

## Keynes vs the Keynesians: Keynes Rediscovered

Geoff Tily. *Keynes's General Theory, The Rate of Interest and 'Keynesian' Economics: Keynes Betrayed*. New York: Palgrave Macmillan. 2007. Pp. 336. ISBN 1-4039-9628-8. US\$95 (hb).

---

Colin Rogers\*

---

As a first reaction to the title of this book a potential reader would be forgiven for wondering what more could possibly be written about Keynes. There must be thousands of publications on Keynes' life, philosophy and economics; after all, did not Axel Leijonhufvud (1968) alert us to the distinction between the economics of Keynes and 'Keynesian' economics, and Robert Skidelsky (1982, 1992, 2003) has provided us with an authoritative biography. So why another book on Keynes?

The simple answer is that much that has been written in the macroeconomics literature about Keynes' *General Theory* we now know to be rather wide of the mark. This book by Geoff Tily is different. It provides a comprehensive assessment of the theory and policy that gets Keynes' economics just about right. I say just about because there are two small changes in emphasis I would propose. With these adjustments Tily's book sets out what Keynes said and why he said it. The reader is not faced with the conundrum of what Keynes really meant because what he said has been filtered through the theoretical lenses worn by so many of his interpreters, including Leijonhufvud. Although Leijonhufvud was correct to stress that Keynes' analysis does not rely on wage and or price rigidities, he ultimately embraced a loanable funds theory of the rate of interest. The fact of the matter is that Leijonhufvud was more Dennis Robertson than Keynes.

Geoff Tily avoids these theoretical distortions because he surveys Keynes' lifetime of work on monetary theory from *Indian Currency and Finance* to the *General Theory* and his post World War II policy proposals. By adopting this historical and evolutionary perspective, Keynes' vision as a monetary theorist and reformer emerges in sharp relief, as does the need for the break with 'classical' theory in the *General Theory*. But at the time very few theorists (academics) were persuaded by Keynes' *General Theory* and that remains true today despite the influence of 'Keynesian' economics.

Tily first carefully exposes the distinction between Keynes and 'Keynesian' economics noticed by Leijonhufvud. In this respect it is interesting to highlight the parallel with Keynes' early attempts at policy advice outlined in *Essays in Persuasion*. Keynes remarks in the preface to *Essays* that, in view of his failure to persuade policy makers, the book would have been better entitled *Essays in Prophecy*. Generally the prophecies were vindicated and this accounted for Keynes' early notoriety. Skidelsky (1983) in *Hopes Betrayed 1888-1920*, captured the theme of betrayal of Keynes' early policy work but entitled the second volume more optimistically: *The Economist as Saviour 1920-1937*. Tily takes a much darker view of the theoretical debate about Keynes' theory and policy proposals pre and post the *General Theory*. For Tily the betrayal of Keynes' ideas continued unabated.

Tily presents convincing evidence that the origins of 'Keynesian' economics lie with the work of Ralph Hawtrey and Dennis Robertson while John

Hicks simply packaged the message that there was nothing at stake for existing theory. On this view, the *General Theory* presented some new definitions and labels but was, once you had seen through the new terminology, just a special case of already existing theory. Tily (chapter 4) carefully documents how this Robertson version of ‘Keynesian’ economics succeeded in squeezing out Keynes’ vision. The model behind Robertson’s vision is instantly recognisable by all students of economics today and consists of the idea that there exists a *unique long-run equilibrium* around which the economy fluctuates during booms and recessions. This vision underpinned Robertson’s (1934) *Industrial Fluctuations and the Natural Rate of Interest* which was essentially a generalisation of Knut Wicksell’s framework to allow for what Robertson called ‘quasi natural rates’. Furthermore, in a footnote reference to James Meade, Robertson (1934, p. 656, n2) makes it clear that fluctuations in aggregate incomes also arise. From this insight it is a simple step to Roy Harrod’s diagram of the ‘classical’ theory of the rate of interest included in the *General Theory* and from there to Hicks’ *IS* curve. But, as Tily explains, the message that Keynes failed to convey was a generalisation of a different sort: one that is based on the existence of *multiple long-period equilibria*. Instead, Robertson, aided by Meade, Harrod and Hicks, offered a vision of *multiple short-run equilibria* associated with variations in the level of income surrounding *unique long-period equilibrium* and this laid the groundwork for mistaken theoretical equivalence.

