Introduction

> For experience seems to show that people are divided between the old ones whom nothing will shift and are merely annoyed [*sic.*, amazed, (sent letter of August 30, 1936, Keynes 1987, p. 85)] by my attempts to underline the points of transition so vital in my own progress, and the young ones who have not been properly brought up and believe nothing in particular. . . . I have no companions, it seems, in my own generation, either of my earliest teachers or of earliest pupils . . . (Keynes to Harrod, draft letter of August 27, 1936, cited by Clarke 1988, p. 259)

Judging by any standard in economics, John Maynard Keynes was truly an exceptional, innovative scholar, who made a significant contribution to economics. His was a contribution not in the ordinary sense of adding a little here or transforming things a little there within the established corpus, contributions which luckily will be simply a footnote in the annals of knowledge. It was rather a contribution like those of Adam Smith, Ricardo, and Marx, which have in essence shaken the corpus, a contribution that will last. Whatever the merits of Keynes's work, it transformed thinking in economics. Throughout his career as an economist, Keynes was above the crowd in his abilities to theorize, to shape the intellectual agenda, and even more astonishing, to be able to participate in a unique way in government decision-making in public affairs. One could reiterate that to be a good economist, one must be a good philosopher, historian, mathematician . . . Keynes had all the attributes of the ideal economist.

In fact Keynes managed to contribute in multiple fields and to attract attention from beyond the economics profession. By the very harsh critics, who did not like or agree with his ideas, he was depicted as a charlatan, but of course over the years he has also had many promoters. The literature on Keynes is enormous. There are biographies, for example, those of Roy Harrod, Robert Skidelsky, Don Moggridge, and Gilles Dostaler, among others, which give accounts of a fascinating man. Numerous books and articles by economic historians, for example, Sue Howson, Roger Middleton, and Peter Clarke, reveal the importance of Keynes's involvement in public affairs and his participation in the shaping of public policy, whether British or international. Rod O'Donnell, Terrence Hutchinson, Anna Carabelli, and Brad Bateman have brought to light influences that drove Keynes's philosophical thinking.

It is on Keynes's economic theory that this book is focused, and specifically as it was developed in *A Treatise on Money* and *The General Theory*. Although other aspects of his works are admittedly integral to the man's thinking, it is not the intention here to study all facets of Keynes's various contributions. Nonetheless, as background for the present study, the variety of works on Keynes, too numerous to mention, are extremely important to understanding the development of Keynes's theory. Such works are a *sine qua non* to putting Keynes's technical theoretical treatment of economics into perspective. For this reason, the authors just named and many more are to be found in the final select bibliography.

While the biographers, economic historians, and historians of philosophy have done their job in analysing Keynes within their own areas of interest, economists and particularly historians of thought, save for a few exceptions, have failed miserably in assessing Keynes's complete theory. Despite the enormous literature and the institutionalization of Keynes, his generalized General Theory has yet to see the light. The so-called Keynesian Revolution was more a controversy over bits and pieces of Keynes's ideas than a product of their comprehensive whole. Keynes's work was recognized from the beginning as expressing an unusually challenging terminology and a new methodological approach, which in themselves posed enormous difficulty in comprehension. Not knowing how to evaluate Keynes's distinctiveness, the first reactions of the orthodoxy were to attempt to figure out his fit within the mould.[1]

By readjusting his terminology, twisting his premises back to the ordinary understanding, and trivializing the novelty of his theory, very early on Keynes was made Keynesian. The outcome was established by consensus, and Keynes's desired revolution was stifled. In a publication by an outstanding Keynes scholar, timed coincidentally quite closely with this book, Luigi Pasinetti has touched on a similar observation: 'The great majority of those theories that we now call "Keynesian" have in fact little to do with the theoretical "revolution" that Keynes had in mind in the 1930s' (2007, p. xiv). In looking back, the failure to recognize Keynes's theoretical contributions on their merits stemmed first from the harsh criticism of the antagonistic reviewers, and second from the protagonists who were so defensive that they made matters worse. What started as personal attacks by Hayek and Robertson on Keynes's scholarship gave any subsequent commentator an almost obligatory caricature of his attributes and then the 'licence' to remedy the perceived deficiencies.

