

The Influence of the Great Depression on Keynes's 'General Theory'

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Keynes famously (or notoriously) proclaimed that ideas determine policies, and through policies, events. The ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed the world is ruled by little else.¹ This line goes back to his *Economic Consequences of the Peace* (1919), a scathing attack on the *ideas* of the peacemakers at Paris. The victors chopped up the empires of Germany and Austro-Hungary without giving a thought as to how to preserve the benefits of what had been a single market; they tried to exact reparations from their defeated enemies instead of helping them back onto their feet. Ruled by the wrong ideas they produced the wrong policy framework for the postwar world which had its predictable consequences: the collapse of the world economy and the second world war. The notion that they might have been prisoners of events (or interests) was absent.

Keynes's view of the relationship between ideas and events proved very influential (vindicating Keynes's view!). Although the Bretton Woods system set up in 1944 was a compromise between American and British perceptions of national self-interest, it was to a unique extent theoretically-based, and deliberately designed to avoid the 'mistakes' which had brought about the downfall of the interwar economy. In the same spirit, the 'golden age' of 1950-1973 has often been called 'the Keynesian age', with its clear implication that governments the world over followed the policy prescriptions of J.M. Keynes. Finally, the 'monetarist' period which followed the 'golden age' has been widely interpreted (at least by Keynesians) in the light of Keynes's dictum that 'it is ideas ... which are dangerous for good or evil.' (My italics.) As one would expect, Keynes had far less to say about the impact of events on ideas. Although he urged economists to 'choos[e] models which are relevant to the contemporary world'² there is no reference to the Great Depression in the *General Theory* (GT: 1936). (Contrast this with Lionel Robbins's *The Great Depression* (1934) which is an attempt to explain the slump along Hayekian lines.) Although the *fact* of the Great Depression (it might be argued) required the wholesale revision of a theory which assumed continuous (or semi-continuous) full employment, this is not the way Keynes introduces his 'revolution'. It is only in the last paragraph of his foreword to the French edition of the GT (1939) that he gets round to saying that 'a theory so based [i.e. the 'classical theory'] is clearly incompetent to tackle the problems of unemployment and of the trade cycle'. Even here the reference to 'events' is unspecific, since these problems long antedated the Great Depression.

Keynes's purpose is clear enough. He wanted to avoid the impression that he was explaining a particularly severe slump; that the inherited theory which assumed full employment was valid as the general case, with the Great Depression as an exception needing at best an *ad hoc* explanation. This would have been a perfectly reasonable strategy. Instead he implied that persisting mass unemployment was a permanent possibility, even probability, in unmanaged capitalist economies. He characterised 'classical theory' as a special case of a 'general theory' which could explain frequent and prolonged lapses from 'full employment'. His 'general theory' amounted to saying that full employment was a limiting case; it cannot be the general case in an economy where contracts, or debts, are fixed in money terms, and

economic agents are free to refrain from spending. The sting in the tail - the revolutionary part of the message - was that such an economy achieves full employment only fortuitously - as a result of a favourable demand condition³ - not through the self-correcting properties of the market system itself.

Why Keynes chose to do it this way rather than that way is a problem - except for those who simply *assume* he was right. Several possible explanations suggest themselves. First, he may have had a polemical purpose - to persuade politicians of the necessity to act. If so, he was a scientific charlatan for calling his theory 'general'. Or, secondly, his polemics may have been aimed at his own profession, especially its younger members, whose 'science' had nothing useful to say at a moment when the world economy was collapsing. Again, there will be a suspicion that truth was being sacrificed to influence. Thirdly, and most plausibly, Keynes was simply behaving like a scientist. Scientists don't like *ad hoc* explanations - explanations which cannot be incorporated into their theoretical schemes. They are generalisers - looking for theories which can explain the largest number of observations. Einstein generalised Newtonian physics, and Keynes believed he was doing the same for economics. Neoclassical theory could not explain unemployment. Of course, neoclassical economists offered all kinds of institutional explanations, but the repeated recurrence of unemployment suggested that the institutions which jammed the economy (e.g., wage-bargaining institutions) were epiphenomena of a deeper reality, which Keynes identified as pervasive uncertainty. Thus his 'general theory' could abstract from the institutions to the central connection between uncertainty and money.

