MACRO ECONOMICS AFTER KEYNES

A RECONSIDERATION OF THE *GENERAL THEORY*

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PREFACE

The Purpose of this Book

This is a book about a book: J.M. Keynes's *The General Theory of Employment, Interest and Money*. It is the outcome of several years' experience using the *General Theory* as the core of my macroeconomics courses for undergraduates at UCL. I believe it sheds new light on Keynes's book, and in that respect my intended audience is my fellow-academics, but it is also meant for students: I feel strongly that the current practice of separating one's audience, reserving new thinking for the professionals and giving students only what is generally accepted, is both patronising to students and inimical to the vitality and progress of our subject.

Therefore I hope to encourage others, by means of this book, to bring the *General Theory* back into mainstream teaching — not because there is anything sacrosanct about Keynes, but because I would argue (*do* argue, in this book) that the *General Theory* gives a far richer understanding of the structure of macroeconomic interactions and methods of analysing them than much of what has been written since.

The macroeconomics that has been developed after Keynes, though claiming inspiration from the *General Theory*, in my view has not, with some outstanding exceptions, been macroeconomics after the *manner* of Keynes — with the method and perspective and insight of Keynes. My title is intended to indicate this jarring fact: that the macroeconomics which has followed the *General Theory* in time has not followed it in spirit. It is the latter we need.

I would go so far as to argue not only that Keynesian economics is not Macroeconomics After Keynes, but that it is not even macroeconomics! Consider the approach in any textbook. One is told that there are three central behavioural equations in Keynes: the consumption function, the investment equation and liquidity preference. That is not unreasonable. Much detailed exposition of these three functions then ensues, based entirely on principles relevant to individual behaviour. There is nothing wrong with choosing the individual level: that is where these decisions are made. But then, flying in the face of what is (usually) said in introducing macroeconomics about the fallacy of composition, the equations representing individual behaviour are regarded as relating to aggregates and given the simultaneous-solution treatment.

The approach of the neoclassical synthesis is one of splitting up the theory into components, tinkering with the parts and never quite enquiring whether they still legitimately fit together into a coherent theory at the macroeconomic level. Nor is the method of simultaneous equations challenged.

In contrast, Keynes set out with the objective of providing a theory of, as he called it, 'output-as-a-whole', one which would admit the possibility of unemployment which was neither voluntary nor transitory. The components were seen as crucial elements in that whole picture. The difference is one between a 'holistic' and a 'reductionist' attitude to theory.

I believe passionately that the urge to simplify a theory, to reduce it to its component parts chiefly because these are easy to handle mechanically, is largely responsible for the unhappy state of the subject and of economic policy.

Consider, for example one effect of presenting 'macroeconomics' as the three behavioural equations mentioned above (substitute a saving function for consumption for greater familiarity, though I argue in the book that the substitution has been disastrous) and an exogenous money supply. Separate the 'monetary' from the 'real' in an *LM* and an *IS* curve, respectively. Then it is easy to talk of fiscal policy without regard to the consequences of the mode of its financing, as if any 'monetary' effects operate solely through the *demand* for money. For a long time this was standard 'Keynesian' theorising, which ignored what Keynes *did* say about the effects of financing and was insensitive to what he, not envisioning intervention on such a scale, did *not* say. Thus the way was left wide open for monetarism's challenge, and the enfeebled theory was too weak to combat it effectively.

It was my dissatisfaction with conventional macroeconomics which first prompted me, in a search for something better, to go back to the *General Theory* and to use it instead of a textbook in my macroeconomics courses for second-year undergraduates. There seems to me to be no point at all in perpetuating the present state of affairs by teaching students about the 'Monetarist-Keynesian Debate', or latter-day alternatives such as New Cambridge and the New Classical economics, on the basis of the oversimplifications and algebraic manipulations which dominate the textbooks, for they are not thereby given any criteria for evaluating the theories or choosing between them. It is my experience that students end up by saying no more than 'X's theory is this' and 'Y's theory is that', making no attempt at evaluation and choosing, if they choose at all, on the basis of their political preferences for some policy prescription associated with a particular theory. If the policy conclusions do not *follow* from the theory (which is all too often the case) the student is, it seems to me, in a worse intellectual state than if he had never learnt any economics at all.