Tily also documents how Robertson played a key role in promoting his vision at the expense of the one proposed by Keynes. In particular, Robertson played a prominent part at the League of Nations in promoting the ‘neo-classical’ synthesis that appeared in Gottfried Haberler’s *Prosperity and Depression* (1937). Robertson used the models by Hicks, Harrod and Meade to support his interpretation against Keynes’ vision and this appealed to those in search of a ‘synthesis’. The Hicks–Harrod–Meade model is essentially the ‘Keynesian’ vision that appeared post the *General Theory* to be augmented later by Franco Modigliani’s (1944) analysis of the aggregate supply side with its conclusion that rigid wages are the cause of unemployment.

Apart from the fact that Keynes (1936, p. 257) described rigidities as the classical explanation for unemployment, Tily makes it clear that this ‘Keynesian’ interpretation overlooks entirely that Keynes was concerned with the existence of *multiple long-period equilibria* in the *General Theory*. Furthermore, despite some ambivalence towards Hicks’ ‘little apparatus’, Keynes rejected the Robertson vision encapsulated in *Prosperity and Depression* and consequently in what now passes for ‘Keynesian’ economics. Tily (2007, p. 114, emphasis added) quotes a letter from Keynes to Ohlin dated 3 February 1937, which is unequivocal:

I am very glad that you have been able to put down in a way that I can understand the theory of interest as established by the demand and supply for credit. This is an idea which is widely held outside Sweden, e.g. to some extent by Dennis Robertson and Hicks. For my part, I am not convinced by it and *consider it fundamental heresy* ... So far from its being an alternative version of my theory, my first impression is that *this and mine are wholly irreconcilable*.

Those who still think the Keynes endorsed Hicks’ IS-LM interpretation should think again.<sup>1</sup>

Tily then goes on to explain how, with the replacement of Keynes' vision by Robertson's, it was a simple step to bring in 'Keynesian' activist policy recommendations as these were widely accepted on both sides of the Atlantic well before the *General Theory*. In America both Harvard and Chicago economists were strong advocates of 'public works' to create employment during the Depression while in Britain most economists, apart from the 'Austrians' at LSE, were in favour of such measures. The Austrians provided a convenient target for the 'Keynesians' by advocating a 'do-nothing' response to the depression, arguing that the mal-investment that had occurred needed to be 'worked off' before recovery could begin. In this fashion the 'Keynesian' advocacy of countercyclical fiscal policy crept in as a means of smoothing the business cycle around its *unique long-run equilibrium* trend. Thus, along with the replacement of Keynes' theory, 'Keynesian' economists substituted an already acceptable policy strategy. In many respects Tily's exposure of the continuity of 'Keynesian' theory and policy pre and post the *General Theory* is consistent with David Laidler's (1999) *Fabricating the Keynesian Revolution*. There Laidler argues convincingly that in view of the continuity in the theoretical and policy proposals pre and post the *General Theory* it is difficult to find any sign of a theoretical revolution! He is quite right. There was none in the work parading as 'Keynesian'.<sup>2</sup>

We turn now to Tily's presentation of Keynes' vision, concentrating on the *General Theory*.

Tily's thesis about the *General Theory* is straightforward and compelling. In terms of theory, Keynes breaks with tradition and replaces the 'classical' theories of the rate of interest with the liquidity preference theory. What has been missed by many 'Keynesians' of all shades in their interpretation of liquidity preference theory is the importance of the normal rate of interest as an *independent variable* that is not determined by the forces of 'supply and demand'. In the *General Theory* Keynes adopted common-sense definitions of saving and investment so that in a national accounting sense saving and investment are always identical. They cannot therefore interact to determine 'the' rate of interest to produce a unique natural rate, as Wicksell supposed. Keynes also generalised the classical notion of time preference by breaking it down into the propensity to consume and liquidity preference. The rate of interest is then determined by liquidity preference, which establishes the composition of wealth held in monetary and non-monetary forms as facilitated by the existing monetary system. There are then as many natural rates of interest as there are *long-period equilibrium solutions* in Keynes' new 'model' based on the principle of effective demand. Which equilibrium is selected depends on 'the' rate of interest determined by the monetary system as it interacts with the liquidity preferences of the private sector including the banks. In modern jargon, the monetary architecture determines the 'normal' equilibrium rate of interest.

