2. What was Keynes's best book?

Large numbers of books and papers are still being written about Keynes in the opening years of the twenty-first century. As the Introduction to the current volume showed, the name 'Keynes' continues to have enormous brand value in economics and has been appropriated by diverse bodies of thought, some of which have only a loose connection with Keynes's own teaching. How should Keynes's work now be viewed? What was its purpose and does it remain relevant? From the perspective of the early twenty-first century, what was his most interesting and durable contribution? What was his best book?

I

Keynes can be seen as an analyst and defender of managed capitalism, the man who showed how harmful fluctuations in business activity could be smoothed out by well-judged government action and who therefore made the market economy work more efficiently. As such, he might be represented as a hero of the Right. Alternatively, he can be interpreted as the champion of the public sector, the foremost advocate of the large-scale nationalization of the British economy which occurred in the late 1940s. If so, he is one of the great thinkers of the Left. The diversity of appreciations of Keynes stems from the difficulty of locating his work in the political spectra of twentieth-century Britain.

Born in 1883, he grew up in the ordered and stable world of late-Victorian and Edwardian England. He was the son of a Cambridge don and was himself to become a Fellow of King's College. One aspect of the order and stability of British society in his youth and early adulthood was its currency, the pound sterling. It had been tied to gold since the late seventeenth century and had much the same value (in terms of the things it would buy) in 1910 as 200 years earlier. When Keynes first started to think about the theory of credit and money, most people believed that the value of money would be roughly the same when they died as when they were born.

Britain's currency stability was ruptured by the First World War. The government resorted to the printing presses to finance military spending. The result was a severe inflation, which led to a large gap between labour costs in Britain and competitor nations, the suspension of the gold standard and a devaluation of sterling against the dollar. The central question for economic policy in 1919 was, 'should Britain return to the gold standard and, if so, at what exchange rate?' The consensus of the great, the good and the orthodox was that Britain should return to gold as soon as possible, with the gold price (in terms of sterling) the same as it had been in 1914. There was much to be said in favour of the orthodox view, not least that it had been the traditional response in previous post-war contexts. Britain's rulers had refused to accept a permanent devaluation of the pound (against gold) after the wars of William III and the Napoleonic Wars.

Keynes's most important insight in the early 1920s was that the gold standard was obsolete. As is well known, he opposed the particular exchange rate against the dollar ($4.86 to the pound) implied by the restoration of the pre-war gold price. He thought, correctly, that the British and American price levels were out of line at the $4.86 exchange rate and that the attempt to bring the price levels into balance (that is, to reduce British prices) would be deflationary, and would lead to unnecessary declines in output and employment. When the Chancellor of the Exchequer, Winston Churchill, decided to return to gold, Keynes brought his criticisms together in a celebrated pamphlet on *The Economic Consequences of Mr. Churchill*. Keynes's analysis was fully vindicated by events. Britain suffered a general strike in 1926 and a few years of industrial semi-stagnation, whereas other nations enjoyed the prosperity of the Roaring Twenties. Keynes's reputation as an economic analyst, commentator and adviser was hugely enhanced.

But his attack on the gold standard was over a much wider front than the criticism of one particular gold price. Keynes saw that the growth of banking systems in the century of peace before 1914 had dramatically reduced the use of gold in transactions. By the beginning of the twentieth century virtually all significant payments, including international payments, were in paper money. In a formal sense gold remained the ultimate bedrock of the system and people appeared justified in believing that their paper was 'as good as gold'. But, in truth, changes in the quantity of paper money (that is, bank notes and deposits) had become both the principal regulator of the business cycle and the main determinant of the price level. In this new world fluctuations in the quantity of gold were accidental, their impact on monetary policy was capricious and their relevance to meaningful policy goals (the stability of output and prices) was highly debatable. What was the point of the gold link? Surely, gold's continuing prestige relied on superstition and tradition, and had no rational, scientific basis. As Keynes remarked in his 1923 *Tract on Monetary Reform*, gold had become 'a barbarous relic'.

