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The General Theory after sixty years

On the twenty-fifth anniversary of the publication of Keynes' *General Theory*, the late Harry G. Johnson recognized the book's outstanding contribution to the way economists think about macroeconomics and its stimulus to research (Johnson, 1961). Nevertheless, he criticized the book for both its exposition and its many analytical flaws. He traced these flaws to the Marshallian tradition of literary exposition, errors or misunderstanding in Keynes' thinking about capital, and his use of income as a measure of current receipts instead of the more classical measure of the flow available from a given stock of capital. Considering it a book on policy, which the *General Theory* surely is, Johnson gave Keynes credit for the importance that governments give to cyclical fluctuations in unemployment, but criticized him for the failure of his followers to give much weight to inflation.

Now, thirty-five years later, the main points on which Keynes labored have either long since been incorporated into standard macroeconomics or disappeared from sight. And although the *General Theory* itself continues to be interpreted, or reinterpreted, it is in the tradition of science that, if the book is now read by students in mainstream economics departments, it is mainly in courses on the history of economic thought. Long ago, mainstream macroeconomists decided the book's principal contributions are (1) the treatment of money as an asset held as part of a portfolio, and (2) recognition that markets—particularly labor markets—do not clear instantaneously. As many have noted, neither proposition originated with either Keynes or the *General Theory*.

A principal difficulty in discussing the *General Theory* is that much of what is believed to be true of that book cannot be found there, but comes from the work of followers known as Keynesians. For example, the IS-LM model, used to teach Keynesian economics to generations of students, originated with the efforts of Hicks to synthesize Keynes' ideas with the orthodoxy of that time. Although many think of econometric

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models as a quintessential Keynesian contribution, Keynes was unsympathetic toward early econometric models. Many of his criticisms were general. In his review of Tinbergen's model of the U.S. economy, Keynes (1973, vol. 14, pp. 316–318) was critical of the use of forecasting models. His reasons include the problem of omitted variables that, he said, bias the weight placed on a particular factor, the problem of simultaneity, and the problem of measuring time lags correctly. Also, he was skeptical that economists could find coefficients that remain invariant as new data become available. In these criticisms he anticipated many of the problems later recognized by model builders and econometricians.

Keynes was an advocate of empirical testing. The emphasis he gave to investment, speculation, and wage inflexibility had a foundation in empirical studies by himself and by others. However, he did not think economics was the discipline that could be used to forecast next quarter or next year with sufficient accuracy to guide policy action. Time has shown this judgment to be correct.

Rather than revisit old theoretical controversies, I shall use this anniversary to call attention to parts of the *General Theory* that, I believe, are both important for contemporary economists and much neglected. In doing so, I draw heavily on my earlier writings, particularly Meltzer (1988). Then, I consider briefly one aspect of policy, neglected by Keynes, that has led to the rejection of Keynesian policies in many democratic countries.

The themes of the General Theory

One of Keynes' strongest views was that laissez-faire capitalism was inappropriate for the twentieth century. He dissented from the classical view of the economy as a self-correcting system that reached an optimal allocation of resources. His concerns about the level of investment and his opposition to the classical gold standard mechanism both come from this philosophical position.

The main themes of the *General Theory* were already present in Keynes' "The End of Laissez Faire," written in 1924:

> Many of the greatest economic evils of our time are the *fruits of risk, uncertainty, and ignorance*. It is because particular individuals . . . are able to take advantage of uncertainty and ignorance, and also because for the same reason big *business is often a lottery*, that great inequalities of wealth come about; and these same factors are also *the cause of the*

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> *unemployment of labour*, or *the disappointment of reasonable business expectations*, and of the impairment of efficiency and production. . . .
>
> I believe that some coordinated act of intelligent judgment is required as to the *scale* on which it is desirable that the community as a whole should save, the scale on which these savings should go abroad in the form of foreign investments, and whether the present organization of the investment market distributes savings along the *most rationally productive channels*. I do not think that these matters should be left entirely to the chances of private judgment and private profits, as they are at present. [1972, pp. 291–292, emphasis added]

Long before he wrote the *General Theory*, Keynes believed that there was a flaw in the system of resource allocation, that he had found a divergence between private and social cost that could be removed. The problem was not general. Keynes did not complain about the markets for consumption goods. Problems arose in the market for investment goods. By 1936 Keynes thought that the divergence was caused by two related problems. Both were consistent with his long-standing belief, exemplified by the preceding quotation, that there was excessive uncertainty. The first we may call Keynes–Knight uncertainty. In modern terms, we cannot assign a meaningful, prior probability to some events. The second is that there is double counting of the premium for bearing uncertainty; the borrower requires a rate of return on the project that compensates for the uncertainty; lenders increase the loan rate to cover the cost. Consequently, investment fails to rise, on average, to the social optimum. The capital stock is less than optimal, and real incomes are below the attainable maximum.

