

Keynes After 60 Years

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The question of what, if anything, Keynes' *General Theory* has to offer us 60 years after it was first published, is not an easy one to answer. In part this reflects the fact that the book changed the landscape of economic thought and left a profound legacy on that branch of economics which has become known as macroeconomics. Nevertheless, there are fundamental aspects of *The General Theory* which have been neglected in the mainstream, and which still have much to offer¹.

It is important to note that much that has been labelled as "Keynesian" economics, really represents attempts to derive Keynesian results in neo-classical theory. However, this often misses the essential message of Keynes. In particular, in *The General Theory*, Keynes showed that, even in a competitive economy with perfectly flexible prices, wages and interest rates, market prices not only could not guarantee full employment but if it was achieved it would only be a fluke. In other words, he showed that there was no mechanism which would drive the economy to full employment. This is a proposition that 60 years later mainstream economic theory still cannot replicate. Either the theory tells us that there is no involuntary unemployment, or else, if there is some, it is the result of some market imperfection. In other words, we still have much to learn from Keynes as to the nature of unemployment in capitalist economies.

I should note, at this stage, that in this symposium, we have a feast in reverse. Geoff Harcourt's main course, starts the proceedings, followed by hors d'oeuvre. As I am the meat in the sandwich between Rod O'Donnell's philosophy and Paul Dalziel's Economics - I would like to focus on two related issues - the first methodological, that is Keynes' use of causal analysis and the second economic - the nature of the relation between real and monetary variables. These, I believe, are two of the most important contributions of *The General Theory*. In other words, I am not focusing on the specific theories of consumption, investment and so on; but rather on the framework of the argument. In particular, it is because of the sequential nature of the analysis implied by Keynes' causal system, as well as by the non-neutrality of money implied by the interdependence of the monetary and real sectors that Keynes shows the likelihood of unemployment as the general case.

Let me begin by considering Keynes' causal method, which he inherited from Marshall. This stresses the relation between cause and effect in determining key variables and relations in the economy. In other words, all variables are not equal - some have more important roles in key areas of the economy. This can be contrasted with the view that everything determines everything else, such as in a general equilibrium framework or IS/LM model where simultaneous determination of equilibrium puts all variables and relations on an equal footing, with all relations being symmetric. In Keynes, by contrast, there is a causal ordering to the way things happen and the manner in which variables influence each other. His system is neither capable of simultaneous determination, nor is it symmetric. In fact, most of the major economic relationships in *The General Theory* are non-symmetric.

The causal method suggests analysis by stages. First one considers (say) the monetary sector, where the level of nominal income, liquidity preference and the money supply determine the rate of interest. Then this rate of interest, together with the marginal efficiency of capital (and expectations) determine the level of investment, which, in turn, with other

variables determines the level of output, which is then used to modify the previous analysis of the monetary sector. This approach was used elsewhere by Keynes, where he separates the analysis into a number of logically and sequentially separate stages. There is a definite logical sequence in which relations are determined, similar to the casual link identified by Pasinetti in the works of Ricardo.²

To illustrate this point, consider the key relationship in the *The General Theory*, the *ex ante* equality of savings and investment. In a general equilibrium framework, or in the IS/LM model both savings and investment are determined by many variables, which are themselves determined by many variables and so on. In equilibrium they are equal - but we can't really say what "caused" that equilibrium, as it is the result of every variable in the model. In Keynes, by contrast, we have an ordering of how influence is transmitted. Although other variables may exert some impact on savings and investment, the major relation is that of the multiplier, whereby changes in investment generate equal changes in saving through their impact on the level of income. That is, it is changes in income which bring *ex ante* savings and investment into equality. This is a specific causal mechanism whereby a key variable, income, is the cause of changes in savings.

So, why is Keynes' causal method important. It imposes a very different vision of the economy. It allows us to concentrate our attentions on certain key variables - such as income and investment. This, in turn, makes policy more transparent in a Keynesian model, precisely because the key variables and relations are identified, it becomes clear which ones should be targeted and what their main or primary impact will be. In other words, unlike the general equilibrium model, where all variables influence all other variables, so policy implications are difficult to draw out in the Keynesian system, the most important causal variables are readily identifiable and so susceptible to policy manipulation.