So this is not a particularly easy book, and for that I make no apologies. Macroeconomics by its very nature requires that one keep track of a fair number of things at once, and a holistic vision is something every reader must construct for himself, from the 'clues to your thought which you are trying to throw him'.*

Students do not find the *General Theory* particularly easy either: it is all words, for a start, with only one diagram and few equations to seize upon. The analysis is often far from clear and particularly difficult to penetrate after learning some 'Keynesian economics'. (Students are quite stunned to see how different the two are, and often quite excited by the discovery.)

Initially, therefore, I conceived this book as an aid to understanding the *General Theory*, sharing what I had learned in returning to it — an exercise, if you like, in restoration, stripping off layers of 'Keynesian' varnish so that the original object could be seen. Leijonhufvud (1968) had also done this of course, but I felt he had still more layers to go. So, it turned out, had I.

The first attempt, in 1974(!), came unstuck on its way round the circular flow of income. Later I came to realise that the circular flow and Keynes's treatment of finance and money were not really compatible. It was right that I should come unstuck.

As first conceived it was also largely an 'anti-text', critical in detail of textbook macroeconomics. I found however that the Keynesians kept getting in the way of my trying to say what I thought Keynes was about. And I wanted also to rework and extend parts of the theory and to point the way to necessary changes. These aims took precedence, so with some exceptions where I felt that prevailing conceptions needed to be dealt with explicitly, I have left the Keynesians more or less in peace. In any case there were more sinister foes around by the time I came back to the project.

This is not a book in the history of economic doctrine as such, which is concerned with illuminating the author's point of view as brightly as possible on his own terms. I hope at several points to have done that, though I do not claim that this book reveals 'what Keynes really meant'. It is obviously important when reading *anyone* to use one's sympathy and intuition to approach as closely as possible the author's point of view, to attempt to understand him or her to the best of one's ability. That effort, and basic respect, is necessary even to make effective criticism — one does not have to agree. But it is a philosophical impossibility to *know* what someone else 'really meant'; what matters is to make coherent sense for oneself of what an author says and to evaluate its relevance to the problem at hand.

The question of relevance ultimately dominates the book, whether evaluating Keynes's ideas vis-à-vis those of his predecessors and their modern representatives or the applicability of his ideas to the present. Theory is all too often presented as if its origins were totally abstract. This helps to foster the idea that later ideas are better, as Truth gradually

* Keynes's *Collected Writings*, Vol. XIII, p. 470.

overcomes Error. When theories are presented for what they are — products of living human minds, with their particular interests, strengths and failings, working in a particular place at a particular time — students can understand that certain minds capture the essence of a problem better than others and even the best theory is only provisional. It is unfortunate that in macroeconomics a very good theory has been superseded by much more limited ones, but even when the better theory has been understood one must not stop there. The book ends by suggesting areas where substantial, perhaps radical, revision is needed.

It follows that the student looking for the Truth here will not merely be disappointed; the disturbing idea will have been put to him that there really is no such thing. Theories are rarely True or False, but they may be judged more or less relevant to the place and time to which they are applied.

Having said that, it will strike the reader as odd, to say the least, that there is precious little in this book on the international aspects of the economy, or on government outside the frame of reference of stabilisation policy. This is the case despite the urgings of many who have seen the manuscript at various stages to include these matters. Let me say immediately that I agree with them that it is a matter of great importance, even urgency, to develop a *macroeconomic* model which fully incorporates these aspects. It is thus with regret and apologies that I have not followed their advice; very simply, I do not feel I have the depth of understanding required to treat these aspects on the same level as what does appear here and to integrate them with the rest of the analysis rather than merely tacking them on, and I feel strongly that 'tacking-on' is not good enough. At points there are some suggestions in these directions which others might like to follow. One does what one feels one can, and leaves the rest to others.

Thanks

One cannot even do what one can without the help and support of others, and I have many debts.

Some of my debts go back a long way, to my student days at Berkeley. There, David Alhadeff and Harvey Leibenstein taught me microeconomics in a way which allowed me to see more in supply and demand analysis than the point where two curves cross. That perception is the fulcrum on which almost all the theoretical argument of this book rests.

Also at Berkeley, Hyman Minsky tried to teach me *The General Theory*, but I didn't really see the point then. I wish to thank him for trying and to apologise for being so obtuse at the time.

I have had the marvellous opportunity of trying out many of the ideas in this book in seminars at many British and several Italian universities and at greater length while a visitor to McGill University and the University of Aarhus. I am most grateful for these invitations and for the stimulating discussions which resulted.

