Is Keynes Dead?

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I want to argue today that Keynes is not dead. The impetus for giving this talk arises from a number of events. The first one was the death of Keynes' favourite pupil Richard Kahn in 1989. (A special issue of the *Cambridge Journal of Economics* is being prepared as a memorial to Richard and for that I have written a paper called "Kahn and Keynes and The Making of *The General Theory*".)

Secondly, a very fine book by a Brazilian economist came out in the late 1980s: Edward Amadeo's *Keynes's Principle of Effective Demand* (1989, Aldershot, Wedward Elgar). I think it is the best analytical account of the transition in Keynes' thought from the *Treatise on Money* to *The General Theory*. I think the best historical account is Peter Clarke's marvellous book on *The Keynesian Revolution in the Making*, 1924-1936 (1988, Oxford, Oxford University Press). There, he uses the skills of the historian, goes to the archives and shows what an extraordinary quick thinker Keynes was because he would appear before the Macmillan Committee during the day and then rush back and revise the proofs of the *Treatise on Money* to take into account the latest arguments raised before the Committee or ideas he had during the day. Keynes did his first draft always in galleys. He had an agreement with Macmillan that he could do everything in galleys, and then he would rewrite the second draft as corrections to the galleys and send the galleys back again. I don't think anyone would do that now because you don't have galleys with modern printing.

The third event was the publication for the first time in English of Kahn's *The Economics of the Short Period* (1989, Basingstoke, Macmillan) which he wrote in eighteen months in 1928-29 as his Fellowship Dissertation for King's College, Cambridge, after he had spent *one year* learning economics. We can see that virtually all the major innovations we need for imperfect competition theory were worked out here. The work was then hidden away till the early 1980s when it was published in Italian and then, in the late 1980s, in English just after he died, although he had corrected the proofs.

Kahn had an extraordinary fertile and innovative mind. This is relevant for thinking about Keynes then and Keynes now because the object of Kahn's work was, first of all, to put the short period at centre stage rather than just a station on the way to the long period cross which is how Marshall saw the short period. Marshall regarded, as Kahn argued, Book V on the Long Period theory of normal prices and quantities as the core of the *Principles*. Kahn's first major change of emphasis was to make the short period a subject of study in its own right. This was tremendously important, not because Keynes had not been coming independently to a similar

opinion, but because he could now work with someone who had that point of view.

It is very interesting if you look through, say, Gerald Shove's Principles Lectures in 1928-29 - of which we have copies in Cambridge - to find that you are three quarters of the way through before he even mentions the short period. If you look at Dennis Robertson's Principles Lectures, the long period dominates, in terms of a Say's Law position, even though Robertson's major innovative contributions, as opposed to expositions, were on the theory of the trade cycle and of monetary-real sector interaction.

Secondly, Kahn departed from perfect or even pure competition. The difference between perfection and purity is that to be perfect you have to know the future as well as have no power, to be pure, you just have to have no power. So Kahn developed a very realistic theory of imperfectly competitive markets and firms, including the kinked demand curve and the reverse L shaped cost curve and all the paraphernalia of modern monopolistic competition or imperfectly competitive theory.

Now, the mystery is why did Keynes take over the first change of emphasis and concentrate on the short period when he came to write *The General Theory*, but resolutely refuse to use microeconomic foundations which were imperfectly competitive when Kahn had them all there?

Then there is the multiplier article, which takes the apparatus of the *Treatise on Money* and works out in quantitative terms what Keynes and Hubert Henderson did not do in their pamphlet *Can Lloyd George Do It?* They could not answer even the crude Treasury view because they could not address two issues: a) what would be the total rise in employment and b) they had not developed the idea that investment created the saving, if you started from a situation of some unemployment.

