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1

Introduction

We might play with the idea that the inability of the interest rate to fall has brought down empires. . . . Thus, it is of overwhelming importance that the optimum interest rate be determined by institutions and banking practice. And the bad effect of saving must be recognised. All past teaching has (if my view here given is correct) been either irrelevant, or else positively injurious. We have not only failed to understand the economic order under which we live, but we have misunderstood it to the extent of adopting practices which operate most harshly to our detriment, so that we are tempted to cure ills arising out of our misunderstanding by resort to further destruction in the form of revolution.

(Martin Fallgatter's notes of Keynes's 1933 lectures, quoted in Skidelsky, 1992, p. 502)

1.1 Keynes's solution to the Economic Problem

In the first half of the twentieth century, John Maynard Keynes provided a theoretical explanation for the operation of a free-market economy. This theory and the associated practical conclusions are lost to society. The 'Keynesian' economics that is most closely associated with John Hicks, Alvin Hansen and Paul Samuelson has betrayed not only Keynes's economic theory but also his policy conclusions. Throughout his life, Keynes was primarily concerned with monetary policy. Ultimately, Keynes set out debt-management, monetary and international financial policies that would facilitate the setting of appropriate rates of interest across the spectrum of liquidity.

The General Theory of Employment, Interest and Money not only demonstrated the effectiveness of fiscal policy but was the theoretical culmination of a prolonged enquiry into the nature of a free-market monetary economy. The theory offered a sophisticated diagnosis of the cause of what Keynes saw as the 'Economic Problem' of high unemployment, the business cycle and the extreme inequity of income distribution. The diagnosis concluded that the Economic Problem was not the inevitable condition of a free-market economy, but a consequence of a specific failure of policy: a long-term rate

of interest that was too high. Following the diagnosis of monetary cause, the theory prescribed a monetary solution. His liquidity preference theory of the long-term rate of interest had the fundamental conclusion that the authorities could bring the rate under their deliberate control.

The Bank of England and the Treasury had a great success at the time of the conversion of the War Loan. But it is possible that they still underrate the extent of their powers. With the existing control over the exchanges which has revolutionised the technical position, and with the vast resources at the disposal of the authorities through the Bank of England, the Exchange Equalisation Fund, and other funds under the control of the Treasury, it lies within their power, by the exercise of the moderation, the gradualness, and the discreet handling of the market of which they have shown themselves to be masters, to make the long-term rate of interest what they choose within reason. (CW XXI, p. 395)

In its historical context, the *General Theory* demonstrated both the feasibility and the validity of the deliberate reduction of short- and long-term rates of interest that, under Keynes's influence, the authorities had been pursuing since the Great Depression began. Moreover, according to the *General Theory*, low interest rates were a *necessary* component of the solution to the Economic Problem. Cheap-money policy should be a *secular policy*, implemented continuously.

Unquestionably in past experience dear money has accompanied recovery; and has also heralded a slump. If we play with dear money on the ground that it is 'healthy' or 'natural', then, I have no doubt, the inevitable slump will ensue. We must avoid it, therefore, as we would hell-fire. . . . A low enough long-term rate of interest cannot be achieved if we allow it to be believed that better terms will be obtainable from time to time by those who keep their resources liquid. The long-term rate of interest must be kept *continuously* as near as possible to what we believe to be the long-term optimum. (ibid., p. 389)

Whether cheap-money policy is sufficient for prosperity is a question for practical experience, not theory. But even then, all other policy interventions, not least fiscal policy, should be regarded as *supplementary* to this secular monetary programme:

My proposals for the control of the business cycle are based on the control of *investment*. I have explained in detail that the most effective ways of controlling investment vary according to circumstances; and I have been foremost to point out that circumstances can arise, and have arisen recently, when neither control of the short-term rate of interest nor

even control of the long-term rate will be effective, with the result that direct stimulation of investment by government is the necessary means. (Keynes, 1933, p. 675)¹

Even in the specific case of fiscal policy, Keynes's conclusions were still inadequately depicted by his 'Keynesian' interpreters, who were seemingly less concerned with the diagnosis and prevention of the Economic Problem than the implementation of their own preferred cure. Keynes obviously advocated the use of public works for an economy in depression, although his analysis of the financing of such policies, though brief, offered a degree of sophistication not present in the 'Keynesian' interpretation. Furthermore, Keynes envisaged a specific and ongoing use of fiscal policy, both taxation and expenditure, as support to monetary policy. He argued that cheap-money policy should be set alongside a policy of re-distributional taxation in order to increase the marginal propensity to consume (MPC). The normal extent of government expenditure should then be dictated by the ability of these policies to reduce unemployment in their own right.