There are many people to thank for reading part or all of the manuscript at various stages. Susan Howson, David Laidler and a student on the course, Hyginus Leon, read almost all the manuscript and Richard Lipsey a great chunk of it. Comments on particular chapters were also forthcoming from Michael Danes, Sheila Dow, Peter Earl, Nicolas Rau, Colin Rogers, Kerry Schott, Thanos Skouras, John Sutton, Christopher Torr, Valeria Termini, and Claus Vastrup. I thank them all for giving so generously of their time and offering me their expertise and their criticisms. They are not to be held responsible for the result.

Those who helped the book take physical shape are also to be thanked. Too many have been involved in the typing at various stages to name them all. I am grateful to all of them, but particularly to Celia Rhodes. Celia, a former student (so she knew what I was about) undertook not only a vast amount of typing in the final stages but also editorial tasks including most of the responsibility for the index. Not only was her nearly faultless typing and intelligent editorial work a boon, but she was always calm, greatly alleviating the stress of such a project. I was very lucky — indeed I wonder if this book would have seen the light of day without her.

I wish also to thank Philip Allan, first for his patience and then, equally, for knowing exactly when and how to lose it. Both were vital, as were his constant support and enthusiasm. Thanks are due him also for organising the book's almost alarmingly rapid production. I should particularly like to thank Ann Hirst, who was both a superb copy-editor and such fun to work with. Geoffrey Harcourt and Basil Moore also spotted some late errors.

Notes on Reading this Book

Keynes was a skilful tactician: he stated the main outline of his theory and drew the lines of dissent with existing theory after a first chapter of only half a page. In retrospect I might have been wise to follow that format. My Chapter 4 corresponds to his Chapter 3 and the three preceding chapters can be pretty heavy going in places. My advice is to have a go but feel free to skip to Chapters 4, 5 and 7 and then come back. (But *do* come back: too much is built on those early chapters.)

I have brought forward the analysis of changes in money-wages (*G.T.* Ch. 19) to Chapter 8; other topics are fairly clearly indicated by the chapter titles. There is a table of correspondences between chapters of the *General Theory* and this book following the Table of Contents.

For teaching purposes there will undoubtedly be a need to make cuts. I cut or skim over different material every year. Any cut damages coherence, but it is not obvious what is most dispensible. (If I knew, the book would be shorter.) My view is that the balance should be determined by what does and does not turn the students and the lecturer on. Students will probably need further background for Chapter 9 than I was able to provide without distorting the shape of the book.

Acknowledgement

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Bibliographical Note

Although other references are indicated by author and date, the *General Theory* and items for which Keynes's *Collective Writings* are the only or most convenient source have been indicated by *G.T.* and *C.W.* (with volume number following) respectively. Page references to the *General Theory* are to the original (1936) edition.

Chapters of the *General Theory* Relevant to Each Chapter of this Book

Macroeconomics after Keynes	*The General Theory*
Part I	
1	1,2
2	–
3	4,6,7
Part II	
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CONTENTS

Part I

PRELIMINARIES AND FUNDAMENTALS

Chapter 1

KEYNES AND MACROECONOMICS

A Monetary Theory of Production

In some sense, Keynes's *General Theory of Employment, Interest and Money is* macroeconomics and in another, very real, sense modern macroeconomics has gone a long way toward restoring the theory that existed before Keynes wrote and which he thought he had overturned.

All theory is simplification, abstraction, stylisation. Theory does not mirror reality; it extracts the salient features that convey the essence of that reality, the way an artist may use only a few lines to suggest both form and feeling.

Good theories are relevant abstractions, and relevance alters as history moves on. In economics, old theories are seldom wrong; they have just become irrelevant. Surveying the economic theory in which he had been trained, Keynes felt that the theory was not relevant to the world which he knew:

> ... [W]e lack a monetary theory of production. An economy, which uses money but uses it merely as a neutral link between transactions in real things and real assets and does not allow it to enter into motives or decisions, might be called — for want of a better name — a *real-exchange economy* ... Most treatises on the principles of economics are concerned mainly, if not entirely, with a real-exchange economy; and — which is more peculiar — the same thing is also largely true of most treatises on the theory of money. ...The theory which I desiderate would deal, in contradistinction to this, with an economy in which money plays a part of its own and affects motives and decisions and is, in short, one of the operative factors in the situation, so that the course of events cannot be predicted, either in the long period or in the short, without a knowledge of the behaviour of money between the first state and the last. And it is this which we ought to mean when we speak of a *monetary economy*. ... Everyone would, of course, agree that it is in a monetary economy in my sense of the term that we actually live. ...