Both *A Tract on Monetary Reform* and *The Economic Consequences of Mr. Churchill* were based on newspaper articles. Neither pretended to be serious academic tomes. Keynes's journalistic activity was frantic at this stage of his career and seems to have been motivated by the desire to have a big income. (He received £4000 for organizing some supplements to the *Manchester Guardian Commercial* in 1922, a sum equivalent to about £125 000 in the money of 2007.) However, the two short books identified the vital monetary question of the twentieth century. If governments could no longer rely on the gold standard, how should the task of monetary management be performed? Even if the British government had restored the gold link at a more sensible exchange rate than $4.86 to the pound, would it really have been advisable to make interest rates depend on the fluctuating moods of the foreign exchange markets and the accidents of gold-mining technology?

Keynes wanted to replace the gold standard by a managed currency, where the essence of the management task was to control the level of bank credit (and of bank deposits, which constituted most of the quantity of money) by a number of instruments which were just beginning to be understood. Bank rate – the rate of interest set by the Bank of England in its money market activities – was a traditional weapon of considerable power. But Keynes was also attracted to the practice of influencing banks' reserves by open market operations, which was being developed in the USA by the newly created Federal Reserve System under the leadership of Benjamin Strong. (The Federal Reserve had been founded in 1914 and was a much younger institution than the Bank of England.) Keynes had no doubt that currency stabilization was vital to the preservation of the market economy. As he remarked in the *Tract*: 'The individualistic capitalism of today presumes a stable measuring-pod of value, and cannot be efficient – perhaps cannot survive – without one.'[1]

Keynes took his analysis further in a two-volume work, the *Treatise on Money*, published in 1930. It was a remarkable production, combining abstract analysis with detailed descriptions of monetary institutions and particular historical episodes. It expressed Keynes's considerable interest in international currency matters and theorized on the role that banking arrangements might play in macroeconomic instability. It went much further than the *Tract* and his miscellaneous pamphlets in setting out an agenda for monetary reform in a world which had outgrown gold. But its publication coincided with the worst collapses in demand and output ever inflicted on the international economy, and the most humiliating setback for the capitalist system. American industrial production fell by 45 per cent between 1929 and 1932. Even worse, in some countries (although not Britain) the recovery from slump was gradual and reluctant. Political extremism took hold in leading industrial nations, notably Germany, Italy and the Soviet Union, and many intellectuals thought that the serious political debate had been polarized between Communism and Fascism. Keynes decided that yet more analysis and explanation were needed. In 1936 he published his *General Theory of Employment, Interest and Money*, a book which is usually regarded as the start of modern macroeconomics. Indeed, it is often described as the greatest book on economics written in the twentieth century.

Its emphasis was rather different from the *Tract* and the *Treatise*. Like its predecessors, it contained ample discussion of interest rates and money, and of their relationships with other variables and their impact on the economy. But its main innovation was a new theory of the determination of national income. National income could be seen, according to Keynes, as a multiple of the level of investment. Unfortunately, investment undertaken by private agents was highly variable from year to year, because it was susceptible to volatile influences from financial markets and erratic swings in business sentiment. In an extreme case – later given the soubriquet the 'liquidity trap' by another Cambridge economist, Dennis Robertson – investors might be so afraid of future capital losses that, even if the central bank injected new money into the economy, they would not buy bonds at a higher price and force down the rate of interest. In other words, the lack of confidence might be so severe that monetary policy had become ineffective in boosting demand. The answer, so Keynes told the world, was for investment to be undertaken to a much greater extent by the public sector. In his words, there should be a 'somewhat comprehensive socialisation of investment'. Moreover, fiscal policy should be used actively to stimulate spending in recessions and to restrain spending in booms.

The message of *The General Theory* was political dynamite. By implication governments were right to nationalize important industries, because this would make it easier for them to prevent economic instability and reduce unemployment. Further, they were wrong to rely exclusively on the old technique of Bank rate (and even some of the new American techniques of monetary policy), which had seemed adequate in the predominantly private enterprise economy of the Victorian era (and the USA in the Roaring Twenties). Indeed, a careless reader of *The General Theory* might conclude that monetary policy was of little interest in understanding macroeconomic fluctuations.

II

The author of *A Tract on Monetary Reform* in 1923 had seemed concerned to preserve 'individualistic capitalism'. The author of *The General Theory* in 1936 celebrated the imminent prospect of a 'somewhat comprehensive socialisation of investment'. Which was the authentic Keynes? What did he really say? Or were there several contradictory spirits in the same man, and did his work have many meanings? In the second volume of his magnificent biography of Keynes, Skidelsky made the controversial suggestion that 'the *Treatise* and not *The General Theory* was Keynes's classic achievement'.[2] For at least four reasons, that verdict looks far more persuasive from the standpoint of the early twenty-first century than it would have done in, say, 1952 or 1962.