There was one enormous cost in Keynes's generalising strategy. It leaves open the question of why the Great Depression was so much worse than previous episodes. By implying that the Great Depression was the general case, Keynes offered no explanation of the Great Depression. As Kenneth Arrow points out, 'The more one uses general categories to satisfy a need to generalize, the more one neglects 'irrelevant' differences among the specific cases, the instantiations of the general statement'.⁴ Of course, the Great Depression was not the general case, otherwise it would not have been called the Great Depression. It was at one extreme end of a range of possibilities, at the other end of which was 'full employment'. Now it does matter enormously for the design of a policy regime to have some idea of where in the range of possibilities an economy with specified features is likely to be most of the time - whether the neoclassical theory or 'Mr. Keynes's special theory' as Hicks perceptively called it is likely to be a reasonable approximation to reality more often than not. There is nothing in the *GT* which gives one any secure guidance on this point. The policy counterpart of Keynes's institutionally featureless 'general theory' is an equally institution-free 'discretionary' financial (monetary and fiscal) management by the central authority. As we have discovered since 1936, there are costs to this, and we want to know whether these costs are being well incurred. Long before the *GT* appeared, Edwin Cannan of the LSE accused Keynes of prescribing for the 'trumpety trouble of a credit cycle' whereas the much bigger problem was 'unlimited currencies'.⁵ To put the matter concretely: if all Keynes's 'general theory' showed was that capitalist accumulation proceeded by fits and starts, then this might be an acceptable price to pay (e.g. for greater dynamism and inventiveness), with the problem of compensating the 'victims of progress' left to 'social policy'. Or to put it in Kuhnian terms: the *fact* of recurring unemployment, would not have called for a 'paradigm shift' had the unemployment been sufficiently transitory. Keynes's achievement was to suggest that the particular fact vivid in his fellow-economists' minds was the most important fact about the *modus operandi* of unmanaged market economies. The impression that Keynes's 'general theory' left on economists and politicians was that the Great Depression was the normal condition of mature capitalist economies, which could only be overcome by a continuous flow of exogenous

government expenditure. This is not a formally correct description of the *GT*, but it was how it was received.

What I shall argue below is that the whole structure, argument, and tone of the *GT* was dictated by the Great Depression itself, and particularly by the collapse of the American economy - Keynes would not have written this kind of book had the world economy not collapsed between 1929 and 1932. So we are dealing with the impact of a particularly dramatic event on the speculative, generalising mind of a scientist in that range of science which is linked most closely to art. However, we must dispose on the way of a strong and increasingly influential counter-thesis: which is that the development of Keynes's thinking, and particularly its passage from the *Tract on Monetary Reform* (*TMR*: 1923) to *A Treatise on Money* (*TM*: 1930) to the *GT* (1936) was the result of an 'internal' logical development, which had little reference to outside events. Whether it was revolutionary or not (and there are fierce arguments between the 'continuity' and 'revolutionary' schools) is a secondary point. The essential point is that the changing state of the world had little to do with it. I believe this is just plain wrong.

Let me guard myself against the charge of setting up an Aunt Sally to knock down. Whether the 'internalists' actually believe that external events had no influence on Keynes's thinking I don't know. They write as though they do. Not only are references to such events sparse in standard accounts of the 'road to' the *GT*, but they are not integrated into the analytical story, being left as historical chit-chat.

II.

The strongest, as well as the most recent, version of the 'internalist' thesis starts the road to the *GT* off with an *undergraduate* essay Keynes wrote in 1904 called 'Ethics in Relation to Conduct'. This was the seed from which sprouted Keynes's *A Treatise on Probability* (*TP*: completed in 1914 but not published till 1921). In the last ten years, dozens of books, chapters in books, and articles have appeared purporting to show how Keynes's earliest philosophical speculations about the nature of rational conduct under uncertainty form the epistemological bedrock of the *GT*, providing him with an alternative model of rationality to the neoclassical one, which he uses to explain why output is subject to dramatic collapses.⁶ I'm afraid I was partly responsible for starting this flood, in volume one of my biography of Keynes (1983), though it was Roderick O'Donnell who first alerted me to the importance of this archival material. Roy Harrod dismissed all Keynes's early stuff as infantile musings, of no interest to the student of his mature thought.