Kahn answered both those questions in a very rigourous and careful way. Nevertheless, he had Marshallian competitive supply and demand structures as the microfoundations. And they went into *The General Theory*. It was not until 1939, when Keynes responded to Tarshis' and Dunlop's findings (also Kalecki's) about real wages and money wages, that he had a rather reluctant flirtation with what we now call normal cost pricing theory. When he wrote to Ohlin, who had noted that it almost seemed that Keynes had never talked to Mrs Robinson, or read her theory of imperfect competition; Keynes said that he was very puzzled about his comments on this because he had showed his proofs to Mrs Robinson and she had never suggested imperfect competition, and he did not see how it was relevant. He continued that as to the criticism of diminishing marginal productivity in the short period, he thought that that was "the one incontrovertable proposition of our miserable subject".

The other thing I want to say about Keynes himself is although Keynes read mathematics as an undergraduate, he really spent as much if not more time on philosophy and he was a philosopher, a innovative and outstanding philosopher, before he became an economist. (The definitive work on Keynes's philosophy and economics was written by Rod O'Donnell who is here today).

This is so important for understanding (a) Keynes himself, and (b) some facets of modern economics, because he brought at least three things from his philosophy, which is very important for understanding economics. People like Rod, Anna Caravelli, John Coates and Athol Fitzgibbons have brought this to our attention.

First of all, the whole is not necessarily the sum of the parts, and that paved the way for Keynes to do macroeconomics in a way which was very innovative. And secondly, his use of philosophy, particularly in the *Treatise on Probability*, to explain how sensible people behave in uncertain circumstances, doing the best they can. That dovetails very well with Marshall's account of business people's behaviour. Marshall had a very realistic account of this and the things they have to cope with, the uncertainty of the future, whenever they are making their production and investment decisions. Keynes could take his philosophical views on that and adapt them to his understanding of what would happen in systems where uncertainty was an inescapable fact of life. Then you try to explain the behaviour, both of the people in the system and of the system itself.

Those were two very important things which I think he took from his philosophical training and because we didn't know, or we had not thought how important that was, it was not until people like O'Donnell mentioned it to us that we could reread *The General Theory* and the contributions there in a new light. The third thing that came over, which I think is the most important lesson we can take both about understanding Keynes but also about doing economics, is that Keynes thought that in a discipline like economics there was a whole spectrum or continuum of languages which range all the way from intuition and poetry to lawyer type arguments to formal logic and mathematics. All had a part to play according to the issues that you were looking at and the aspects of the issues that you were dealing with; so that as you go through *The General Theory*, the language continually changes.

The most striking example is where Keynes struggles with being formal about investment theory in chapter 11 and makes one heck of a mess of it. I think he was eleventh wrangler, that means he got the eleventh best first class honours in maths, but I think he probably forgot all his maths by the time he was in his late forties, so there is a lot of errors running through the maths of *The General Theory*. His incoherent conception of specified rigorous models in chapter 11 cannot be straightened out. As Tom Asimakopulos, Joan Robinson and Kalecki have shown the ingredients are there, but you need a new recipe to make it sensible.

But then having written the chapter on the MEC, he went off into probably the best chapter of *The General Theory*, chapter 12, which is about the state of long-term expectations, where he uses beautiful English language to try and capture how people behave under uncertainty, how stock exchanges work, how valuations of stock exchanges feed through into real investment expenditures, the conditions under which speculation is beneficial, the conditions under which it's harmful and so on... all beautifully written. And it is interesting that when Shove wrote to him about *The General Theory* to say how much he enjoyed it and what a revolutionary book it was and so on, he said "I get lost though in your work on expectations". Keynes wrote back to say "No, you don't because you must remember that when you enter the realm of expectations, you leave the realm of the purely formal" and he described the change in language that occurred between chapter 11 and chapter 12. When you look at it that way, Shove was presumably better able to understand what was going on. So that's the third of many things that you can take from Keynes' philosophy as far as his economics is concerned.