The myth developed that Keynes was a 'bad', 'sloppy', 'careless' writer, that he 'did not read' or 'understand' much of the Classics, that he was 'ignorant of Austrian and Swedish theories', and that he was 'confused and inconsistent about his own ideas'. To give just a few examples of this mythology, which, as will be shown in Chapter 3, Hayek and Robertson established as the footprints to follow, see Klein[2] in his abundant use of 'the confused state of Keynes' ideas at the time . . . the seeming contradiction . . . the principal fault of the *Treatise* . . . inadequate formal theory . . . exceedingly superficial' (*passim*); Patinkin's repetitions, 'the ineffectualness of the "fundamental equations" . . . obscurities . . . Keynes failed to realized . . . Keynes' failure . . . Keynes not only failed . . . his failure to explore' (1976, 1982, *passim*); and Leijonhufvud's condescension,

> Keynes was not entirely successful . . . another omission may be more glaring . . . his model was not logically watertight . . . the *General Theory* was in several respects, as has frequently been said, 'a badly written book'. . . the defects of organization and presentation were disappointing . . . it is the defects of the model that are serious . . . when a model contains logical errors, later interpreters are given considerable freedom in deciding where 'repairs' should be undertaken

like plumbers called upon to fix a leaky pipe (1968, *passim*). Neither did Keynes's ardent pupils, in a state of defensiveness in the face of such criticism, help others understand their teacher during his lifetime, and especially not thereafter. The irony is in fact that they did not but add to the myth. Here again, as Pasinetti has rightly pointed out, '[T]he result is that Keynes's pupils, taken all together, appeared more cohesive as a group of critical thinkers than as a group of theoretical founders' (2007, p. xvii).

As apologists for what others saw as Keynes's deficiencies, Keynes's pupils also fell into the absurd mode of caricaturing. It is astonishing to read the presumptuous, famous statement by Joan Robinson, 'There were moments when we had some trouble in getting Maynard to see what the point of his revolution really was' (1988, p. 256)[3], or the mildly modest one of Richard Kahn, 'Schumpeter's suggestion that my "share in the historic achievement cannot have fallen very far short of co-authorship" is clearly absurd' (1984, p. 178). More study, especially of the exchanges between Keynes and his pupils, particularly those in the immediate circle, 'the Circus', is needed to appreciate the role of those caught in the fervour of the controversies between Keynes and his staunch opponents, yet equally unable to interpret the essence of their teacher's ideas on his own terms. Witness Keynes's paralleling them to 'the old ones' in his impressionistic letter to Harrod, cited at the beginning of this Introduction, and even his comments about Harrod himself: 'Your preoccupation with the old beliefs – and much more so in the case of other people – would prevent you from seeing the half of what I am saying' (letter to Harrod, August 27, 1935, CW, XII, p. 548). There are numerous instances in the correspondence, where Keynes reacted directly in the same manner to other members of the Circus, which are yet to be explored.

Even though his pupils were bright and had their hearts in the right place, their impact on the formation of Keynes's vision has been vastly exaggerated by them and by others. There seems to be confusion in identifying the inspirations of Keynes himself with the stimulation a teacher like Keynes could obtain from his students. Keynes was in a league of his own to which his students were no match. He undoubtedly needed a platform from which to diffuse his ideas and did have great hope in and patience with the younger scholars. The timing of Pasinetti's *Keynes and the Cambridge Keynesians* is fortuitous for this work and will no doubt be of great help in re-evaluating the first generation of the Cambridge Keynesians.

The exercise of assessing the merits of Keynes's own work – from his own text and on its own terms – has, generally, evaporated. While the target discussion of this book is narrowed down especially to Hayek and Hicks, a general point is worth stating: the first generation of economists, whether critics or proponents, did not do enough for the next to help steer the discipline into the intricacy of Keynes's theory. It is simply incredible that the persona of Keynes in economics as a whole is exemplified by the myth that Keynes was confused, sloppy, wrote badly, and so on. Since it has become such a part of common parlance, the tacit conclusion is that any good understanding of Keynes must come from second-hand interpretation, such as Hicks's very powerful IS-LM. The literature on Keynes continues thus to perpetuate a consensus contaminated with a warped perception of Keynes's theory.