Furthermore, Keynes' analysis is *causal not simultaneous*, and causation runs from the rate of interest to output and employment. From this perspective it is apparent that the static equilibrium in the *General Theory* is about Marshallian long-period equilibrium and is defined only for a set of factors treated as given. Examples of factors treated as given were the quantity of money and the state of expectations.<sup>3</sup> But in treating a factor as given, Keynes (1936, p. 245) does not mean that it is constant or fixed. In Keynes' analysis the independent variables are the rate of interest, the marginal efficiency of capital and the marginal propensity to consume. Economic policy can influence *all* of these factors but of particular importance are the rate of interest and expectations. Tily stresses Keynes' view that the manipulation of

expectations was an important element in the implementation of economic policy. Policy that was seen to be experimental or lacked conviction would not work.

I am in full agreement with this overview of Keynes' vision and attempted a brief theoretical sketch of it along these lines in Rogers (1989). What is compelling is that it clears away all the muddles that have surrounded 'Keynesian' interpretations of Keynes and clearly encapsulates 'classical' theory as a special case that relies on *unattainable aggregate market behaviour* to achieve full employment equilibrium *automatically*.

The only addition I would make to the positive statement of Tily's interpretation of Keynes' theory would be to place more stress on the role of the principle of effective demand. The essence of the principle of effective demand is the idea that, in a *laissez-faire* monetary economy, the existence of the 'normal' rate of interest as an independent variable, held in place by 'rational belief' in its 'natural' character, produces a limit to the profitable expansion of investment and output before full employment is reached. Hence Say's Law fails. Say's Law fails because any attempt to increase supply beyond this point of effective demand causes entrepreneurs to incur losses by driving demand prices below long-period supply prices. Arguing that wage and price flexibility, via deflation, can restore full employment equilibrium automatically in the long run is then seen to be wishful thinking. It requires costs, that is, wages, to fall faster than prices and there is no *a priori* reason why this should be true. It may happen in some circumstances but experience with deflation suggests that the stories told to generations of undergraduates about the Pigou effect are just 'too fantastic for words'.<sup>4</sup>

Once we have a clear outline of the theory underlying Keynes' *General Theory*, his policy proposals come into sharper focus. In particular it is clear that Keynes' policy proposals are aimed at making a *permanent structural change* to a *laissez-faire* economy. As Keynes (1936, p. 204) stressed, if left to itself such an economy could fluctuate for decades about a level of activity too low for full employment—largely because what was thought to be a 'natural equilibrium' rate of interest was too high. Consequently, Keynes proposed a two-pronged policy attack to *shift permanently the point of effective demand closer to full employment*: (i) the creation of the 'green cheese factory', that is, a central bank, acting in the public interest and, (ii) the 'socialization' of investment. These policy proposals were intended to achieve the following results.

First, it is necessary in a monetary economy to have some control over interest rates. Although much institutional detail is suppressed in the *General Theory*, the importance of the reform of the monetary architecture required by Keynes' notion of the principle of effective demand is revealed by his cryptic remark about the need for public control of the central bank. Recall that Keynes was appointed to the board of the Bank of England in 1942. Keynes (1936, p. 235, explanation added) makes the point as follows:

Unemployment develops, that is to say, because people want the moon; – men cannot be employed when the object they desire (that is, money) is something which cannot be produced and the demand for which cannot be readily chocked off. There is no remedy but to persuade the public that green cheese is practically the same thing and to have a green cheese factory (that is, a central bank) under public control.