This is quite wrong. The ethical beliefs Keynes formed as a Cambridge undergraduate under the influence of G.E. Moore controlled his conception of what economics was for; and traces of his distinctive - or as it is called logical - theory of probability can be found scattered through his mature economic writings, including the *GT*. I would also allow that his distinctive theory of rational belief was at odds with the neoclassical theory of rationality (which assumes known probability distributions); and that some of his characteristic doctrines, like the liquidity preference theory of the rate of interest, presuppose the existence of unknown probabilities. O'Donnell's work, in particular, builds up the structure of Keynes's thinking from its 'philosophical foundations' with exemplary care and attention.

However, it would be wrong to see the *GT* in terms of an ineluctable application of Keynes's philosophical beliefs to the terrain of economic life, unmediated by intervening events. For one thing, there was very little emphasis on unknown probabilities in the *TP*; and Keynes's 'credit cycle' investment philosophy in the 1920s was predicated on the opposite assumption, viz. on the ability correctly to predict swings in currency and stock markets.⁷ Secondly, Hayek, Keynes's arch theoretical opponent, similarly rejected the perfect information postulate of classical (Ricardian) economics. Keynes's famous remark: '... the

fact that our knowledge of the future is fluctuating vague and uncertain, renders wealth a peculiarly unsuitable subject for the methods of the classical economic theory⁸ could well have been written by Hayek. Yet whereas Keynes drew from this consideration the conclusion that government could improve on market outcomes, Hayek drew exactly the opposite conclusion that government intervention, however well-intentioned, would damage the only mechanism (the price system) able to transmit dispersed economic information 'and coordinate individual plans (however imperfectly). Keynes, it must be said, never justified his assertion that the state was *better* able to 'calculate the marginal efficiency of capital-goods on long views' than the market system⁹, i.e., never explained why its power of calculation should be greater than that of dispersed agents.' The imperfect information postulate is evidently consistent with a large variety of theoretical analyses and policy regimes. It is worth making the point that none of those with whom Keynes debated theoretical or practical issues ever claimed that the market mechanism was perfect. What they disputed was the utility of a theoretical account of economic behaviour that put market failure at its heart; and they particularly feared the policy implications of doing so: for example, the banker Robert Brand who wrote in 1925: 'I should myself still prefer to rely on the gold standard, defective as it is ... than entirely on the skill and economic knowledge of bankers harassed by politicians'.¹⁰

The strongest objection to the 'internalist' thesis in the above form follows from the last point: it cannot explain the differences between the *TM* and the *GT*. The notion that vague, uncertain, and fluctuating beliefs about the future can bring about severely sub-optimal states of affairs - especially via liquidity-preference - is clearly present in the *TM*, as in earlier of Keynes's writings. (See 'The End of Laissez-Faire', 1924-6, when Keynes writes that 'many of the greatest economic evils of our time are the fruits of risk, uncertainty, and ignorance'¹¹.) What is lacking from the *TM* is the notion of a determinate sub-optimal equilibrium. But neither this lack, nor its remedy in the *GT*, has anything to do with Keynes's theory of knowledge.

The more familiar form of the 'internalist' thesis is that which sees the progression from the *TMR* to the *GT* as a process of correcting logical mistakes, as anomalies and difficulties multiplied in Keynes's attempt to give a theoretical explanation of certain states of affairs. Notice that practically all 'internalist' accounts assume that Keynes was trying to explain the *same state of affairs* in each of his three theoretical books.

Take Eprime Eshag on Keynes's gradual emancipation from the quantity theory of money: 'the quantity theory was primarily concerned with the explanation of price changes when the levels of employment and production were explained in real non-monetary terms'; consequently, it 'was found ... to a large extent irrelevant as an instrument of analysis of short-run unemployment and production problems ...'¹². Was this why Keynes abandoned it after he had written two books (the *TMR* and the *TM*) which had both tried to use versions of the quantity equation to analyse 'short-run ... problems'? I very much doubt it. A key point, which I shall expand later, is that his three theoretical books were designed to explain different problems.