I suppose to economists these days *The General Theory* is a relatively easy book, which can be put down into one or two diagrams, so we wonder why he spent three

or four hundred pages writing it. We have to think back to what he was facing when he was doing it, not only because it is interesting historically but because as Keynesianism is now rising again like a phoenix from the ashes, it is again confronting exactly the same system conceptually, I mean much more squiggly sophisticated than Keynes was facing, but it is exactly the same system of thought as Keynes himself was liberating himself from. So it's interesting to see what were the steps of his liberation.

The first thing that he was brought up on by Marshall was that if you are going to write the *Principles of Economics* in three books (which is what Marshall set himself to do, though he never did get round satisfactorily to doing it) then in the first book, you talked analytically about real things, real quantities, relative prices; money and money prices had no analytical role to play. Marshall used partial equilibrium analysis, so he just showed how there was a tendency for individual markets to clear. But then the question arose of whether it would be analytically interesting to ask what determined employment and total output. The answer was no, because although he had only used partial equilibrium to show this tendency for markets to clear with supply and demand being equal, there was an appendix where you had a general equilibrium model and the same argument went through. So while it was an important practical problem, because Marshall knew about the trade cycle and all that, as an analytical or long period problem it was not an interesting one; so it was all done in real terms and Say's law was really a deduction from volume one.

Secondly, when you came into the saving-investment market, there was the concept of a real rate or a natural rate of interest which was the clearing price. Where on the saving side this reflected time preferences while on the investment side it reflected some sort of Fisherian rate of return over cost curve transforming present consumption into future consumption. That explained how the composition of Say's Law output was divided up between consumption and investment.

When you arrived in Volume II, you carried over for the version of the quantity theory of money that you used, the Say's Law long-period equilibrium output level to fit into the equation so that output and employment was in fact given, you had V and M and therefore you had a theory for the general price level. That is where money and absolute prices came in and then you discussed why the economy could fluctuate round those positions and how one might design monetary institutions which allowed the economy to recover from shocks and get back to that position as quickly as possible. If the fundamental determinants of that position changed, the tastes or the endowments or the techniques of production, the role of Volume II was to tell you how to go with as little pain as possible from the old to the new equilibrium position.

That was the sort of constraint on Keynes when he wrote the *Treatise on Money*, even though he was getting more and more interested in the cycle and lapses from full employment. He notes that he felt constrained from following out too far the intricate theory of short-period production because that was not the acceptable way to proceed when you are writing a treatise on money. You are not supposed to be talking about those things, by and large. He still thought that what he was doing in The *Treatise on Money* was providing a more usable version of the quantity theory of money and that his fundamental equations, which explain the price levels for available and unavailable goods, were just other ways of writing down the quantity

theory of money. Indeed, as Amadeo shows, they were in fact that, particularly in the long-period position so that you could either express the general price level in the fundamental equations or you could express it in quantity theory terms, you got the same answer.

In the *Treatise on Money* it is still true that real things rule and monetary things all had to adjust to them. For example, if you had malfunctioning in the economy, that meant that the banking system had set a money rate of interest which was inconsistent with the underlying natural rate or real rate and you would get malfunctioning until the banking system came to its senses.

He did try to talk about short-period production and employment problems in the famous banana plantation parable. In this parable, there is no endogenous process which stops a cumulative process once it has started. Keynes has a thrift gospeller to come in to help the people in this economy, where investment is making plantations and consumption is making bananas, and the gospeller tells them to save more. Then on the *Treatise on Money* equations, there is a cumulative downturn in prices, employment and production until they either all starve to death or they decide to change their investment function.

What Kahn did in the multiplier was really to provide the endogenous process, which would bring the process to an end. If you start off with investment rising then the output and employment rises till saving is equal to investment again, even on the *Treatise on Money* definitions. That was a tremendously liberating move to allow Keynes to go from *The Treatise on Money* to *The General Theory*.