The purpose of this book is to return to the initial controversies that led to the misconceptions about Keynes's theory, in short, to address the myth. It will be shown that Keynes had a command of the language unsurpassed by his critics and commentators. He read carefully among the Mercantilists, the Classicals and the neoClassicals. Despite the colossal amount of work and the multitude of duties he imposed on himself, Keynes was lucid, coherent, and almost obsessive about defining and clarifying terms and concepts in his written work, particularly as concerned the core of his theory, developed in *A Treatise*, the various drafts of *The General Theory*, and in *The General Theory* itself. It will be shown that Keynes developed a coherent and complete theory, which ran from the *Treatise* through *The General Theory*. It is asserted even further that Keynes's theory is applicable not only to the situation of the slump but also is capable of explaining any phase of the trade cycle.

Keynes made two major breakthroughs in economics: one in the theory of value, the other in monetary theory. Along with the myth that commentators and critics developed about Keynes's semantics, there was also their wondering where his theory fit within the moulds of economics. His theory of value did not depend on labour as did the Classicals nor on utility as does neoClassical theory. It had to be recognized that his concept of value is a hybrid, based on average cost and market fluctuations embedded in the discrepancies between savings and investment, and that his price-level is an index embodying both a monetary component, usually associated with income, and a component related to liquidity shifts. It is with this price-level index that Keynes showed the way out of the Quantity Theory of Money.

Keynes's commentators and critics were set to wondering what the source of Keynes's inspiration had been. Misunderstanding the thrust of Keynes's own references, Hayek and Hicks both forced Wicksell upon him as his prime source. In the eyes then of others as well (for example, Klein, Patinkin, and Leijonhufvud), Wicksell became the 'official' inspiring author for Keynes. It will be shown in this book that there is very little evidence that this is the case and that in fact the results of the theories of Wicksell and Keynes are actually quite opposing. While for Wicksell, the ultimate goal of his theoretical endeavour was to show that price stability is required for containing income inequality, for Keynes, price changes, through the various inflationary and deflationary pressures, are necessary for sustaining employment and redistributing income.

The present book was completed in September 2008. Just as it was making its way to the publisher, the world underwent the outright meltdown of the financial system in the latest economic crisis, reviving, for many, thoughts of the similar financial crisis of the 1930s and the circumstances during which Keynes wrote his theory. Many have seen parallels between the two crises and a new appropriateness of theoretical links to Keynes, a revival of Keynesianism. Even as it delayed the release of this study of Keynes, it became imperative to take into perspective these latest developments in economic thinking. Chapter 1, 'The financial crisis of 2008 and the unKeynesian Keynes' has thus been added, to use the crisis of 2008 to illustrate how Keynes's own and the Keynesian perspective are different in both their explanations of the causes of economic crisis and the means they feel are needed to cure the problem. The core of the book remains the same and is found in Chapters 5 and 6. In Chapter 5 an alternative model is presented, Keynes's Efficiency of Capital/Supply Price model (EC-SP), distilled from a straight reading of the theoretical core of the *Treatise*, the drafts of *The General Theory*, and *The General Theory* itself. It is shown why the Hicksian IS-LM is inconsistent with Keynes's theory and that the EC-SP model is the corrective counter to the popular and erroneously well-established IS-LM.

In Chapter 1, ‘The financial crisis of 2008 and the unKeynesian Keynes’, Keynesian application of the concepts of Aggregate Demand and Aggregate Supply, derived from the IS-LM model, and Keynes’s Effective Demand, derived from the EC-SP model of Chapter 5, are used as illustrations to explain the difference between the management of Aggregate Demand and that of Effective Demand. The core, interdependent components of Keynes’s theory, namely Money, Investment, and Consumption, are all conceived and analysed from the firm’s perspective, and not dichotomized into Aggregate Demand and Aggregate Supply, as by the variants of Keynesianism. Keynes was a supply theorist, in the sense that his economic policies derive from a macroeconomic production theory in which the profit motive and entrepreneurs’ investment decisions are the key to the determination of employment. Keynes’s economy is production, not demand-driven. To advocate demand expansion in every phase of the business cycle is not Keynes; consumerism promoted as the only way out of a financial crisis is not Keynes. The attempt in Chapter 1 is to shed light on the respective appropriateness of Keynes’s and Keynesianism’s tools to remedy economic crisis.

