Graduate School of Public Administration of Harvard University and for stimulating discussions with graduate students and colleagues in the Department of Economics. I am indebted to Dr. Richard Goodwin for helpful suggestions; to Professor Paul Samuelson and Professor Abba Lerner for comments on the chapter on interest-rate theory. None of them is to be held responsible, however, for what I have written. I am also grateful to Mrs. Berwyn Fagner and Mrs. Robert Lindsay for assistance in preparing the manuscript for the printer and to Mrs. Lindsay for making the index.\*

I wish to express appreciation for permission to quote generously, which permissions have been granted by the authors and publishers and are duly noted in the footnote references. My thanks are especially due, in view of the exceptionally large number of quotations from *The General Theory*, to the Keynes trustees and Harcourt, Brace and Company, Inc.

*Alvin H. Hansen*

CAMBRIDGE, MASS.

FEBRUARY, 1953

## *Editor's Introduction*

For years many teachers of economics and other professional economists have felt the need of a series of books on economic subjects which is not filled by the usual textbook or by the highly technical treatise.

This present series, published under the general title, the Economics Handbook Series, was planned with these needs in mind. Designed first of all for students, the volumes are useful in the ever-growing field of adult education and also are of interest to the informed general reader.

The volumes are not long—they give the essentials of the subject matter within the limits of a few hundred pages; they present a distillate of accepted theory and practice, without the detailed approach of the technical treatise. Each volume is a unit, standing on its own.

The authors are scholars, each writing on an economic subject on which he is an authority. In this series the author's first task was not to make important contributions to knowledge—although many of them do—but so to present his subject matter that his work as a scholar will carry its maximum influence outside as well as inside the classroom. The time has come to redress the balance between the energies spent on the creation of new ideas and on their dissemination. Economic ideas are unproductive if they do not spread beyond the world of scholars. Popularizers without technical competence, unqualified textbook writers, and sometimes even charlatans, control too large a part of the market for economic ideas.

In the classroom the Economics Handbook Series will serve, it is hoped, as brief surveys in one-semester courses, as sup-

plementary reading in introductory courses, and in other courses in which the subject is related.

In 1936, Keynes published his famous *General Theory of Employment, Interest and Money*. There are few who would deny, as of now, seventeen years later, that the book has had a greater impact on economic analysis and policy even in this short time than any book since Ricardo's *Political Economy*. It may be a little too early to claim that, along with Darwin's *Origin of Species* and Karl Marx's *Das Kapital*, the *General Theory* is one of the most significant books which have appeared in the last hundred years. (Darwin's book, though not strictly in the social sciences, greatly affected them.) But whatever the exact significance of the *General Theory*—and the results of the ideological struggle of our age will influence the long-run assessment—it is clear, judging from the reviews of the book when it first came out, that it has had a much greater effect than most had anticipated in 1936. It continues to gain in importance. Not surprising is the fact that few aside from Keynes's closest "collaborators" came even near to sensing the place the *General Theory* was to occupy in economics. Keynes, however, had once boasted in a letter to G. B. Shaw, of his forthcoming revolutionary book, the *General Theory*.

Breaking new ground, Keynes encountered all kinds of difficulties. The fact that he wrote the book in his fifties, a well-advanced age for highly creative work, together with the great demands made upon him by his richly diversified activities, may partly account for the deficiencies of the book. These certainly help to explain his failure to read more widely as well as to some extent his originality—for the less versed in what others write, the easier a fresh approach. The exposition proved difficult; many ideas had not been clearly thought out; there were some confusions and even errors; the relation of the *General Theory* to the accepted doctrine was not at all clear; and Keynes, like many other innovators, and particularly

those not immersed in the literature, was inclined to exaggerate the novelty of his approach and development. Those conversant with Keynes's *Economic Consequences of Peace*, his *Tract on Monetary Reform*, his *Essays in Persuasion*, and the many brilliantly written parts of the *Treatise on Money* were disappointed in the writing, which seemed not up to Keynes's usually sparkling literary skill.

Few books as difficult to read (*Das Kapital*, about which Keynes complained as a confused work, is a somewhat similar case) have had anything like the wide success of the *General Theory*. This success reflects intrinsic merit, for few books have had the fine combing both by believers and by vigorous critics.

Unfortunately, Keynes had little opportunity or leisure to clarify his views in his last decade following the publication of the *General Theory*. The international crisis required virtually all his energies in those years; and a serious illness limited his working day. At least, his *How to Pay for the War* (1940) cleared up one point: that his system applied to inflationary as well as deflationary periods. Keynes had some brilliant students at Cambridge, and they, other followers, and other economists in the years after 1936, and Keynes himself to some extent, cleared up obscurities, improved the integration of the various parts, and eliminated positive error. This naturally helped to put Keynes in perspective.<sup>1</sup>

Professor Hansen is the obvious choice for a volume on Keynes in the Economics Handbook Series. As the most prominent Keynesian in the United States, Hansen has interpreted Keynesian economics for American students and laymen; and he has greatly enriched it as well.