Leaving this to one side, none of the 'monetary reformers' of the 1920s, such as Keynes, Irving Fisher and Knut Wicksell held to the *QTM* in its stringent form, i.e., that which regarded *V* as a short-run constant. Rather, what they did was to use the *quantity equation* to analyse the monetary disturbances they were concerned with. Eighteenth century rationalists paid due obeisance to God as the ultimate cause, and then proceeded to formulate their doctrines without further reference to Him. Early twentieth century quantity theorists behaved in much the same way. Their doctrine seems to have consisted of the following elements:

- a) the short-term non-proportionality between money and prices. This means that *V* (velocity) is not constant in the short-run, and that changes in the quantity of money

supplied and demanded affect both prices and output, upwards and downwards. (Keynes's 'In the long run we are all dead' is the best-known phrase in this type of argument.) Thus the starting point (especially of the upward swing) is not necessarily full employment (though no one said this quite clearly). Most of these early 'monetarists' would have said that changes in the quantity of money do not affect prices proportionately because some prices (contracts) are stickier than others, bringing windfall gains and losses to entrepreneurs, and because price instability produces contractual uncertainty. All this goes back to the nineteenth century: hence the emphasis of the monetary reformers on price stability, their attack on the gold standard for not ensuring it, etc.;

b) instability of the price level could arise either from changes in the supply of money (M) (acts of inflation or deflation by the monetary authority) or from changes in the demand for cash to hold (k - the reciprocal of V) - agents wanting to hold less or more of their incomes in the form of money balances. Thus, the total quantity of cash in circulation was the result of both money supplied and money demanded. However, the interaction between the M and k was not well explained except in the case of inflation (here the *TMR* broke new ground in Keynes's analysis of the 'inflation tax').

c) the demand for money to hold was a transactions demand - that is, money balances were held for business reasons (by firms) and for convenience (by individuals). This meant that the demand for money fluctuated with the state of business, though it did so - outside hyperinflationary episodes - in a contra-cyclical, or stabilising way. An increased demand for money would raise interest rates in booms, a decreased demand would lower them in slumps. In the *TM* Keynes added a crucial innovation in the form of a 'speculative' demand for money which could be pro-cyclical, or deviance-amplifying. Here the demand for cash was linked to the expected prices of securities, with the stability of the system depending on a 'division of opinion' between 'bulls' and 'bears'.

That changes in the quantity of money could bring about short-run changes in output as well as prices was thus already accepted by the so-called 'quantity theorists'. What was left largely unanalysed, until Keynes started on it in the *TM*, were the causes and effects of 'autonomous' fluctuations in the demand for cash balances. Here Eshag is right, because the quantity equation does not contain the variables necessary for a short-run theory of output. From the standpoint of such a theory fluctuations in the demand for cash appear as effects rather than causes.

Despite this the quantity equation retained its usefulness for policy by indicating how changes in bank deposits might be *offset* by changes in the quantity of money supplied by the monetary authority. This is clear in the *TRM* (iv, 68) and even more so in the *TM*, where Keynes writes:

Those who attribute sovereign power to the monetary authority on the governance of prices do not, of course, claim that the terms on which money is supplied is the *only* influence affecting the price level. To maintain that the supplies in a reservoir can be maintained at any required level by pouring enough water into it is not inconsistent with admitting that the level of the reservoir depends on the many other factors besides how much water is poured in.¹³

More fundamentally, the reason the monetary reformers were willing to concede the long-run to the quantity theory was that the problems they were analysing did not require its abandonment. They were working with a model of self-adjusting economies, which needed monetary 'therapy' to ease the pains of the transition from one state of satisfactory equilibrium to another. Keynes's *TMR* was at least as much concerned with the problem of inflation as of unemployment: it was, in Fisher's phrase, the 'ebb and flow' of prices which Keynes wanted to control, and not surprisingly since the *TMR* was written against the background of high, even hyperinflation. When Keynes was writing the *TMR* he had no inkling that the heavy

unemployment which had developed in England since the end of 1920 would persist for the rest of the decade: indeed recovery had already started, and he expected it to continue. Persisting mass unemployment was not therefore a problem to be explained. What there was was a 'credit cycle' and this could and should be controlled by the monetary authority in the interests of social peace.

This was very much the frame of mind in which Keynes started on the *TM* in 1924: he thought of it, at first, as a theoretically expanded *TMR*, designed to illuminate the processes by which credit was created and liquidated by the banking system, with actions of the Federal Reserve Board as the shining example of credit cycle management. By the end of the decade, when he finished writing the *TM*, persisting mass unemployment was a problem, but it was not a world problem: it was Britain's problem. Most of the rest of the world - and particularly the United States - had boomed in the 1920s. Hence, embedded in the credit-cycle theory was an analysis designed to show how the adjustment mechanism could get 'jammed' by policy decisions inappropriate to a particular set of institutions. Kaldor (not a generalizer by nature) wrote that Keynes in the *TM*:

put forward a macroeconomic 'model' of the British economy which in certain respects was superior to that put forward six years later in the *General Theory*. This is because his analysis specifically referred to Britain and examines the *modus operandi* of the British economy in the context of her peculiar institutions. Exports, the trade balance, the flow of overseas lending, the nature of the adjustment mechanism in foreign trade, the instruments employed by the Bank of England are brought into relationship one with another to show how the system generates a low employment trap, as a result of the high interest rates enforced by the Bank of England ...¹⁴