First, *The General Theory* is distressingly hard to read. While its subject matter is inescapably complex, Keynes did not make it accessible to the general reader. The first sentence of the preface warned that the book was 'chiefly addressed to my fellow economists', but the second expressed a hope that it would be 'intelligible to others'. But the truth is that the book's contents were unintelligible even to economists until they were further clarified by Keynes in short subsequent papers, and translated into diagrams and equations by disciples and critics. Samuelson – who in due course became one of Keynes's vocal admirers – admitted *The General Theory* 'is a badly written book'. It was 'poorly organized' and abounded in 'mares' nests of confusions'. Indeed, 'I think I am giving away no secrets when I solemnly aver – upon the basis of vivid personal recollection – that no one else in Cambridge, Massachusetts, really knew what it was all about for twelve or eighteen months after publication'.[3] Part of the trouble was that Keynes, keen to emphasize the originality of his contribution, used familiar terms in unfamiliar ways and had to devote several pages to explaining what he was about.[4] This would have interrupted the flow of the argument in any circumstances, but the problem was compounded by both repetition and digression. (*The General Theory* contained an appendix on the accountancy of depreciation, and a chapter on mercantilism and various contemporary monetary cranks. Neither had much to do with the main argument.) The *Treatise on Money* was also a rather unwieldy book and it had its fair share of esoteric terms, but it was more direct in its message and easier to read.

Secondly, *The General Theory* has little to say about banks and credit creation, and almost nothing about international finance. But, as the author of the *Tract* and the *Treatise* was fully aware, any attempt to understand the real-world problems of monetary management is also necessarily an attempt to understand the behaviour of banking systems and internationally traded currencies. As Hicks noted, 'the *General Theory* is the theory of the closed economy. If we want to read what Keynes said on the theory of international money . . . we have to go to the *Treatise*'.[5]

True enough, *The General Theory* makes countless references to money and interest rates. But – unlike the *Treatise* – it does not distinguish clearly between the central bank and the commercial banks, and between legal-tender monetary base assets (always worth their nominal value, by law) and the deposits issued by commercial banks (which might not be repaid in full if banks went bust). When Keynes was writing, the collapse of hundreds of American banks, because of loan losses and their inability to meet deposit obligations, was a central fact about the American economic scene. Deposits were not as good as notes, and the notion of 'money' was heterogenous and difficult to define. But in *The General Theory* Keynes treated all money assets identically, as a single homogenous mass, in the apparent belief that the potential insolvency of private commercial banks was not an important element in financial and economic instability. To quote Hicks again, 'Money, in the *General Theory*, is stripped to its bare bones; we get no more of the monetary system than is necessary for a particular purpose. The *Treatise* is a Treatise on Money, in a way that the other is not.'[6]

Further, by identifying certain special and unusual conditions in which the interest rate could not be reduced by central bank policy (that is, in the conditions Robertson labelled 'the liquidity trap'), the *General Theory* misled two generations of British economic policy-makers into thinking that monetary policy-making was trivial in normal times. They thought that they could neglect banking, money and monetary policy, with disastrous results in two boom–bust episodes. (The Heath–Barber boom of the early 1970s and the Lawson boom of the late 1980s are analysed from a monetary perspective in Essay 14 later in this book.)

Thirdly, in a significant sense *The General Theory* was a less general book than the *Treatise*. The *Treatise* was an attempt to produce a comprehensive text covering everything of importance in the monetary field. In addition to describing a range of banking institutions, the *Treatise* was clear that the problem of maintaining balance in an investment portfolio involved money and a variety of other securities, including bonds *and equities*.[7] Implicitly, the level of the equity market (and indeed of other asset prices) was influenced by the quantity of money. But – apart from one or two exceptional passages – in *The General Theory* portfolio balance is reduced to the choice between money *and fixed-interest bonds alone*.[8] If fixed-interest bonds are taken as representative of capital assets as a whole, this truncation of the problem of portfolio balance might appear harmless. But Keynes's narrowly restricted approach to portfolio balance in *The General Theory* was essential to a critical part of its argument.