Especially is this so because Kahn's work was accompanied by what is called Mr. Meade's relation. James Meade was sent to Cambridge for a year to learn economics before he could teach it in Oxford, and while he was there he was working in the Cambridge "Circus" discussing the *Treatise on Money*. Mr. Meade's relation was doing the multiplier by the saving leakage rather than leakage through the MPC and of course that was very important because it showed where the saving, which matched the investment, came from.

I am very careful to say "matched". Keynes, I think, was always very careful to say that investment led and saving responded and therefore, as he showed in 1937, because he had forgotten it in *The General Theory*, investment in turn is constrained by finance. You have to have the finance that allows the investment to occur, then the saving is created. But you still read in the textbooks about there being a need for the saving to finance the deficit and the investment: as though the savings had to come first in an unemployed situation, and then the investment followed.

But what Keynes argued when he brought in the finance motive in his article in 1937 was that the investment market can become congested through a lack of finance or cash; it can never become congested through a lack of saving. And he was explicitly assuming unemployment when he said that. Everybody would accept, I think, that at full employment saving has to come first to release the resources. As long as you have got unemployment there is such a thing as a free lunch. You can have saving, investment and consumption, all at the same time, without one being the alternative to the other.

Anyway, the point about Mr. Meade's relation was that he made explicit where the saving came from and that was the explicit answer to the Treasury View, that there is only a certain amount of saving around so if you use so much in the public

sector, there is that much less left to the private sector to invest. Of course, Keynes rather blew it as a debator in doing this because he revealed prematurely his answer to the Treasury View and they said "that's not our view at all. What we're really saying is that the public sector is so inefficient you should not let them do investment anyway because private people would do it so much more efficiently". That has a certain modern ring to it, in light of what Donald Horne calls "the economic fundamentalists" and others call the "economic rationalists".

Keynes then realised that Say's Law did not hold and therefore the quantity theory of money was not an explanation of the general level of prices. This had occurred in the *Treatise on Money*, although he could not see at that time that it was inconsistent with his system. But by the time Kahn wrote the multiplier article, he began to see it clearly. So he started to build up his system again, with money there right from the start rather than having it as a veil, as it were, in Volume II. He argued that Marshall's dichotomy, between the real and then the money, was quite wrong. You have to have a theory of a monetary production economy where money had a role to play as a medium of exchange, unit of account and store of value right from the start of the story.

What other changes occurred, because Keynes liked to make things always very stark so that you could see in very simple outlines what the fundamental change was before he put the modifications in? In the *Treatise on Money* it was the natural rate of interest which equilibrated real saving and investment, and then the monetary rate of interest had to be consistent with it. By the time Keynes got to *The General Theory*, he turned this round 180 degrees and he argued the money rate of interest, determined by the demand for money including liquidity preference and the supply of money, ruled the roost because of the peculiar nature of liquidity preference. His version of the natural or real rate of interest, which had become the expected rate of profit or the marginal efficiency of investment, had to measure up to the money rate of interest. That is the subject principally of Chapter 17 of *The General Theory*.

It is fashionable to be particular types of Keynesians, chapter 3, ch.12, ch.11, and the most sophisticated and really trendy thing to be in recent years was a chapter 17 Keynesian. If you can understand own rates of interest, and the money rate of interest rules the roost, and the peculiar nature of the liquidity variable, then you are a chapter 17 Keynesian. Barry Hughes pointed out to me that there are a number of hard-nosed financial American journalists who suddenly became chapter 17 Keynesians because they have recently discovered the liquidity trap level of the money rate of interest on American financial markets and they've given Keynes great credit for this theoretical idea. They have suddenly rediscovered liquidity preference, including a real life liquidity trap, which Keynes just conjectured as a theoretical probability.

The other major change was to build up the theory of the consumption function with the leakages and saving, and the theory of investment. Finally, there was chapter 21 on the general theory of prices where he said we will bring back to the fore those homely but intelligible concepts of short-period elasticities of supply and marginal costs. Again, he was quite Marshallian, but he just adjusted it or adapted it to get an aggregate short-period Marshallian supply curve which was the basis of the aggregate supply function.