Individuals face this premium for uncertainty but, Keynes believed, society does not. Keynes treats society as analogous to an individual with an infinite life span. In contrast to risk-average individuals, society can avoid the borrowers' and the lenders' risk of default and therefore can make investments that individuals do not make. The risk, which Keynes called moral risk and we now call moral hazard, is, on his argument, an avoidable risk. Freed of this risk, society would achieve a higher capital stock and a higher standard of living.

Details aside, the core of Keynes' argument is that, in a society with the optimal capital stock, the social rate of interest is zero. As in the classical stationary state, all productive opportunities are realized. The decisions of risk-averse private individuals cannot achieve the social optimum. Hence, there is an ineradicable difference between private and

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social returns if investment is left entirely to private decisions.

This is the argument for which Keynes had been searching in the *Treatise*, where Keynes highlights four factors: (1) the excessive variability of prices, (2) a real theory of the business cycle based on expectations—waves of optimism and pessimism, (3) emphasis on the primacy of investment, and (4) a stock-flow analysis of interest rate determination. The key to progress and stability is investment. Saving has a more passive role, and increased saving is not a means of increasing investment. By reducing sales and profits, attempts to increase saving lower output. In the *Treatise*, Keynes introduces a demand for assets in place of the more or less well-behaved velocity of classical economics and his own *Tract*. People can choose to hold liquid assets instead of real capital, thereby affecting the interest rate and investment.

The key difference, after the *Treatise*, is Keynes' discovery that output does not fluctuate around the optimal level. Output is not given, as in classical theory, but depends on social institutions, anticipations, and policy arrangements. Hence, output can be changed and standards of living increased by proper policies.

The change in view is reflected in the policy recommendations that Keynes drew from his work. In the *Tract* and the *Treatise*, Keynes proposes changes in monetary institutions to reduce price variability. In the *General Theory*, a main proposal is for the state to act as the director of investment to smooth the flow of investment so as to reduce uncertainty and increase the capital stock and the level of output.

"The philosophy toward which the *General Theory* leads" is, not by accident, the philosophy that its author had expressed ten years earlier. Although Keynes recognized that many of his views were compatible with socialism, there were important differences. First, Keynes distrusted the socialists. "Am I a Liberal?" explains that the socialists would not be led by the intellectual elite, who, Keynes believed, could be expected to place public interest ahead of class or personal interests (1972, vol. 9, p. 297). Hence, they could not be relied upon to choose policies that, on Keynes' analysis, were socially optimal. Experience with the Labour government in the early 1930s confirmed Keynes' belief that a Labour government would not seek to produce Keynes' vision of the social optimum. Second, Keynes favored policies to increase investment, not consumption. He believed that income redistribution from rich to poor would increase consumption and reduce saving. Hence, he held ambivalent views about income redistribution. He clearly favored lower profits and interest rates and, more generally,

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lower returns to capital. But he favored policies to lower these returns by increasing the capital stock to the point at which capital ceased to command a return above its cost of production.

By emphasizing the divergence between private and social cost and the optimal capital stock, have I neglected Keynes' major achievement? Many see his work as concerned primarily with the development of a theory of short-run fluctuations and policies for reducing fluctuations. I do not deny that he was concerned with these issues, but the basis of the alternative interpretation suggesting that these topics were his main concern in the *General Theory* is a disservice to Keynes.

The principal reason is that Keynes' attempt at a theory of employment or unemployment has not been fruitful. In the sixty years since the publication of the *General Theory*, neither Keynes' suggestions about the theory of labor supply nor the various interpretations of that theory have produced an empirically successful theory of the labor market or unemployment. The conjecture that unemployment could be caused by the rigidity of money wages is an old idea. Keynes did not claim to have originated the conjecture, and he did not have to write a book to present an idea that was well known. In fact, he had used downward inflexibility of money wages as an argument against returning to gold at the prewar parity in 1925.

Keynes argued that returning to the prewar gold price was a mistake. The main mistake was a failure to recognize that the equality of prices of internationally traded goods in the United States and the United Kingdom did not imply that wages in the export industries had adjusted. Even more, the adjustment of wages in the export industries, should it occur, would not imply that wages in other industries, particularly what he calls the sheltered sectors, would be adjusted to the new level. He argued that correct analysis would have emphasized the difficulties of obtaining wage and price adjustment. Keynes set out the argument that Churchill's advisers should have made:

> Money wages, the cost of living, and the prices which we are asking for our exports have not adjusted themselves to the improvement in the exchange, which the *expectation of your restoring the gold standard*, in accordance with your repeated declarations, has already brought about. They are about 10 percent too high. If, therefore, you fix the exchange at this gold parity, you must either gamble on a rise in gold prices abroad, which will induce foreigners to pay a higher gold price for our exports, or you are committing yourself to a policy of forcing down money wages and the cost of living to the necessary extent.