By taking 'bonds' as the alternative to money, Keynes could make statements about the relationship between the quantity of money and the yield on bonds, and by regarding the yield on bonds as synonymous with the 'rate of interest', he could make grand claims to be propounding a new theory of the monetary determination of interest rates. In this theory a change in the quantity of money would usually alter the equilibrium rate of interest, with the rate of interest adjusting until the demand to hold money balances was equal to the actual quantity of money in existence. Keynes was not shy about the virtues of this theory, which he opposed to an alternative 'classical' view in which changes in the rate of interest were responses to differences between savings and investment. By denying the validity of the classical view, he was able to cast aspersions on the efficiency of market mechanisms and the self-adjusting properties of a capitalist economy dominated by private property. But these aspersions were legitimate only if the monetary theory of interest rate determination were correct, while its correctness depended on the assumption that bonds were the only non-money assets in the economy.

An obvious question needs to be asked. If the range of non-money assets were widened to include equities, houses and commercial real estate, would Keynes's monetary theory of 'the rate of interest' still hold water? The answer must be 'not necessarily, because so much would depend on investors' expectations and the scope for substitution between bonds and other assets'. If – starting from equilibrium – the quantity of money were increased in an economy with equities and real estate, logically the equilibrium values of both equities and real estate would advance, at least in the short run. The dividend yield on equities and the rental yield on real estate would fall, on just the same lines as – according to Keynes – the price of bonds ought to rise and the 'rate of interest' on bonds to decline.

However, in the medium and long runs the result of the money injection, and the drop in asset yields and surge in asset prices, might well be a boom in the economy and inflation. If so, holders of fixed-interest bonds would see the real value of their investment fall. It follows that the initial reaction of alert, forward-looking investors to an increase in the quantity of money might be to sell bonds in the search for a yield high enough to compensate for future inflation. An increase in the quantity of money would lead to a *rise*, not a *fall*, in the equilibrium 'rate of interest'. In short, if the analysis of *The General Theory* were made more general (and closer in fact to that of the *Treatise*) by adding extra assets, the monetary theory of 'the rate of interest' would crumble into incoherence.[9] One of Keynes's difficulties was that he wanted his 'rate of interest' (that is, his bond yields) to be susceptible to central bank action in normal conditions, but – as he well knew – central banks did not typically deal in long-dated bonds. Sometimes he wrote as if the central bank's task was the setting of the 'rate of interest' at the short end, which would affect the much more important long-dated bond yields almost by sympathetic magic. But in the real world long-dated bond yields do not move mechanically with the money market rate. As Keynes admitted, he had 'slurred over' problems of definition.[10] The *Treatise* – which did not make extravagant boasts about a new theory of interest rate determination – was less ambitious, but also more satisfactory.

Finally, the practical results of Keynes's recommendations in and after *The General Theory* have become tarnished. In Britain the 'somewhat comprehensive socialisation of investment' of the late 1940s led to mismanagement and inefficiency in nationalized industries on a scale which only became fully recognized following privatization under the Conservatives in the 1980s.[11] It speaks volumes that the Labour government elected in 1997 left the transport and energy utilities in private hands, with the problematic exception of the railways. Fiscal activism failed to stabilize output and employment in the late twentieth century, and in most countries has been replaced by fiscal rules, typically with a medium-term orientation. In the 1980s and early 1990s the large budget deficits endorsed by some Keynesians threatened financial ruin for Italy and other significant countries. By contrast, the issues raised by the *Tract* and the *Treatise* are very much alive, and the conclusions drawn by the early Keynes are still surprisingly viable. The *Tract*'s argument became particularly pertinent when the USA ended the convertibility of the dollar into gold in 1971 and thereby broke the last remnant of a gold-based currency system. The method of currency management proposed by Keynes in 1923 – to stabilize the growth of bank credit and the money stock – has clear affinities with the actual behaviour of one of the great modern central banks, the European Central Bank. It has also been adopted – if more reluctantly – by other central banks, such as the American Federal Reserve and the Bank of England, at various times in the last 30 years.