Incidentally, much of this was clearly presented in Lorie Tarshis' Ph.D disserta-

tion. Tarshis used Gardner Means' theory of administered prices and built up a macro theory of distribution which is very like Kalecki's and then put in Kahn's, Joan Robinson's and Means' microfoundations in *The General Theory*. But that's never seen the light of day because when Tarshis submitted it to a publisher, a jealous and envious contemporary was the reviewer and, seeing his chance, rejected the manuscript for publication. Lorie went off to liberate Italy from the Germans in the American army and to meet his second wife in the process. So his Ph.D thesis was never published which was a great tragedy, but he did put Keynes' model in the 250 pages of his textbook published after the war. This was written in terms of aggregate demand and aggregate supply, which was always his framework of thought, and which he derived from Keynes' lectures, having been brought up on the *Treatise on Money* before he did *The General Theory*.

Tarshis fell victim of the U.S. Right Wing. His book was being prescribed by virtually every economics department in America when suddenly the Right got to hear about it, and fearing for the subversion of American youth, got Rose Wilder Lane to write a pamphlet condeming it and sent the pamphlet to every university in America. As a result a lot of the universities decided not to adopt the book. Lorie's book had only modest sales and the next year Samuelson's book, which was to teach generations of American economists, came out. Now I am not saying that Paul escaped the Right because he didn't. He got the remnants of its backlash; but he survived and his book took off. I think that it was a tragedy that it was Samuelson's book with the Keynesian cross which took over. Many people who have read Tarshis's text still say that his was the best account of Keynesian economics at a textbook level.

It is unfortunate in many respects that we have all been brought up on Samuelson instead of Tarshis. Let me explain why it is a tragedy (this relates very much to why Keynes is still very much alive). The monetarists and the rational expectations people thought that they had a caste iron empirical case in the 70s and 80s with which to reject Keynesianism. They believed that the stagflation episode conclusively disapproved the claims of Keynesianism.

Partly that was because the Americans Keynesians in the 1960s were grossly overconfident. It was Samuelson and Solow who said society could dine a la carte on any combination of inflation and unemployment they wished to choose. That was a very naive application of the Phillips Curve, and it meant that the Phillips Curve became identified as an important part of Keynesianism. Now you cannot find the Phillips Curve in *The General Theory*. It is completely foreign to Keynes' philosophy and understanding of the world to expect to find a sustainable empirical relationship of the nature of the Phillips Curve. Bill Phillips never claimed that it was other than an interesting empirical relationship, it was what people made of it and grafted it onto their view of Keynesianism that did the damage.

If we had used Lorie Tarshis' version of *The General Theory*, we would have had no trouble at all in having the start - not the end but the start - of an understanding of the stagflation episode. If you had built an imported cost inflation or an autonomous money wage rise into Lorie's version of *The General Theory*, the aggregate supply function would have moved in such a way that it would have given you a lower level of employment and a high general price level, which could have precipitated a stagflationary process. That is how Lorie saw it but given that we were not

brought up on that, and instead on IS - LM or the Keynesian cross, we just did not think in that way and so no one, with the exception of Lorie and the people who were influenced by Lorie, ever challenged the monetarists and rational expectationists on this.

Such a framework, however, would have led you to reply that stagflation is perfectly predictable from the analysis that comes out of *The General Theory*. I think that's a very important message to remember, especially since Lorie developed the aggregate supply function in an imperfectly competitive setting and not a purely competitive setting. He had made the step forward to put in the sort of micro foundations which Kalecki and later Sidney Weintraub also used.

The reason why I think that Keynes is alive and is also relevant, is that his framework of thought, which arose out of his struggle against the ideas that preceeded him, created an approach which, suitably adapted, is still relevent for understanding the world today and for mounting a critique of the present day alternative framework of thought which in its essence is the very framework from which Keynes liberated himself.