I would like, now, to turn to the question of the relation between monetary and real variables³. In mainstream theory the neutrality of money is a fundamental result. Within the analysis, the inflation rate is seen as being a monetary variable determined by the quantity of money. There are no long run effects of monetary variables on real ones - though, in the short run, the veil of money may flutter and splutter. So, when I was talking about simultaneous determination, it was only about real variables that I was referring. Employment, saving, investment, the rate of interest and relative prices were all determined within the real sector. The price level was seen as being a monetary variable determined within the monetary sector via the quantity theory. Accordingly, in the long run, the price level was seen as being exogenous to the real sector, being determined by the supply and demand for money. As a result, we had the neutrality of money in the long run, whereby monetary variables could not effect real variables, and vice versa. According to Pigou, money is a veil. It is a surface phenomenon, having no real influence except that it can hide the underlying real story. Economic agents see the economy through the veil of the monetary variables, which lie between the real variables and those agents. In other words, the perception of the economy was as if there was a box in which real variables were determined (including the rate of interest). In another box the monetary variables determined the inflation rate, with no connection between the boxes at least in the long run. This can be represented as in the Table below, where there are no connections between monetary and real variables⁴: In other words, monetary variables cannot affect real ones.

For Keynes, on the other hand, there are causal links between monetary and real variables. He passionately believed in the necessity of integrating monetary and real analysis. As the rate of interest is determined by the supply and demand for money, it is the reward for parting with liquidity - and is, therefore essentially a monetary phenomena. It, in turn, influences investment, which, in turn effects nominal and real income. With a given money supply, this will feedback into further changes in the rate of interest. Note the clearly spelt out

Table 1
Relation Between Monetary and Real Sectors in Neoclassical Economics

MONETARY SECTOR		REAL SECTOR	
money demand	V	interest rate	
absolute prices	E	saving	
	I	employment	
money supply	L	investment,	
		relative prices	

causal relations. In other words, for Keynes' analysis, monetary and real variables cannot be separated. Monetary variables affect real variables and real variables affect monetary ones.

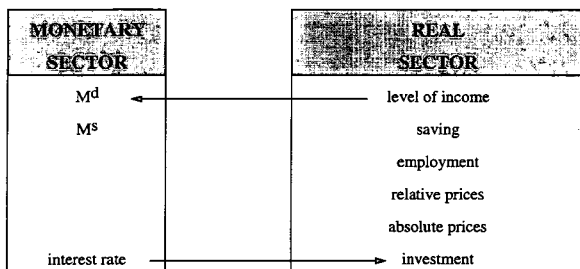
Keynes used this to argue that, instead of the neoclassical dichotomy between monetary and real analysis, these need to be integrated, and that the correct dichotomy was between micro and macro analysis:

The division of economics between the theory of value and distribution on the one hand and the theory of money on the other hand is, I think, a false division. The right dichotomy is, I suggest, between the theory of the individual industry or firm and of the rewards and the distribution between different uses of a given quantity of resources on the one hand, and the theory of output and employment as a whole on the other hand. ... as soon as we pass to the problem of what determines output and employment as a whole, we require the complete theory of a monetary economy. [p. 293]

In Keynes' analysis monetary and real variables cannot be separated, as they are in neo-classical theory. Money is not neutral, as these comments, indicate. The rate of interest, which is a monetary variable, with the marginal efficiency of capital determines the level of investment, which, in turn, determines the level of both nominal and real income. These, in turn, influence the rate of interest by their effect on the demand for money. The absolute price level also moves from being determined in the monetary sector to being determined in the real sector by costs of production [pp. 292-298]. This can be summarised in the following Table. In other words, for Keynes, monetary variables can affect real variables and real variables can affect monetary ones.

I would like to conclude by reiterating what I see as the two main contributions of *The General Theory* which have, in a sense, been lost to the mainstream, and which could fruitfully be reconsidered. The first is the causal method which allows causal statements to be made, and is vital for any policy advice. The second is Keynes' abandoning the real/monetary dichotomy, in favour of an analysis where the real and monetary sectors are fundamentally seen as interdependent. Keynes believed that without these two aspects of economic theory, economics could not usefully analyse capitalist economies.

Table 2
Relation Between Monetary and Real Sectors For Keynes



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Notes

- ¹ Clearly any such discussion must be prefaced with a warning that the author has selected those aspects which he believes are most important.
- ² Pasinetti (1974) p. 44.
- ³ This part of my argument draws heavily on Kriesler (1997)
- ⁴ It should be noted that "real" in this table is used to explain variables determined in the "real" sector, and is being contrasted to variables determined in the "monetary" sector. This is a different dichotomy to that of nominal/real, which is referring to the role of price changes, not the sector in which the variables are determined.

References

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- Pasinetti, L. (1974) *Growth and Income Distribution* (Cambridge University Press)