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> We must warn you that the latter policy is not easy. It is certain to involve unemployment and industrial disputes. [1972, vol. 9, p. 214, emphasis added]

By 1928, before he had completed the *Treatise*, Keynes had the main ideas that later became his theory of aggregate demand. There is no need for nuanced interpretation. Keynes is explicit about the idea that became the multiplier, the role of investment, and the importance of anticipations and their relation to demand:

> Generally speaking, the indirect employment which schemes of capital expenditure would entail is far larger than the direct employment . . . the greater part of the employment they would provide would be spread far and wide over the industries of the country. But the fact that the indirect employment would be spread far and wide does not mean that it is in the least doubtful or illusory. . . .
>
> The fact that many work people who are now unemployed would be receiving wages instead of unemployment pay would mean an increase in effective purchasing power which would give a general stimulus to trade. Moreover, the greater trade activity would make for further trade activity; for the forces of prosperity, like those of trade depression, work with a cumulative effect. . . . In the economic world, "coming events cast their shadow before," and the knowledge that large schemes of work were being undertaken would give an immediate fillip to the whole trade and industry of the country. [1972, vol. 9, pp. 106–107]

Joan Robinson (1985, p. 86) comments on this passage by reporting that "R.F. Kahn went off for his summer holiday with this in his rucksack. . . . He came back with his analysis of what became known as the multiplier."

Although it is true that Keynes did not have the precise formulation of the short-run theory of effective demand in 1928, it is also true that his method did not require precise formulation once the point was clear. To draw the conclusion that increased government spending for investment would raise aggregate demand by a multiple of the initial spending, he did not require more precision than he had achieved. The main idea was clearly formulated before he completed the *Treatise*.

Nor did Keynes need the *General Theory* to argue for fiscal stimulus. He made these arguments (with Henderson) to support Lloyd George's political campaign in 1929, as shown in the material just quoted. Indeed, Keynes' main arguments for fiscal stimulus to raise income during the depression antedate the *General Theory*. There is only one mention of

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public works spending in that book, and much less emphasis on expansionist policy after the book was published. This is difficult to explain if the main point of the *General Theory* is to establish that government can manage aggregate demand by changing public works spending or taxes.

The interpretation of the *General Theory* as a theory of demand management of short-term fluctuations or of the special problem of the 1930s depression is so well entrenched that few read what Keynes said about his aim: "This book has evolved into what is *primarily* a study of the forces which determine changes in the scale of output and employment as a whole" (1936, p. xxi, emphasis added). To an economist trained in Marshallian analysis, the study of changes in the scale of output is a study of the factors affecting the long-run stock of capital available to firms, in this case to firms in the aggregate.

Keynes was concerned with the problems of unemployment and output. The *General Theory* attacks these problems by proposing a means of permanently changing the scale of output. Keynes interpreted classical theory, specifically Say's law, as a statement that increases in investment must come at the expense of consumption. Scale is fixed. Output is given. This same argument, called in the particular instance the Treasury view, had been used against Keynes' efforts to increase output both when he supported Lloyd George's program and afterward.

Whether or not one accepts the argument that Keynes' principal concern is to reduce the divergence between private and social returns to investment, and to increase the scale of output by reducing uncertainty, there can be no doubt that the argument is present and that it leads to the main policy conclusion in the *General Theory*. Concentration on short-run aggregate demand management has obscured what I believe is an important insight.

Keynes' would-be defenders do him no honor by insisting on short-run, cyclical interpretation of the *General Theory*. For me, Keynes' most important insights in the *General Theory* include the following three points that remain relevant for the current generation of economists:

First is the treatment of expectations and information. Keynes assumed, with modern rational expectationists, that short-term expectations are fulfilled (1936, p. 50). Long-term expectations are entirely different, and far more important. In the preface to the *General Theory*, Keynes wrote: "A monetary economy . . . is essentially one in which changing views about the future are capable of influencing the quantity of employment" (1936, p. 7).

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Although the conclusion about the level of employment does not follow, Keynes was right to emphasize the role of uncertainty, expectations, and, by inference, information as distinguishing characteristics of a monetary economy. Like modern rational expectationists, he recognized that information was valuable, a driving force in the process by which uncertainty is reduced and expectations formed. Unlike most modern rational expectationists, Keynes recognized that information is costly.

In a modern rational expectations model, information is valuable but its cost is most often zero. Hence, everyone knows everything that is known by anyone, and a representative agent is a useful abstraction. For Keynes, information is costly, so response can be slow or fast depending on how fast information spreads. The representative agent model is the wrong model for studying fluctuations, asset markets, unemployment, and a host of other problems.