Of course, there are a number of adaptations that have to be made. I mentioned the change in the microfoundation. Secondly, it is very interesting that Keynes who spent most of his life writing and thinking about open economies, on the whole wrote *The General Theory* in terms of a closed economy. In the modern world, that is just impossible because we are so interrelated and so have to bring back the open economy aspects of Keynes' macroeconomics.

Thirdly, Keynes for the most of his life was an endogenous money person, rather than an exogenous one. In *The General Theory*, for quite wrong tactical reasons, he had money as exogenous. The quantity theory of money as an explanation of prices properly understood is a long-period proposition, not a short-period proposition. Most of *The General Theory* model, however, is short period and yet he is saying if you start from unemployment and you change the quantity of money, you may get patches of time where there is very little change in prices at all, because the marginal cost curves are rather flat. Most of the impact is on output and employment. So the quantity theory stands refuted, but that is a cheap debating point because you have changed the rules by which you are playing.

Now Kahn was always sceptical about the quantity theory of money. He could not understand why Dennis Robertson and Keynes thought of it as a causal relationship. Kahn kept pounding on at Keynes not to use quantity theory in a causal way. I think this had one bad result; Keynes then became an exogenous money person and that let Friedman in the door, which was a very serious error, not only for economic theory but much more so for the people who have been made unemployed as a result of contractionary monetarist policies.

Another change that had to be brought into Keynes' theory before we can say that Keynes has been suitably resurrected is that there is an implicit assumption in *The General Theory* that the long-term movement in prices is neither up or down, that there are cyclical ups and downs but there is no secular upward trend. That runs through the model and as Vicky Chick has pointed out you have to redo the model in the light of an expectation of rising prices before the model is suitable for understanding modern problems.

If Keynes is resurrected in the hands of Stiglitz, Blinder and Akerlof, and Solow

and Hahn redo *The General Theory* in modern terms, then Post Keynesian growth theory is going to make a comeback. Not only in the form of Kaldor's contribution but also Joan Robinson's contributions, suitably adapted to take in the cyclical growth theories of Kalecki and Richard Goodwin. Richard Goodwin is already becoming flavour of the month with many of the discerning young Turks in Italy and America and I wouldn't mind betting that he gets a Nobel Prize as a result.

Kaldor has come back even though he has not been acknowledged on the whole in the new growth theory - Lucas, Romer, Helpman and Grossman. Sometimes they remember to say that these ideas actually came from Kaldor, Myrdal and Allyn Young, but since the way they now train youngsters in America is that economics began ten years ago, these writers are unknown to them. What is worthwhile in the new growth theory is the taking up of the ideas of Kaldor, Myrdal and Young. I am sorry it is done in the way in which it's done. On the other hand, there is a very bright young fellow from Harvard, a Korean now at Notre Dame, and he has been doing the new growth theory but in a sort of post Keynesian - post Marxian cum Marglin framework. He has an article coming out on endogenous technical progress which I think will be the classic counter blast, it certainly will be the seminal answer to the new growth theorists.

If what Stiglitz and company have been doing does take on and attracts the bright young minds into Keynesian economics again then they will start reading about Keynes: and this, despite Mankiw saying that the best way to become a Keynesian is never to read *The General Theory*, which is a prejudice of his mentor, Bob Solow. Bob says that he is very glad that he learnt Keynes through Oscar Lange and Hicks' IS and LM rather than from *The General Theory* itself. I think that this is an aberration by Solow, and I hope that when people come back they will actually read *The General Theory* and the literature that is growing up around it on it's philosophical basis. But I also think that growth theory, in the form of cyclical growth, will come back into its own.

So for those reasons I would like to put to you the proposition that Keynes will come back, because Keynes is not dead, Keynes is very much alive and kicking.

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