For the balance of the book, highlighting Keynes’s generalized General Theory is the purpose. Keynes provided a novel, general theory different from that of the Classicals and neoClassicals, a theory yet unrecognized as being behind both *A Treatise on Money* and *The General Theory.* Contrary to the commonly perpetuated belief that Keynes’s theory was only appropriate to a depression, his generalized model encapsulates a unique vision, pertinent not only to those circumstances of his time but applicable also to each and every economic situation well beyond: recession and stagflation, as well as full employment. Keynes’s unique liquidity theory emphasized the role of banking and credit in sustaining economic activity but also showed how shifts in financial assets, due to excessive bullishness and bearishness, cause economic instability and potentially violent fluctuations. The extremely important distinction Keynes made between unproductive consumption (associated with investment in fixed capital) and productive consumption (linked to investment in working capital) that has gone unnoticed is brought to light.

A further important and unexploited characteristic of Keynes’s theory is that for him unemployment goes hand in hand with income distribution. Cyclical fluctuations are by definition a reallocation of resources, whether through shifts in the factors of production from one sector to another, in financial liquidities from one form of asset to another, and/or in the level and/or composition of output. There are bound to be movements in prices corresponding to these reallocations. When Inflation or Deflation of the general price-level is decomposed into the various Inflations and Deflations (commodity, wage, income, capital, profit, and raw material), changes of relative prices and earnings (or relative purchasing power) are revealed to be occurring at every phase of the cycle across an economy, where different varieties of Inflation or Deflation run ahead or behind one another, offsetting one another or accumulating to create acceleration or deceleration in economic activity. Inflations and/or Deflations can result in a Slump, Stagflation or True Inflationary phase of the credit cycle.

In relation to one variable or another, income redistribution is for Keynes a permanent feature of the business cycle. Even at the extreme highs and lows of the cycle, Inflations will coexist with Deflations. Adjusting the various Inflations and Deflations is key to his economic policy. The interest rate is only one tool, which in some circumstances on its own is not sufficient to achieve the desired level of economic activity. To advocate, thus, as Wicksell did or as is now the practice of the central banks, a stabilization of the currency and hence the price-level, arrests addressing all the causes of unemployment or disparities of earnings. Keeping the general level of price constant does not guarantee that its components will remain unchanged. Keynes, in *A Treatise*, showed that unless inflation is decomposed and its various components analysed, the overall price does not reveal much and can be very misleading.

Although Keynes's theory and policy are presented here in a new light in Chapters 5 and 6, the challenge of confronting Keynesianism in its totality is a serious one. Some more groundwork is necessary to undertake that questioning, and this is provided in Chapters 2 through 4 and the Appendix. The overall goal of the book is to demonstrate that the convictions of those who derailed Keynes's theory, from the very start, notably Robertson, Hayek, and Hicks, stemmed primarily from their puzzlement over Keynes's prose. The main stumbling block to understanding Keynes's ideas was semantics, not substance. Most of Robertson's and Hayek's objections to Keynes's *Treatise* were theoretically *baseless.* Hicks's later interpretations and the ensuing IS-LM apparatus for *The General Theory*, which became the surrogate for Keynesians new and old, was in fact *antithetical* to Keynes.

After Chapter 1, the book is organized as follows:

Chapter 2, 'Money, price, and interest', puts Keynes's own theory of money in perspective. It is explained how:

1. the controversies about what money is and how money, prices, and interest rates interrelate, which all predate Keynes, are part of the evolution of what divides the Banking from the Currency School;
2. Keynes countered earlier treatments of interest-rate theory, as reflecting the characteristics of money as a commodity, in the tradition of Marshall-Pigou-Fisher;

3. the three characteristics Keynes uniquely attributed to money stem from his novel approach to defining the interest rate in *The General Theory*. Through Keynes's attempt to show that the special characteristics of money set it apart from commodities, it is revealed that these ideas exposed in *The General Theory* link it back directly to the *Treatise*.

Both Chapters 3 and 4 are devoted entirely to the dissection of the semantics and the theory behind the Fundamental Equations of *A Treatise on Money.*

Chapter 3, 'Keynes's semantic shifts', is directed to his contemporaries' objections to the use of terms and concepts, such as money, income, investment and saving, profits, and capital, found in the *Treatise*.

1. It is devoted to a discussion of the disagreement over semantics and a justification for rejecting Hayek's and Robertson's criticisms of the *Treatise* as baseless.
2. It explains that, while Keynes's concepts share some affinity with Wicksell's, the two authors are diametrically opposed in terms of their theories and policies.
3. The chapter develops into a full exposition of Keynes's macroeconomic model deriving from his Fundamental Equations, encapsulating both his monetary theory, from Chapter 2, and his capital theory, newly presented.