Basically, there would have been no British unemployment problem had the authorities not overvalued the pound in 1925. And the pound would not have been overvalued had British wages been more flexible. No theoretical revolution was required to explain Britain's 'peculiar' problem. Keynes was exceedingly unlucky in the *timing* of the *TM*, since by the time he finally stopped writing it in 1930, the world depression had struck. So there were actually three books in one, trying to explain three different phenomena - the credit cycle, Britain's low employment trap, and the onset of the world depression - by means of a single theoretical framework. No wonder the task defeated the increasingly frantic rewriting by which Keynes tried to keep up with events.¹⁵

The final proposition in the 'internalist' account of the development of Keynes's thought is that the determinate equilibrium theory of the *GT* was the result of the correction of a logical mistake in the *TM*, involving the famous 'banana parable' in which Keynes tried to encapsulate his new theory.¹⁶ In this parable, Keynes showed how the economy of bananaland, in face of an increased propensity by its inhabitants to save, ran down uncontrollably until it became so poor that saving petered out.¹⁷ Patinkin has argued that this parable ignored the equilibrating effects of income adjustment, which would bring the downswing to a halt long before impoverishment brought saving to an end. Keynes was implicitly assuming, Patinkin argued, that the community's saving equalled business losses until income had reached a desperately low level. Once Richard Kahn had produced his multiplier theory, and Keynes had converted it into the consumption function, Keynes realized his mistake and the royal road to the *GT* was open. A stable position of equilibrium was possible at less than full employment. No reference to the state of the world is needed to explain the 'transition' from the *TM* to the *GT*. The only thing to argue about is when Keynes first grasped the equilibrating mechanism.

I don't read the banana parable in this way. There was no consumption function, to be sure, but Keynes certainly did not assume such an odd propensity to save: he was clear that as

the community got poorer the amount of the community's saving dropped. The parable was used to drive home as dramatically as possible the point that if the rate of interest was prevented from falling, large parts of industry would be bankrupted, and economic life would sink to a much lower level. He later admitted, in the preface to the *GT*, that he had left the course of events following a 'shock' in a 'very confused' condition, largely it seems as a result of his dysfunctional definition of saving. There was evidently a good deal of intellectual tidying up to do. But it would be absurd to claim that this justifies an entirely 'internalist' interpretation of the transition from the *TM* to the *GT*. Another feature of the banana parable has not been so widely noticed. An impoverished community is not necessarily one in which people are unemployed. This may be thought of as another 'mistake'. But all Keynes is saying is that in a community without a dole no point of rest is possible short of full employment. This is correct. The concept of unemployment equilibrium is only a particular application of the general Keynesian theorem, that when people want to save more than they want to invest the community becomes poorer; whether in this state of poverty everyone gets some sort of work or some people are maintained in idleness is a matter of institutional arrangements.⁸

III.

All revolutions in thought are brought about by active intelligences reflecting on the nature of reality. Moreover, once a science is established, reality is interpreted within the established categories of the relevant discipline. In that sense, all scientific revolutions are partly 'internalist'; I doubt if there has been a genuine Kuhnian 'paradigm shift' since 'normal science' got established in any branch of intellectual enquiry. Events do not determine thought. Even in the social sciences when the active intelligence confronts a shifting reality, a reductionist interpretation is untenable: ideas are never epiphenomena. Moreover, some so-called revolutions in economics do not appear to be much affected by external changes: for example, no public events cast much light on the marginal utility revolution of the 1870s, which, incidentally, was entirely consistent with the earlier Ricardian paradigm. Nor am I claiming that the Great Depression was the only 'external' event shaping the *GT*. Keynes's commitment to the inherited way of doing economics had been weakened by a succession of events about which mainstream economics had nothing to say. Analysis of the business-cycle and monetary disturbances was left to peripheral sub-divisions of the central discipline, and not incorporated into the established picture of how 'normal' economies behave. Keynes shifted the focus of the discipline onto these problems. This said, it can be shown that the Great Depression was decisive for the reshaping of the *TM* into the *GT*, both in terms of method and units of analysis. The crucial influences of the world depression on the *GT* are seen in:

- A. *The shift from an open to a closed economy analysis.*
 - B. *The shift from dynamic to static analysis.*
 - C. *The assumption of wage flexibility.*
 - D. *The liquidity trap.*
- All in a sense follow from A.*

A. The analytic structure of the *TM* was set up to illuminate the problems of an 'open' economy with a rigid cost structure. Given the chosen exchange rate the credit-cycle adjustment mechanism was jammed. The unjamming was a matter of lowering the exchange rate: there was nothing in the *TM* to suggest that this would not do the trick. Otherwise it can be read as a theory of deep cycles. By 'closing' the economy - by treating the world as a single economy - Keynes was adapting his analysis to the fact of world depression. In addition, if the problematic of the *TM* was the British problem, that of the

GT was the American problem. Keynes was particularly impressed by the scale of the American collapse. Here was no sclerotic economy like Britain's, but one which retained a great deal of its fluidity, and which, moreover, was only marginally involved in foreign trade. The collapse of the American economy could not be explained by the circumstances of its interaction with the 'world economy'. The US collapse spurred Keynes to think more generally about the predicament of modern economies. The older emphasis on institutions gives way to an increased attention to 'uncertainty', the ravages of speculation and the shrinkage of investment opportunities. Ch. 12 of the *GT* on the stock market is much more a stylised account of the New York stock exchange boom-bust of the late 1920s, than of anything to be found in Europe.

In face of the world collapse, whose epicentre was the United States, a terms of trade analysis of the unemployment problem was analytically irrelevant. As Keynes noted in the *New Statesman* of 24 December 1932, 'The course of events, as we all know, moves round a closed circle. When we transmit the tension, which is beyond our own endurance, to our neighbour, it is only a question of a little time before it reaches ourselves again travelling round the circle'. By closing the circle in the *GT* Keynes is able to dispense with having to distinguish between domestic and foreign trade. He is also saying that the unjamming mechanism he relied on in the *TM* - devaluation - is no longer operative.

B. The influence of the Depression is also seen in the switch from dynamic to static analysis. In the *TM* Keynes is interested in uncovering the dynamics of the 'credit cycle'. As he put it before the Macmillan Committee: 'I want to understand what happens during the process of disequilibrium'.¹⁸ Dynamic analysis is about disequilibrium states - about the processes of transition. The Swedes never abandoned this kind of theory. In the *GT* the focus is on the forces capable of determining an equilibrium position short of full employment. (The dynamics - analysis of the business cycle round a point of sub-optimal equilibrium - is segregated into chapter 22.) This shift in attention is reflected in the change in focus from prices to output. Hicks suggests that 'no change in world conditions between 1930 and 1936 can explain this change in focus ...'.¹⁹ But changing prices are disequilibrium phenomena, whereas what needed to be explained, it seemed, in the early 1930s, was the relative stability of prices (in the industrial world at least) and the heavy fall of output.

C. Keynes no longer needs wage rigidity to explain anything. The fact that some wage systems were rigid and others flexible made no difference. In July 1932 he told the Australian economist Giblin 'if wages are reduced prices are sure to go down too ... prices [are] related to costs as a cat to her tail'.²⁰ This is a closed economy idea. If a firm reduces its costs it can sell more of its output; so can a country; but wage reductions applied all round simply destroy demand. Clarke is right to suggest that Keynes's new emphasis on the 'fallacy of composition' was 'continually prompted by the experience of the world depression'.²¹

D. Experience of the Great Depression undermined Keynes's faith in the efficacy of monetary policy. 'It may still be the case' he said in Hamburg February 1932 'that the lender, with his confidence shattered by his experience, will continue to ask for new enterprise rates of interest which the borrower cannot expect to earn If this proves to be the case there will be no means of escape from prolonged and perhaps interminable depression except by direct state intervention to promote and subsidise new investment'. He hoped the world economy would not have to wait for a new war to pull it out of the

slump.²² Technically, there is no 'liquidity trap' in the *GT*. But liquidity trap situations certainly existed in Germany and the United States at the bottom of the slump. (When prices are collapsing, as they did in primary products, no liquidity preference theory is needed to explain the rise in real interest rates.) Keynes's 'Means to Prosperity' which he wrote in 1933 recognised the inefficacy of monetary policy in both situations. It advocated loan-financed public works policies for industrial countries, and a variety of price raising schemes for primary commodity producers.