In writing *A Guide to Keynes*, Professor Hansen expresses the hope that the student or informed layman will continue to

<sup>1</sup> See *The New Economics*, edited with an introduction by Seymour E. Harris, Alfred A. Knopf, Inc., 1947, especially Parts 1-3, 9.

read the *General Theory*. Sweating through a 400-page classic like the *General Theory* is part of the educational process. The professional economist who has not given a summer to a thorough study of Keynes's *General Theory* has lost much.

But there are many who can spare but a few days or a week or two or three on Keynes. This applies to many undergraduates who must learn about Keynes's work as part of a single course in economics, or even to students who devote several courses to economics, and to the numerous laymen who may want to know what Keynes is about. Even those who choose the painful though profitable task of reading and interpreting the *General Theory* will be greatly helped on their way by Professor Hansen's new book.

Page by page, line by line, he has culled the fruits of the *General Theory*. He not only has weeded and raked the rich field but also has fertilized the soil and replanted to achieve the landscape envisaged by Keynes.

The resulting product is a rare one which few who wish to understand Keynes and modern economics can afford to neglect. Every page of Professor Hansen's book reflects his painstaking examination of practically every paragraph of the *General Theory*, as well as his command of the literature, both European and American. The book reflects, also, many years of teaching Keynes's theories to students, both graduate and undergraduate, in his courses in business cycles, money and banking, and fiscal policy and the guidance of many theses dealing with Keynesian economics. Hansen's *Guide* also reflects many of his own contributions to the system about which he modestly remains silent (*e.g.*, his treatment of economic maturity, of the consumption function, international disequilibrium, the problems raised by the financing of deficits, the integration of local, state, and Federal finance as facets of full employment policy) and reflects finally the fruits of years of application of Keynesian economics to the



policy questions of an economy floundering between deflation and unemployment, on the one hand, and full employment and inflation, on the other.

Space does not allow a listing of all the aspects of Keynesian economics on which Professor Hansen sheds light in this book. Suffice it to present but a few: the validity of Say's law; the relation of the marginal efficiency of capital, the consumption function, and the rate of interest to the level of employment; relation of savings and investment; the appraisal of the static, periodic, and dynamic aspects of Keynes's theory; the three versions of the multiplier; the own rates of interest; the reconciliation of Keynes's liquidity theory of interest, the loan fund, and the Hicksian theory; the relation of effective demand, money, and prices; the assumptions under which Keynes developed his analysis, etc.

Hansen is a great admirer of Keynes; but this does not blind him to credit or discredit where it is due. For instance, he is critical of Keynes for his failure to give the Continental economists and many of the English economists, particularly Professor D. H. Robertson and Professor Pigou, adequate credit for their contributions. When Keynes claims too much, Hansen gently reminds the reader of Keynes's overreaching. Errors, confusions, inconsistencies, failure to carry a line of reasoning through, irresponsible statements—all these receive the attention of Keynes's friendly but firm critic. But more important, Professor Hansen measures Keynes's unprecedented contributions to economics.

My prediction is that the net result of Professor Hansen's book will be a much wider understanding of Keynes's economics and Keynesian economics, and that it will result in the *General Theory* being read more than ever.

Seymour E. Harris

## NOTE ON PAGE REFERENCES, TERMINOLOGY, AND NOMENCLATURE

At the head of each chapter in this volume, reference is made to the chapter or chapters in the *General Theory* which are under discussion. Scattered throughout each chapter, I have made page references to the *General Theory*. All page references, unless otherwise indicated, are to the *General Theory*.

Frequently, I have grouped two or more of Keynes's chapters for treatment under one general heading. Accordingly, this volume contains only thirteen chapters, while the *General Theory* contains twenty-four.

I have, however, followed in general the sequence of topics found in Keynes's book. A more logical arrangement might indeed be offered, but any drastic rearrangement would have defeated my primary purpose; namely, to induce the student to read, and help him to understand Keynes. The *General Theory* and the present volume can therefore conveniently be read side by side.

For the most part, I have followed Keynes's terminology and nomenclature. There are, however, the following exceptions, which the student should carefully note:

1. Marginal efficiency of capital. For this I use the symbol  $r$ ; Keynes uses no symbol for this concept.
2. Rate of interest. For this I use the symbol  $i$ ; Keynes uses the symbol  $r$ .
3. Liquidity preference functions:
  - a. Total liquidity preference function (including both the transactions demand and the asset demand for money). This function I write as follows:  $L = L(Y, i)$ ; Keynes's nomenclature is  $M = L(Y, r)$ .
  - b. Transactions-demand function. I write it as follows:  $L' = L'(Y)$ ; Keynes writes it  $M_1 = L_1(Y)$ .
  - c. Asset-demand function. I write it as follows:  $L'' = L''(i)$ ; Keynes writes it  $M_2 = L_2(r)$ .