1.2 Neo-classical and 'Keynesian' economics

Now, no doubt, Keynes and his most intimate colleagues began by creating an open-ended system very different from the mechanical excellence of the old determinate 'science'. But its development and application would have implied an historical and sociological approach to the unique sequences of economic development. This the profession was fiercely unwilling to undertake.

Instead a new theoretical edifice was erected which could be reconnected to the neo-classical theory of harmony and just shares in the distribution of income. . . .

The 'Keynesian' Revolution gained acceptance because ultimately it was, after its formalisation, deeply conservative in character. (Balogh, 1976, pp. 83–4)

'Keynesian' economics was never a reconciliation between the *General Theory* and classical economics, but an alternative theory opposed to both the theoretical scheme and practical conclusions of Keynes's work. Furthermore, the originator of this theory was not Hicks, but Keynes's two contemporaries: Ralph Hawtrey and Dennis Robertson. Keynes was familiar with this work and referred to it as 'neo-classical'.²

Early neo-classical positions had been set out in Hawtrey's *Good and Bad Trade* (1913) and *Currency and Credit* (1919), and Robertson's *A Study of Industrial Fluctuation* (1915) and *Banking Policy and the Price Level* (1926). The authors developed classical theory in the light of the new emphasis

given to credit creation at this time. Between the publication of the *Treatise on Money* and the *General Theory*, Robertson went on to make a number of contributions towards what would become the first of the 'Keynesian' versions of neo-classical economics. Hicks and Nicholas Kaldor acknowledged, retrospectively, the importance of Robertson himself and of these specific contributions:

I cannot help suspecting that what has happened to Mr. Kaldor is something which I recognise from my own experience when I was writing *Value and Capital*. The effect on Mr. Kaldor's mind, as well as on my own, of the *General Theory* has been profound; but we have each of us been led, sometimes consciously, sometimes unconsciously, through Keynes to Robertson. (Hicks, 1942a, p. 55)

In the early 1930's, 'Keynesian' ideas were in the air, long before the publication of the *General Theory* gave them a systematic expression. Professor Robertson's paper in the December, 1934 issue of the *Economic Journal* ('Industrial Fluctuation and the Natural Rate of Interest') is illuminating, for it clearly marks the transition from the old to the new methods of thought. (Kaldor, 1951, cited in Young, 1987, p. 57)

The *General Theory* was one of *three* contemporaneous theories; it was rivalled by both classical and neo-classical theory.

The almost unanimous response of the classical economists to the publication of Keynes's book was of hostility. Across the world, most academic economists refused to accept either Keynes's theoretical reasoning or his practical conclusions. Lionel Robbins's 1932 assertion that 'economics is the science which studies human behaviour as a relationship between ends and scarce means which have alternative uses' reflected classical economists distancing themselves from the practical failings of economic theory with which Keynes was specifically concerned. This state of affairs was not lost on reviewers of the *General Theory*:

There has been of late years a general trend among economists, led by what might be described as the London School, away from the real world of economic affairs. A certain scorn even that economists should concern themselves with 'realistic economics' breathes in the whole tone of the manifesto of this school, Professor Robbins's *Nature and Significance of Economic Science*. (A. L. Rowse, September 1936, re-printed in Backhouse, 1999, p. 108)

Instead the *General Theory* was first criticised in detail by comparison with the neo-classical theory. In the years following the publication of the *General Theory*, many prominent economists made contributions to this neo-classical theory and pursued this approach to the critique of the *General Theory*. The

monetary aspect of the theory was, and still is, known as ‘loanable funds’. The various theories of Alvin Hansen, Roy Harrod, Hicks, James Meade, Franco Modigliani and Paul Samuelson are all developments of this neo-classical approach. Hicks’s 1937 ‘Mr. Keynes and the “Classics”; a Suggested Interpretation’ is only the best known of these contributions.