Second, throughout his life, and assuredly in the last chapter of the *General Theory*, Keynes was concerned with the design of institutions that reduce risk or uncertainty to the minimum required by nature and market processes. He tried in the *Treatise* to design a monetary system to replace the gold standard. He proposed a commodity money standard in which money was convertible into gold at a gold price that adjusted to the value of a commodity basket. He was one of the principal architects of the Bretton Woods system. And he proposed a fiscal rule to respond to cyclical fluctuations and recommended state intervention to smooth the rate of investment. Economists have begun to focus much more on contracts and institutional design, as Keynes did.

Third, Keynes was concerned with living standards and economic growth. He believed that the driving force was the capital stock and that a laissez-faire economy did not achieve an optimal capital stock. His proposals to reduce excess burden in the monetary system and in investment were intended to remove the excess burden and to expand the optimal capital stock.

Policy issues

Some of Keynes' policy issues—institutional design, elimination of excess burden, achieving the optimal capital stock, reducing uncertainty and improving information—are now part of the research program of modern economics. In contrast, the appeal of traditional Keynesian fiscal policies has fallen markedly. After some attempts at activist fiscal policy, governments have returned to concerns about budget balance,

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the size of the public sector, and the effects of deficit finance on interest rates and exchange rates. There are many examples, and I will mention only a few.

When she was prime minister, Margaret Thatcher raised tax rates in the midst of a deep recession. Several hundred economists signed a statement predicting that this policy would harm the economy and delay the recovery. The Thatcher government persisted, claiming that keeping the unconditional promise to reduce the budget deficit would have beneficial effects on anticipations that would overwhelm any negative effects of the tax increase. A possible rationale for this argument is that the public believes that deficit finance is, at least in part, tax deferral, so that the only effect of the tax increase in 1982 was a modest change in the timing of tax payments. The Conservative party was reelected.

At the start of the Clinton administration, the chairman of the Council of Economic Advisers, the secretary of the Treasury, and other administrative officials argued repeatedly that a tax increase would increase output by reducing interest rates, contrary to all Keynesian analysis.

In Europe, despite unemployment rates of 10, 12, or 20 percent, recent governments have pursued exchange rate stability even if it meant continued high unemployment. The Socialist government in Sweden, the Liberal government of Canada, the Conservative provincial government in Ontario, and the mixed government in the United States now promise to reduce the size of government, to reduce tax rates and budget deficits. Voters appear to favor these programs of fiscal balance as they did in earlier periods.

Keynes understood that activist government policies to increase investment in a single country would not be successful without capital controls. He had favored restrictions on capital movements since the 1920s and, for postwar Britain, he favored strict control of capital movements (Meltzer, 1988, pp. 208, 235, 240, 246). The developed countries have gone in the other direction, impelled in part by voters who profess to dislike budget deficits.

Many governments now claim to follow medium-term strategies that are more rulelike and less discretionary than Keynesian policies. There are several reasons for the change. Standard fiscal policies proved to be blunt and cumbersome instruments not only in the United States, with its system of checks and balances, but in many of the European parliamentary governments. Accurate forecasting, required for careful timing, proved beyond the capabilities of economists' models or policy makers'

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judgments. Perhaps most important of all, the policies were followed by high inflation and large public sectors, which many voters dislike. The policies appealed most to those with a surfeit of redistributionist zeal and a high discount rate on the future, and appealed least to those who disliked inflation or who worried about the burden of the debt on future generations and about the crowding out of capital to increase current consumption.

On many of these issues I believe Keynes would have stood with the critics. He was not an inflationist. He did not favor income redistribution. And he always favored increased investment to increased current consumption. Throughout his life, his main goals included satiation of the capital stock, achieving maximum output, removing the excess burden of excessive variability, and raising the living standards for our grandchildren.

Conclusion

For economists, 1996 is not just the sixtieth anniversary of Keynes' *General Theory*, it is also the fortieth anniversary of *Studies in the Quantity Theory of Money*. The first book was the product of a long search to escape from laissez-faire and the quantity theory. The second sought to revive the role of money in macroeconomics by reinterpreting the quantity theory as a theory of the demand for money and showing the empirical power of the resulting theory.

If, as some of Keynes' defenders insist, one of Keynes' main purposes was to construct a theory of short-term disequilibrium and propose activist fiscal policy as a solution, that effort appears to have failed. One rarely finds fiscal variables in recent mainstream research, whether the author's framework involves real business cycle theory, rational expectations–natural rate theory, neo-Keynesian theory, or heterogenous agent theory. Fiscal variables have almost disappeared from mainstream research in macroeconomics, although they continue to live in large econometric models.

Here, and elsewhere, I have argued that there is an alternative interpretation of Keynes in which Keynes offers novel and insightful ideas about past and current outstanding problems. This version of Keynes takes seriously that information is costly, that the future is difficult to know, and that the model of a nearly fully informed representative agent is not useful as the basis for short-run analysis (Meltzer, 1995).

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