Keynes's contribution is far more substantial than his overrated *General Theory*. The *General Theory* represents only a fraction of all the words he wrote on economics, while the range of his work includes a major book on probability theory, essays in biography, and dozens of topical articles on politics and culture. As a sponsor of the Bloomsbury Group, he helped to change the moral climate of inter-war Britain. It must be conceded that – despite its faults – the *General Theory* did stimulate a revolution in macroeconomic thinking. But the *General Theory* can be more easily understood if it is seen as a sequel to the *Treatise on Money*, which is in many ways a superior piece of work. For all his ambiguities, complexities and wrong turnings, Keynes was the central intellectual influence on British economic policy – and indeed on British public life – in the twentieth century.

NOTES

1. D. Moggridge and E. Johnson (eds), *Collected Writings of John Maynard Keynes*, vol. IV, *A Tract on Monetary Reform* (London: Macmillan, 1971, originally published 1923), p. 36.
2. R. Skidelsky, *John Maynard Keynes*, vol. 2, *The Economist as Saviour 1920–37* (London: Macmillan, 1992), p. 337.
3. Samuelson's remarks appeared in his contribution to S. Harris (ed.), *The New Economics* (New York: Alfred A. Knopf, 1948). They were quoted by Murray Rothbard in his contribution to M. Skousen (ed.), *Dissent on Keynes* (New York: Praeger, 1992). See p. 184 of Skousen.
4. According to H. Johnson, the *General Theory* gave 'old concepts new and confusing names' and emphasized 'as crucial analytical steps that' had 'previously been taken as platitudinous'. E.S. Johnson and H.G. Johnson (eds), *The Shadow of Keynes* (Oxford: Basil Blackwell, 1978), p. 188.
5. Sir John Hicks, *Critical Essays in Monetary Theory* (Oxford: Clarendon Press, 1967), p. 189.
6. Hicks, *Critical Essays*, p. 189.
7. As Patinkin noted, the money-holders' choice in the *Treatise on Money* was between bank deposits and 'securities', whereas in the *General Theory* it was between money and bonds. Don Patinkin, *Keynes' Monetary Thought* (Durham, NC: Duke University Press, 1976), pp. 38–9.
8. The restriction of wealth to money and bonds continues to affect textbook writers to the present day. A standard text – *Macroeconomics* by Dornbusch and Fischer – says, in a discussion of the demand for money: 'The wealth budget constraint in the assets market states that the demand for real [money] balances . . . plus the demand for real bond holdings . . . must add up to the real financial wealth of the individual.' So, 'the decision to hold real money balances is also a decision to hold less real wealth in the form of bonds'. R. Dornbusch and S. Fischer, *Macroeconomics* (New York: McGraw-Hill, 6th edition, 1994), p. 103. Surprisingly, the adoption of the limited definition of wealth follows shortly after an excellent account of real-world assets, which refers at length to equities and houses. Keynes's awareness that he spoke of 'the rate of interest' in a dangerous way is evident in a footnote on p. 151 of the *General Theory*, in which he said that high stock market valuations had the same stimulatory effect on investment as a low rate of interest.
9. The argument that an increase in 'the quantity of money' reduces 'the rate of interest' begs many questions, not least the meaning of the phrases 'the quantity of money' and 'the rate of interest'. Keynes's analysis related to 'the short period' (that is, with the capital stock fixed) and assumed an economy in which the only non-money assets were bonds. But, as soon as one thinks of an economy with several assets, including equities, houses and other forms of real estate, and in which agents look ahead over many periods, it is possible – as explained in the text – for an increase in the quantity of money to lead to higher inflation expectations, a *fall* in bond prices and a *rise* in the rate of interest. Keynes's theory of the monetary determination of the rate of interest would then disintegrate. The point will be elaborated in my *Money in a Modern Economy* (forthcoming), to be published by Edward Elgar.
10. A. Leijonhufvud, *On Keynesian Economics and the Economics of Keynes* (New York and London: Oxford University Press, 1968), p. 152.
11. The political implications of the *General Theory* were highly topical in the late 1930s and enhanced its influence on the public debate. In 1954 Joseph Schumpeter remarked: 'There cannot be any doubt that it [*The General Theory*] owed its victorious career primarily to the fact that its argument implemented some of the strongest political preferences of a large number of modern economists.' This quotation appeared in Don Bellante's contribution to Skousen (ed.), *Dissent on Keynes*, p. 119.