The universally recognised paradigm shift to ‘Keynesian’ economics at the end of the War reflected the ‘formal’ endorsement of this model, now expressed in simultaneous equations, and the dismissal of the *General Theory*. On a theoretical level, ‘Keynesian’ economics resolved all of the theoretical disputes between Keynes and his detractors in favour of the detractors in a manner that denied that the disputes had ever existed.

Only post-Keynesian economists have regarded the pursuit of these differences as important. A succinct and invaluable summary is contained in Geoff Harcourt’s entry for ‘bastard Keynesianism’ in the *New Palgrave*:

The starting point of this analysis was the expression of what was argued to be the analytical core of the *General Theory* in terms of the IS/LM general-equilibrium framework, associated especially with Hicks. . . . The attempt to confine Keynes’s contributions within a small general equilibrium model allowed the neoclassical synthesis to occur. . . .

This interpretation of Keynes’s contributions was regarded by Joan Robinson in particular (but also by Kahn, Kalecki and Shackle amongst others; for a contemporary view, see Chick, 1983) as illegitimate – hence the name, bastard Keynesianism. . . . Keynes argued that, because of the uncertainty which of necessity must surround decisions about investment and holding money, and because producers in a monetary production economy of necessity must produce in anticipation of demand and of a money profit, and must make contracts in money terms, there are no necessary equilibrating forces which take the economy to full employment either at a point in time or over the cycle.

Moreover, Keynes himself stressed both the likely instability of his core functions, especially the investment and liquidity preference functions, *and* the dependence of this instability on movements in the economy itself, so that positions were not independent of paths. The IS/LM apparatus was therefore peculiarly unsuited to capture this vision of the operation of the economy, and the neoclassical synthesis itself was a denial of the revolution both in vision and in method which Keynes had provided. (Harcourt, 1987, p. 204)

On a practical level, ‘Keynesian’ economics supported the re-positioning of the policy debate from the role of monetary policy to the role of fiscal policy – a re-positioning that has held fast to the present day. As a consequence, the profound theoretical contributions and practical conclusions of the *General Theory* have been lost and, outside post-Keynesian economics, are yet to be subject to detailed and impartial critique.

1.3 Outline of the work

The discussion is divided into three parts. The first part sets out a history of monetary economics, examines Keynes's contribution to that body of work and its practical application, and then traces the history of the rival 'Keynesian' theory and practice. In Chapter 2, a theory of interest is set out, based on a discussion of the nature of money and the institutional development of banking. This both serves as the necessary monetary foundation to the work as a whole and provides an insight into the identification of the profound social and economic consequences that Keynes saw as following from the control of interest.

The second part of the work examines Keynes's theory. The presentation of the theory differs from Keynes's own, for the aim is different. Keynes sought to present a substantial and detailed theoretical statement of his *General Theory* as rival, and therefore in contrast, to the classical economics. My aim is primarily to present the theory in a manner that justifies the implementation of a secular cheap-money policy. First, I seek to explain why and how cheap money *can* be set; and second, why cheap money *should* be set. This involves an order of presentation different from that in the *General Theory* and the incorporation of elements outside the *General Theory* that throw light on the argument of the *General Theory* itself:

- aspects of monetary theory from the *Treatise of Money*;
- the debate on saving and investment that took place after the publication of the *Treatise*; and
- the deliberations and Report of the National Debt Enquiry (NDE) on monetary and debt-management policy for post-war Britain.

With the aid of these sources, the theoretical justification for specific practical policies is fully explained. Finally, going beyond Keynes's writings but based on them, the theory of the trade cycle is developed to include considerations related to debt- and capital-market inflations (CMIs).