In Chapter 4, 'Keynes's theoretical shift', Hayek's Austrian period-of-production theory is spelled out and contrasted to Keynes's capital theory of the *Treatise*. It is shown that Keynes and Hayek started from different premises, but that:

1. they both developed a trade-cycle theory. Both analysed the real economy as having virtually the same structure of production, Hayek seeing that process as horizontal; Keynes, as vertical;
2. here again they differed dramatically on the notion of money itself and the impact of monetary policy, for example, on what would result from a policy of manipulating the money supply.

The ambitious objectives of Chapter 5, 'Keynes's causal relations', are multiple. It sets out:

1. to show that Keynes's two works, the *Treatise* and *The General Theory*, are intimately connected, that there is in fact a traceable,

straight line of development in Keynes's theoretical analysis from the *Treatise* to *The General Theory*, with the Fundamental Equations extending their use into *The General Theory* (with a slight modification in formulation, but with components comprising the same type of variables), and further, that the concluding chapters of *The General Theory* hark back directly to the business-cycle concerns of *A Treatise* to form a generalized General Theory;
2. to demonstrate where Hicks's conception of *The General Theory* went astray and to explain why his assessment of Keynes is, at best, simply a misrepresentation, at worst, a wrong analysis. Hicks's assessment of Keynes's *General Theory*, which led to the IS-LM model, is shown to be both classic and theoretically antithetical to Keynes.

By Chapter 6, 'Inflation/Deflation and the policy of the general *General Theory*', the last chapter in the book, Keynes's contribution to the analysis of inflation and deflation can be read as deriving from the combination of his ideas in the *Treatise* and *The General Theory*, thus from the perspective of Keynes's generalized General Theory. It is demonstrated throughout this book that the Fundamental Equations, so crucial to the *Treatise*, are also critical to *The General Theory*. Further, it will have already been shown in Chapter 5 that the Fundamental Equations extended their use into *The General Theory*.

1. It is recognized as true that discussion of inflation is found in much more detail in the *Treatise* than in the first four books of *The General Theory*, but it is asserted now that Keynes's earlier work is taken as their backbone and Chapter 21 as their distillate.
2. It is illustrated how, in terms of policy, stabilizing the currency was not Keynes's target as it had been Wicksell's.
3. Analysis of inflation and deflation stems from the Fundamental Equations of the *Treatise*, already introduced in Chapter 4, in which decomposition of the price-level is shown to lead to changes in profits, income, wages, and the prices of capital, commodities, and raw materials.
4. In Chapter 6, in light of the EC-SP model, the various inflations and deflations in the dynamics of Keynes's credit cycle are analysed as deriving from the components of the Fundamental Equations.

The Appendix, 'False novelties', addressed to those interested in the development of economic ideas and premises, is a synopsis or an attempt to identify and highlight what makes Keynes's theory unique and accessible. It provides:

1. a bare-bones list of various characteristics and theoretical premises that make Keynes's theory distinct from those of the neoClassical and Classical schools;
2. his original perspective on the distribution of income, an aspect of Keynes not usually described as novel. Keynes sympathized with the approach of the Classicals, but had his own theory of income distribution in which a mechanism permits the economy to be brought pre-emptively to a 'near-full' employment equilibrium.

In conclusion, it is maintained that Keynes provided a complete set of macroeconomic relations and the ingredients of a new theoretical model, much more reflective of and analytically appropriate to the corporate world of the twenty-first century, than those on which current macroeconomics is based. Keynes ought no longer to be encapsulated in the IS-LM, which is damaging at present, witness the responses of Keynesianism to the crisis of 2008. Presented in this book are the premises of Keynes's contribution. Current macroeconomics needs a new generation of economists to readdress his ideas and orient the discipline in a new direction.

NOTES

1. In *The Keynesian Revolution* (1966), Klein, on the opening page, asserts boldly 'Keynes was always a classical economist.'
2. Contrast Klein's assertion that Keynes accepted Schumpeter's position on technological change without reservation (1966, p. 16) with Keynes's own statement on fixed capital in *A Treatise on Money* (1930, II, p. 100). Also, as will be shown here further on, Klein's claim that Keynes intended to keep prices stable and his bold statement that 'the fundamental equations were not the essential contribution' of the *Treatise* (1966, p. 17) are both indications that Klein missed the point.
3. Cited by Clarke (1988), p. 256.