In other words, the principle of effective demand dictates a policy that requires public control of the central bank, which is to be tasked with setting the

rate of interest to ensure not only price stability but also high employment. This aspect of Keynes' policy proposals was implemented when the Bank of England was nationalised in 1946. Although the existence of a central bank operating in the public interest is now taken for granted, Keynes' theoretical analysis of its role has been forgotten. Nevertheless, Keynes' objectives are clear.

For Keynes, once the principle of effective demand determines equilibrium in a *laissez-faire* monetary economy, the trade cycle is driven by fluctuations in the marginal efficiency of capital. As Tily explains, Keynes advocated low and *stable interest rates*, a 'cheap money' policy, as a means of stabilising the cycle in addition to shifting the point of effective demand in the right direction. Although Keynes' emphasis on low interest rates has been forgotten, contemporary monetary policy aimed at price stability usually has some weight attached to high employment and these twin objectives are still written into most central bank charters. Keynes saw that high interest rates are a recipe for a boom-bust cycle for reasons we would now recognise as the phenomena of adverse selection.

Second, Keynes proposed a policy to increase the expected marginal efficiency of capital and reduce its variance in terms of what he called the 'socialization' of investment. The 'socialization' of investment is a more ambitious scheme than advocating temporary public works, which, as we have seen, many economists recommended well before the *General Theory*. What Keynes was advocating was a *permanent role for the state in investment in public infrastructure*. Jan Kregel (1983) has provided a useful outline of what Keynes had in mind. One thing is clear, the vision behind the proposal was based on the objective of 'crowding in' private sector investment.

To some extent Keynes' message has been absorbed by post World War II policy makers where the state now accounts for approximately 20 per cent of GDP and much of that is directed at what we would classify as public infrastructure. The motivation for this state of affairs seems to be public pressure and political expediency rather than the principle of effective demand, as the latter has disappeared from sight as a guide to macroeconomic policy. Nevertheless, the existence of 'big government' acts as a stabiliser but without Keynes' principle of effective demand to explain what the objectives of policy should be. It is then all too easy to slip into policies of income support and away from investment aimed at the marginal efficiency of capital. The costs associated with rent-seeking behaviour and moral hazard are then also too easily underestimated.

Of these two complementary proposals, Tily places most weight on the first prong, the need for low interest rates, in an attempt to restore the impression created by 'Keynesian' economics that Keynes was all about countercyclical fiscal policy. This impression has arisen partly, on the monetary side, because money is neutral in the long run in 'Keynesian' models, and perhaps because Keynes noted that cyclical fluctuations in the marginal efficiency of capital would be too great to be offset by monetary policy, *unaided*. Keynes was not advocating countercyclical manipulation of interest rates. Also, on the fiscal side, Keynes was supportive of 'public works' as an emergency measure in a crisis but his main objective was the *permanent structural change* to the economy that could be implemented by his proposal for the 'socialization' of investment. The intention was to rescue free enterprise from itself—not to nationalise it. Without a grasp of the principle of effective demand 'Keynesians' miss this dimension to Keynes' policy proposals and to some extent Tily also underestimates this aspect. It is here that I think Tily's thesis would benefit from more emphasis on the second prong.<sup>5</sup>

Nevertheless, the clear message from Tily's thesis is that current 'Keynesian' theory is at best a special case of Keynes' *General Theory*. Policy based on that theory is then also dependent on special circumstances and in need of re-interpretation and generalisation. An important example of current analysis in need of generalisation is the 'Keynesian' analysis of interest rate rules that are presented as a variation on the Hicks–Robertson loanable funds version of the IS–LM model. The traditional LM curve now vanishes to be replaced by an interest rate rule, with the central bank setting the interest rate at Wicksell's unique natural rate and adjusting it only when the price level or rate of inflation deviates from the target level or rate. This 'New Keynesian' model is pure Wicksell as, for example, in Romer (2000).