The third part of the work turns to the loss of Keynes's theory and policy. In Chapter 8, Keynes's response to the rival neo-classical theory is examined. In Chapter 9, the key papers and events that saw the seamless substitution of 'Keynesian' theory and practice for Keynes's theory and policy practice are traced. This includes discussion of the later role of the 'Keynesians' in preparing the ground for abandoning their theory to Friedman's re-assertion of classical economics. In Chapter 10, the contributions of those economists that variously supported Keynes, opposed the 'Keynesian' construct and developed post-Keynesian economics are examined. These prominent and respected scholars consistently rejected the 'Keynesian' imposter and associated policy manoeuvres. Finally, Chapter 11 turns to the social and economic

consequences of the loss of Keynes's economics. This discussion is anticipated in the next section of this introduction.

The primary audience for the work are the post-Keynesian economists who have built a school of thought on the rejection of 'Keynesianism' alongside the re-assertion of fundamental principles of monetary economics. But I am equally concerned that the work be in large part accessible to economists more generally. I have therefore attempted to offer background where possible and to ensure that the argument is self-contained. But some prior knowledge of the broad economic debate of the post-Second World War era and the key protagonists is inevitably assumed.

In terms of positioning this book within the broad church that is post-'Keynesian' economics, I am primarily concerned with a re-statement of Keynes to emphasise his monetary policy conclusion. My expositional technique, particularly in the more detailed theoretical chapters, is to set out what I regard as the essential theoretical components drawn from Keynes's and post-Keynesian economics and then to present and, to a limited extent, develop these components within the context of the policy perspective. Attempts to go beyond Keynes's discussion are primarily with a view to clarify, with the exception of the discussion of the role of debt inflations in the business cycle. I therefore make no comment on the growth, long-period and distributional theories that emerged in particular from the Cambridge post-Keynesians after Keynes's death. While my re-interpretation fits into the tradition of post-Keynesianism concerned with monetary theory, even within this school there are substantial theoretical differences and material differences in policy emphasis that I look to draw out and, where possible, to reconcile.

I should stress that I make no claim for theoretical precedence, beyond the re-arrangement of these existing components. Much of the work draws on primary sources, and I have not in general sought to trace all those who have subsequently emphasised the same components and approaches. Indeed, the longer historical retrospective suggests that much of economic reasoning involves the restoration of truths known to certain of our predecessors. Precedent for some of the most important notions of monetary economics extends to at least the start of the eighteenth century.

1.4 The social and economic consequences of the loss of the *General Theory*

The *General Theory* was a theoretical work. But it was written with matters of the most profound practical importance to the world uppermost in the writer's mind. Ultimately the practical application of the *General Theory* concerned the management of money across the world and what Keynes later referred to as 'the future economic ordering of the world between nations'.³

As Keynes saw from very early on, the gold standard was a seriously defective mechanism for the management of monetary economies. Instead a system was required that on the one hand permitted sufficient international liquidity for trade purposes, and on the other permitted autonomy over domestic monetary and other economic policies. The analysis of the *General Theory* justified the exchange management and capital control policies that he had advocated and that had been implemented throughout the world in the 1930s following the failure of the gold standard after the First World War. These initiatives were then precursors of his proposal for an International Clearing Union that was the British Government's contribution to the Bretton Woods' deliberations.

In the broadest possible terms, the social and economic history of the post-Second-World-War era could be regarded as a consequence of a two-stage dismantling of these initiatives.

First, at Bretton Woods, Keynes's proposals were watered down. The Bretton Woods Agreement, which gave governance of international finance to the International Monetary Fund (IMF), saw the proposed currency management policies replaced with an excessively inelastic exchange system, not dissimilar to the gold standard, under which currency crises would be commonplace. However, the agreement had the virtue of preserving capital controls. These facilitated the continuation of low long-term interest rates across the world for close to a quarter of a century. And in turn cheap money fostered the strong growth in private investment that underpinned the unprecedented era of prosperity known to posterity as the 'golden age'.

The second stage was the dismantling of Bretton Woods in the early 1970s and the financial liberalisation effected over the 1970s and start of the 1980s. In the early 1980s, long-term rates of interest rose rapidly and have remained at a high level ever since. According to this interpretation of the *General Theory*, the lower but more volatile investment – what the International Labour Organisation (ILO) has described as 'pervasive worldwide employment problems' (ILO, 2003, 'overview') – and the stark polarisation of the world between rich and poor have as root cause these high rates of interest. Moreover, after 25 years of dear money the financial condition of the global economy is highly precarious, based as it is on a structure of indebtedness and asset inflation of a degree unknown since the Great Depression.