> Nevertheless it is my belief that the far-reaching and in some respects fundamental differences between the conclusions of a monetary economy and those of the more simplified real-exchange economy have been greatly underestimated by the exponents of the traditional economics; with the result that the machinery of thought with which real-exchange economics has equipped the minds of practitioners in the world of affairs, and also the economists themselves, has led in practice to many erroneous conclusions and policies. The idea that it is comparatively easy to adapt the hypothetical conclusions of a real wage economics to the real world of monetary economics is a mistake. It is extraordinarily difficult to make the adaptation. ... Accordingly I believe that the next task is to work out in some detail a monetary theory of production. ... [T]hat is the task on which I am now occupying myself, in some confidence that I am not wasting my time.
>
> (*C.W.* XIV, pp. 408–411)

The student might think it extraordinary that a theory of real exchange would be applied to an industrialised nation. One might even think it odd that such a theory would have been constructed in the first place. Consider, however, what sort of economics one would write if one lived in a society which was largely agricultural, in which much domestic trade was not monetised.

A theory of direct exchange of labour-time for 'corn', the representative commodity, would not be unreasonable. Money would enter the picture in the section on international trade. If one's work is good enough, one might capture the minds of succeeding generations so completely that the analysis and habits of mind appropriate to one situation continue to be brought to bear long after the situation to which they are applied has altered enough to require a change of theory. The laws of inertia apply to thought as to the material world.

The economy that Keynes observed was nothing like that. It was a world which, in broad outline, is similar to our own, (though of course there are differences, some of them important). He saw, and so do we, an industrial economy, capitalist[1] in form, with a sophisticated financial system to bridge the gap between the ownership of capital by a few and the need for a broad source of funds to finance that ownership: a monetary, production economy.

Of course, one might think. But what is the fuss about *now*? Surely Keynes succeeded in his task and the issue is settled? No, it is *not* settled. In some bizarre and tragic way, although the result of his efforts is still counted amongst the three or four most important books yet produced in economics, it was, or it has so far been, a waste of time. By three steps, much of the old real-exchange theory has been restored. One wonders what it is that is so deeply appealing about it.

The first, the biggest step was the 'neoclassical synthesis', based on the *IS–LM* framework, in which Keynes's theory was retained in outward form but lost in substance. The three essential behavioural elements are there — the consumption function, the marginal efficiency of capital and liquidity preference — but they are put together in a framework of simultaneous equations — a method only suitable to the analysis of exchange[2] — and everything, even the liquidity-preference function, is 'real'.

The restoration of the method appropriate to real-exchange theory was the major step, but monetarism provided two more: first, the distinction between consumption and investment, already weakened in *IS–LM* analysis, was virtually obliterated,[3] returning us to the 'corn' economy; second, the development of 'rational expectations', while making the analysis *seem* to deal with uncertainty and forecasting, takes the analysis back almost to the model of perfect certainty; only random errors, which are not forecastable, remain.

In Keynes's theory, shifts in investment are a major source of disturbance (for good or ill) to the economy. The effect of restoring a theory of undifferentiated output is to remove this source of disturbance, leaving government policy as the main cause of fluctuations. This is a major step toward restoring the theorem, prevalent before Keynes, that the economic system was 'self-righting': fluctuations were temporary and self-reversing and the best policy was to leave the economy alone. The introduction of rational expectations reinforces this conclusion, since expenditure plans are no longer based, as Keynes's investment plans are, on long-range, very uncertain forecasts and government expenditures are nullified in their effect by the knowledge that they are matched by future tax liabilities, We have moved from the economics of Keynes to the 'economics of Dr. Pangloss'.[4] The *status quo ante* is virtually restored, and that, I believe, is tragic both for theory and for policy.

How did it happen? Most of the trouble lay, perhaps, in the complexity of the *General Theory* and the desire of interpreters to simplify its message rather than taking pains to understand its complexity. Part of the trouble lies in the fact that the assumptions of today's real-exchange model are tacit, as they were in the version Keynes attacked. One can thus be fooled by the words one uses — note his remark about the 'real' character of *monetary* theory, and I have asserted that the standard textbook theory of output is really a theory of exchange. (One cannot see others' assumptions clearly if one does not know one's own. For this reason, we shall pay much attention to *method*.)

So although on some points the world to which Keynes's theory most closely pertains differs from our own, the difference is far less than the gulf that separates the reality of the modern industrial economy from the nearly-perfectly-certain, one-commodity exchange economy of modern macroeconomics. This fact — it is a fact as I see it — is the *raison d'être* of this book.

Money

Macroeconomics has never really come to terms with money.