This broad-brush overview of what I perceive to be the vision underlying Tily's thesis should make it clear why I think it is such an important book. It is not merely another book on the history of Keynes' monetary thought. It provides compelling evidence of where the 'Keynesians' of all shades have gone wrong and simultaneously provides them with the ammunition to generalise what passes for modern monetary theory and macroeconomics. It enables macroeconomists to put Keynes back into Keynesian economics.

---

\* School of Economics, University of Adelaide, South Australia 5005, Australia.  
Email: colin.rogers@adelaide.edu.au.

## Notes

1 Tily also points out that the similarity between the interpretations of the *General Theory* produced by Harrod, Meade and Hicks arose as a result of the collaboration between them. Tily documents that Hicks saw the Meade and Harrod papers before completing his own and makes the case that they were all attempting to generalise Robertson's diagram from *Industrial fluctuations and the natural rate of interest*. For a comprehensive analysis of the flaws in the Robertson theory of loanable funds see Bibow (2001).

2 Tily's interpretation of the 'Keynesians' also has much in common with Skidelsky (1992, chapter 16).

3 Most of the 'Keynesian' interpreters came to recognise this without acknowledging the importance of the principle of effective demand. See Tily (2007, p. 285). For a discussion of the treatment of expectations as 'rational beliefs' for the case of multiple stationary equilibria in the *General Theory* see Rogers (1996).

4 See Rogers and Rymes (2000, p. 89, n.9). Not to mention the consequences outlined in Irving Fisher's (1933) debt-deflation process.

5 Keynes also noted that the propensity to consume was a function of the distribution of income and this opened up the possibility of a third prong to policy, as Tily suggests.

## References

- Bibow, J. 2001. 'The loanable funds fallacy: exercises in the analysis of disequilibrium', *Cambridge Journal of Economics*, 25, pp. 591-616.
- Fisher, I. 1933. 'The debt-deflation theory of great depressions', *Econometrica*, 1, pp. 337-57.
- Haberler, G. 1937. *Prosperity and Depression: A Theoretical Analysis of Cyclical movement*, 5<sup>th</sup> edition, 1964. London: Allen & Unwin.

- Keynes, K. M. 1936. *The General Theory of Employment, Interest and Money*. London: Macmillan.
- Kregel, J. A. 1983. 'Budget Deficits, Stabilisation Policy and Liquidity Preference: Keynes' Post-War Policy Proposals', in *Keynes' Relevance Today*, edited by Fausto Vicarelli. London: Macmillan.
- Laidler, D. 1999. *Fabricating the Keynesian Revolution, studies of the inter-war literature on money, the cycle, and unemployment*. Cambridge: Cambridge University Press.
- Leijonhufvud, A. 1968. *On Keynesian Economics and the Economics of Keynes*. London: Oxford University Press.
- Modigliani, F. 1944. 'Liquidity preference and the theory of interest and money', *Econometrica*, 12, pp. 45-88.
- Robertson, D. H. 1934. 'Industrial fluctuations and the natural rate of interest', *Economic Journal*, 44, n.176, pp. 650-6.
- Rogers, C. 1989. *Money, Interest and Capital: A study of the foundations of monetary theory*. Cambridge: Cambridge University Press.
- Rogers, C. 1996. 'Self-fulfilling expectations and the *General Theory*', *History of Economics Review*, 25, pp. 172-83.
- Rogers, C. and T. K. Rymes. 2000. 'On money in ISLM and AD/AS models, in *IS-LM and Modern Macroeconomics*, edited by Warren Young and Ben Zion Zilberfarb. London: Kluwer.
- Romer, David. 2000. 'Keynesian macroeconomics without the LM curve', *National Bureau of Economic Research, Working Paper 7461*. Published in the *Journal of Economic Perspectives*, 14(2), pp. 149-69.
- Skidelsky, R. 1983. *John Maynard Keynes: Hopes Betrayed 1883-1920*. London: Macmillan.
- Skidelsky, R. 1992. *John Maynard Keynes: The Economist as Saviour 1920-1937*. London: Macmillan.
- Skidelsky, R. 2003. *John Maynard Keynes 1883-1946: Economist, Philosopher, Statesman*. London: Penguin Books.