The IMF has gone from the master of a controlled exchange regime to first the enforcer and now to the victim of a financial 'liberalisation' that is totally beyond its control. The vast majority of economists fail utterly to comprehend the forces unleashed by financial liberalisation and how they have served to degrade economic and social relations across the 'world between nations'.

We must re-learn the fundamental importance of bringing these forces to heel through the global management of money. In order to do so we must reject an economics based ultimately on the neutrality of money and turn once again to the *General Theory of Employment, Interest and Money*.

1.5 A note on the *Collected Writings*

The claimed restoration and elaboration of Keynes's argument does not rely exclusively on the *General Theory* but draws on the full range of Keynes's writings, beginning with his first contribution to monetary theory in March 1909. The most important source for this task is obviously *The Collected Writings of John Maynard Keynes (CW)* under the main editorship of D. E. Moggridge.⁴ While the source is absolutely invaluable, attention must be drawn to a number of limitations.

In the first place, *CW* is not a complete reproduction of all of Keynes's economic writing. While omissions are understandable given the sheer volume of Keynes's work and of his private correspondence, it is of concern that a number of the papers omitted are, in my view, significant. In most cases my attention has been drawn to the existence of unpublished material through their use in the works of other authors (sometimes Moggridge's own). Any use of these papers in published work emphasises their non-trivial nature (insofar as published work is not trivial). The extensiveness of the omissions might be judged by the number of citations in this book that are noted as not published in *CW*.

An area of particular concern is the period between the publication of the *Treatise* and the *General Theory*. While Volume XIII is dedicated to papers from this period, there is very little material relating to the substantive steps towards the *General Theory* and hence very little detailed discussion of the implications of these crucial theoretical developments. In particular, there is no material relating to the elaboration of the notion of multiple equilibrium, very little detail on the savings–investment relationship and, perhaps most critically of all, virtually nothing as Keynes developed the theory of liquidity preference.

Apart from the content, the presentation of Keynes's theory in the *CW* is also important. Keynes's early work on monetary theory is scattered throughout the series – his early monetary lectures are included as the last chapter of Volume XII; his first papers on the monetary affairs of India are presented as Chapter 1 of Volume XI; his reviews and associated early published material concerning monetary theory appear as Chapter 5 of the same volume; and his later papers on India (from 1913) are in Volume XV. The arrangement is such that the early monetary work bears very slight relation to the central elaboration of his theories in Volumes XIII, XIV and XXIX. Moreover, the more detailed presentation of the material between the *Treatise* and the *General Theory* is in accordance with the 'Keynesian' perspective. All of the material relating to the savings–investment relationship is presented in a chapter 'Arguing out the *Treatise*', with the implication that it is not relevant for the *General Theory*. The next chapter, 'Towards the *General Theory*', then leads on the work of the so-called 'Cambridge Circus' and their role in the 'discovery' of 'output adjustment'.

This state of affairs is a significant complicating factor in any discussion of the broader theoretical and contextual considerations of the *General Theory*.

Notes

1. The source of this quotation is not included in the *Collected Writings* – see the last section of this introduction.
2. Keynes's used 'neo-classical' and 'classical' in a unique way. He listed those that he regarded as classical economists on page 1 of the *General Theory*; a later description from private correspondence contrasts classical economists with neo-classical economists: 'I mean by the classical school, as I have repeatedly explained, not merely Ricardo and Mill, but Marshall and Pigou and Henderson and myself until quite recently, and in fact every teacher of the subject in this country with the exception of yourself and a few recent figures like Hayek, whom I should call "neo-classicals"' (letter to Hawtrey, 15 April 1936, CW XIV, p. 24). (In the *General Theory* he refers to the neo-classical 'school' on page 177.) Keynes does not specify the differences in theoretical approach. My interpretation is that the original neo-classical economists were those who accorded prominence to monetary aspects of economics, but tended to endorse classical conclusions on matters of monetary policy (though taking a more eclectic approach on other policy issues).
3. *Manchester Guardian* 15/10/43.
4. E. A. G. Robinson and Elizabeth Johnson co-edited some volumes.

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