(Microeconomics hasn't either.) Few have seen with this kind of clarity what the shift to a monetary theory entails:

> [T]he task of monetary theory is a much wider one than is commonly assumed; ... its task is nothing less than to cover a second time the whole field which is treated by pure theory under the assumption of barter, and to investigate what changes in the conclusions of pure theory are made necessary by the introduction of indirect exchange.
>
> (von Hayek, 1935, p. 110)

Money, as is well known, permits the separation of the act of selling goods from the act of purchasing them: that is, indirect exchange. In much economic theory even today this attribute of money is treated as a pure convenience. In such theory the presumption is that the existence of money does nothing to change the nature of transactions; in its absence the same sales would simply take place with greater awkwardness and higher real cost. Relative prices are unchanged; money is neutral. Goods exchange for goods: the real-exchange economy.

Indirect exchange means a separation in time between actions involving real goods. The real value of a sales transaction, therefore, cannot be known for certain. In that sense, every transaction is a speculation (Hicks, 1939) and in the possibility that the gap between transactions may be quite long in aggregate, Marx finds an explanation of the 'crisis'.[5] Even a theory of a monetary exchange economy can give important results.

Production

Production also, in the nature of things, takes time.

The time-consuming nature of production places upon producers the necessity to make decisions based on an *estimate*, a forecast, of the demand for their product: the goods must be placed on the market before people can buy them, and thus before demand can be known.[6] The existence of money can enhance the difficulty of making that estimate, for when people save for future purchases, they need not place specific orders even if they know what they will want and when. They can hold money instead, or one of the many claims on future money that a developed financial system provides. This action gives producers no clue as to their future plans.

These are the basic facts which Keynes's theory incorporates, and using them he attacks the prevailing orthodoxy. The attack was at one and the same time a declaration of all-out war and a battle for a specific objective. The specific objective, one manifestation of the prevailing orthodoxy, was the theory of employment. Events determined his specific objective, for while Keynes knew that his theory was a full scale critique of Real-Exchange Economics, the condition of the British economy in the 1930s was too dire to permit a lofty, disengaged approach, even if Keynes's temperament would have allowed it.

Historical Background

All books are products of their place and time. And the place and time that stand as backround to the *General Theory* are extraordinary. The time, the early 1930s;[7] the place, Cambridge. These influenced both the form and the content of the book.

First, form. Styles change. Economics today is couched in a technical (or seemingly technical) language, infiltrated by mathematics. The *General Theory* is almost entirely verbal. Words whose meanings were taken as given were those in agreed usage in Cambridge at the time. There were other words, whose meaning is now (wrongly, I think) taken as agreed, which were even then (and there) the subject of heated controversy — saving, for example. A full understanding of the book, to which I do not lay claim, requires a knowledge of the particular language current in that closely-knit group of economists amongst whom Keynes was working. At the least, one must be alert to the 'fallacy of common language'[8] and the need to exercise interpretive imagination. Cambridge Economics was (and still is) a distinct intellectual tradition. The reader of the *General Theory* must make a translation from the language of Cambridge in the 1930s to the language of the present.

More important, content. It is necessary to view the *General Theory* in the context of history, both the history of the British economy and the history of economic thought. The *General Theory* is a direct reaction to established doctrine. A famous passage in Keynes's preface describes the book as:

> a long struggle of escape ... — a struggle of escape from habitual modes of thought and expression ... . The difficulty lies, not in the new ideas, but in escaping from the old ones, which ramify ... into every corner of our minds.
>
> (*G.T.* p.viii)

I cannot possibly give a full exposition of macroeconomic theory as it existed before Keynes,[9] much less list the contents of Keynes's mind before he began the train of thought that resulted in this work.[10] But a sketch of the more important ideas is in order, for his opposition to the prevailing orthodoxy shapes the entire argument. It is an orthodoxy which has by no means died, though it has changed its form slightly.[11]

Keynes was anxious to refute a particular manifestation of orthodox theory, namely Say's Law and the theorem which derives from it: that involuntary unemployment is impossible. This was hard to believe in Britain in the early 1930s, when Keynes began working on his new ideas.

From 1921, when reasonable data became available, rates of unemployment in the UK were not a pretty sight. The percentage of insured workers unemployed was 15.6 per cent in that year. It fell to 9.7 per cent in 1927 and reached its peak of 22.1 per cent in 1932: 2.8 million people. The registered unemployed numbered over two million until late 1935.

These are data for the country as a whole; they are given in full in Table