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*Book One*

**Introduction**



## CHAPTER 1

# *The Postulates of the Classical Economics and the Principle of Effective Demand*

[GENERAL THEORY, CHAPTERS 1-3]

### PRE-KEYNESIAN DISSENTERS

It is safe to say that any economic doctrine long accepted by any considerable group of competent economists was never wholly without merit. Though later discarded, such doctrines often afforded as a first approximation significant insights into the functioning of the economic system. This is true, for example, of the long-since-discredited wages-fund theory, and it is true of Say's law. In both cases (under the stress of petty and often sterile controversy) rigid and dogmatic formulations emerged—stereotyped “laws” which sought to compress very complex phenomena into a rigid mold. But in flexible hands, and for those with fluid minds, these theories could be—and often were—illuminating and useful.

Say's law, in a very broad way, is a description of a free-exchange economy. So conceived, it illuminates the truth that the main source of demand is the flow of factor income generated from the process of production itself. The employment of hitherto unused resources, by adding to the circular flow of income and output, pays its own way since it enlarges the income stream by an amount equivalent (in equilibrium conditions) to the amount taken out of the income stream through the sale of its products. A new productive process, by paying out income to its employed factors, generates demand at the same time that it adds to supply.

The classic statement of Say's law maintained the thesis that the free-price system tends to provide a place for a growing population and an increase in capital. In an expanding society, new firms and new workers wedge their way into the productive process, not by supplanting others, but by offering their own products in exchange. The market is not regarded as fixed or limited—incapable of expansion. The market is as big as the volume of products offered in exchange. Supply creates its own demand. Viewed as a broad generalization, this statement presents in the large a picture of the exchange economy.

But the history of thought illustrates again and again how a great, living principle, tossed about on the sea of controversy, is likely to lose its vitality. Too often it may be applied, as a tool of analysis, to highly complex problems for which it is unsuited. Misleading conclusions inevitably emerge. This is what happened to Say's law.

Beginning students who read the current literature on the "Keynesian revolution" are likely to get the impression that all economists, young and old alike, presented up to 1936—the year in which the *General Theory* was published—a solid orthodox-classical front. Nothing could be further from the truth. The generation of economists embarking upon their professional life in the period around the First World War were in no inconsiderable measure unhappy about the then prevailing state of economic analysis. The prevailing theory was neatly logical, but it was often incapable of coming to grips with reality. Many economists, accordingly, turned to descriptive and institutional studies. .

This state of distrust of orthodox theory was indeed not peculiar to the period referred to above. On the contrary this situation had been the rule, except for rare intervals, since the days of Ricardo. R. L. Meek, in his article on "The Decline of Ricardian Economics in England,"<sup>1</sup> cites evidence, from the

<sup>1</sup> *Economica*, February, 1950.



proceedings of the Political Economy Club, of the “rapid decline of certain basic Ricardian doctrines.” The years 1823 to 1833 saw widespread attacks on Ricardo. Henry Sidgwick, in his *Principles of Political Economy* (1883), quotes Malthus as saying in 1827 (only four years after Ricardo’s death) that “the differences of opinion among political economists” have “of late been a frequent subject of complaint.”<sup>1</sup>

J. S. Mill attempted to remedy this situation, and for a time his *Principles* (1848) won wide acceptance. Sir James Stephen, in 1861, was able to report “that the conclusions of those who understand the science are accepted and acted on with a degree of confidence which is felt in regard to no other speculations that deal with human affairs.”<sup>2</sup> In commenting on the commanding authority of Mill, Sidgwick stated: “The generation whose study of Political Economy commenced about 1860 were for the most part but dimly conscious of the element of stormy controversy from which the subject had so recently emerged.”<sup>3</sup> Yet already by 1869 Mill surrendered to the attacks of Longe and Thornton on the wages-fund dogma, and, in 1871, came Jevons’s smashing attack on the then prevailing doctrines. Marshall, however, rebuilt a new orthodoxy (*Principles*, 1890) in his synthesis of the Austrian (and Jevonian) approach with that of the classical system.

Still there were plenty of dissenters.<sup>4</sup> In the United States,

<sup>1</sup> H. Sidgwick, *The Principles of Political Economy*, 3d ed., Macmillan & Co., Ltd. (London), reprinted 1924, p. 9

<sup>2</sup> *Ibid.*, p. 3.

<sup>3</sup> *Ibid.*

<sup>4</sup> Keynes was fully aware that, for decades past, economics had not been a settled and peaceful discipline. He himself had been at the forefront of doctrinal controversy. He had over a long period made a frontal attack on one of the most deeply rooted and awe-inspiring pillars of the modern world—the gold standard. In this battle he had been aided by many of his fellow economists, and at long last he had converted the great majority of British men of affairs in government, industry, and finance. With respect to employment theory and policy there remained “deep divergencies of opinion