IV.

The main argument of this paper has been that historical context is crucial for understanding the development of Keynes's ideas. No purely 'internalist' explanation of the 'road to the *GT*' can be sustained. Even in the Keynesian heyday, a dissenting minority of economists always recognised that Keynes's work was not context-free, Robertson regarding it as a theory of a very deep slump. Technically, Keynes did produce a 'general' theory, but its utility depended very largely on the world being more like the world of the 1930s than the world of (say) the late 19th century. To invert Keynes, the 1930s was a 'special case', and Keynes's 'general theory' was constructed to understand this 'special case' and suggest an appropriate role for government.

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Notes

- ¹ JMK, GT, p. 383.
- ² JMK, CW, 14, pp. 296-7, 300.
- ³ JMK, GT, p. 307.
- ⁴ In William Parker ed. *Economic History and the Modern Economist*, Oxford: Basil Blackwell (1986), p.17.
- ⁵ E. Cannan to JMK, 9 February 1924; q.R. Skidelsky in M. Blaug et al. *The Quantity Theory of Money from Locke to Friedman*, Aldershot: Elgar (1995), p. 89.
- ⁶ See R.M. O'Donnell, *Keynes: Philosophy, Economics and Politics* (1990); Anna M. Carabelli, *On Keynes's Method* (1988); Athol Fitzgibbons, *Keynes's Vision: A New Political Economy* (1988); John B. Davis, *Keynes's Philosophical Development* (1994) for the most substantial work in this genre.
- ⁷ See R. Skidelsky, *The Economist as Saviour* (1992), p. 106.
- ⁸ JMK, CW, 14, p. 113.
- ⁹ JMK, GT, p. 164.
- ^{*} He would have claimed that the state's investment decisions would be less volatile, obviating periodic collapses caused by stock-market gambling, panics, etc. Hayek would be replied that leaving investment to the state multiplied the risk of cumulative mistakes. Keynes, in any event, abstracted from all possible sources of volatility emanating from the political process.
- ¹⁰ q. Skidelsky, *The Economist as Saviour*, p. 161.
- ¹¹ JMK, CW, 9, 291.
- ¹² Eprime Eshag, *From Marshall to Keynes: An Essay on the Monetary Theory of the Cambridge School*, Oxford: Basil Blackwell (1963), p. 34.
- ¹³ JMK, TM, 6, p. 304.
- ¹⁴ In A.P. Thirlwall ed. *Keynes as a Policy Adviser*, London: Macmillan (1982), pp. 8-9.
- ¹⁵ For the best account of how Keynes made up 'theory on the hoof' in the TM, see Peter Clarke, *The Keynesian Revolution in the Making*, Oxford: Clarendon Press (1988), esp. pp. 54-8.
- ¹⁶ D. Patinkin was the best known exponent of this proposition: see his *Anticipations of the General Theory?*, Oxford: Basil Blackwell (1982) esp. pp. 15, 49.
- ¹⁷ JMK explained the meaning of the banana parable rather more clearly to the Macmillan Committee in 1930; see JMK, CW, 20, p. 127.
- ¹⁸ What Keynes might have been driving at here survives in a rejected draft of the GT, where he is discussing the meaning of involuntary unemployment: 'This does not imply that labour, which is suffering involuntary unemployment is idle. It may be employed as a *pis aller* in some occupation where it earns a real wage less than the wage potentially available'. (CW, xiv, p. 364.) On this view an accountant who could find work only as a taxi driver would be regarded as 'involuntarily unemployed'.
- ¹⁹ JMK, CW, 20, pp. 50-1.
- ²⁰ J.R. Hicks, *Critical Essays in Monetary Theory*, Oxford: Clarendon Press (1967), p. 192.
- ²¹ JMK, CW, 21, p. 99.
- ²² Clarke, op. cit., p. 272.
- ²³ JMK, CW, 21, pp. 59-60.

References

- JMK refers to John Maynard Keynes; CW refers to the *Collected Writings of John Maynard Keynes*, published for the Royal Economic Society, 1970-1989; GT to *The General Theory of Employment, Interest and Money* (1936), Macmillan, London, volume 7 in the CW; TM to *A Treatise on Money* (1930), vols. 5 and 6 in the CW.