# Introduction

**Sheila Dow, Jesper Jespersen and Geoff Tily**

## ABOUT *THE GENERAL THEORY AND KEYNES FOR THE 21ST CENTURY*

The chapters in this volume, and its companion volume, *Money, Method and Contemporary Post-Keynesian Economics*, originated in a celebration marking the happy coincidence that 2016 saw the 80th birthdays both of the publication of Keynes's *General Theory of Employment, Interest and Money* and of Victoria Chick, who has contributed so much to the development of Post-Keynesian theory and method. Her monograph *Macroeconomics after Keynes: A Reconsideration of the General Theory* has been one of the stepping stones for two generations of macroeconomists. As with Keynes, from the very beginning of her career monetary, banking and financial theory have been of special interest: how to analyse the development of money and finance, and the intertwined relationship between financial and real activities.

The papers collected in these volumes serve as a reminder to academic and professional economists of the narrowness, let alone the limited relevance, of the conventional account of Keynes. They are indicative of a more substantial and richer approach to economics, just as mainstream economics is being forced to confront its grave limitations in the wake of the global financial crisis and subsequent stagnation. Those from the mainstream who are approaching these limitations in a constructive manner are therefore found assessing the nature of money and deposit creation, the role of uncertainty and ideas around multiple equilibria and open system analysis – constant themes of Vicky's research.

The publication in 1936 of Keynes's *The General Theory of Employment, Interest and Money*, the book which lies at the core of Vicky's work, had immediately set a new agenda for understanding macroeconomics. In the second half of the 20th century it became for a while the most quoted book in macroeconomics. For many economists, *The General Theory* continues



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to be the most important text.[1] But the undercurrent of mainstream macroeconomics changed during the last three decades of the 20th century. Keynes's economics, or rather Keynesian economics, was increasingly challenged by a neoclassical counter-revolution. The decline of prestige of Keynesian macroeconomics and politics was a consequence both of the stagflation of the 1970s, which could not be explained within the conventional Keynesian textbook models or econometric macro models, and of more (neo)liberal politicians being in power.

This development had been underway for quite a long time. As far back as in 1968 Milton Friedman (1968) was successful in initiating this counter-revolution by his Presidential address to the American Economic Association. There he presented a simple but seemingly correct prophecy that another analytical approach in macroeconomics was needed to explain rising unemployment and inflation. The new field of macroeconomics was in some ways a retreat to pre-Keynesian economics, with monetary and real-sector economics being separated, the longer-run Phillips curve made vertical, and the money supply assumed to be controlled by the central bank. This general equilibrium framework was shortly after elaborated by the New-Classical macroeconomists, guided by Lucas and Sargent (1978), among others. They claimed that the general equilibrium model needed an explicit microeconomic foundation to secure a stable structure of households' and firms' behaviour and market equilibrium. They introduced an analytical framework building on representative agents, who were assumed to conform to the principles of individual rationality and the hypothesis of rational expectations (that is, correct information about the entire economic model).

This counter-revolution in macroeconomic theory and method began to dominate the macroeconomic arena during the 1980s, and textbooks were rewritten. Now the neoclassical microeconomic foundation together with 'rational expectations' became the standard, and neoclassical growth theory was given priority over business cycle theory; both kept within a methodological framework of general equilibrium models. In addition money and finance were relegated from the analysis of real sector activities. Direct references to Keynes and Keynesianism became rare within this real business cycle and neoclassical growth theory paradigm, except for remarks, with an antagonistic tone, critical of the previously conventional Keynesian approach.

However, weak growth rates and rising unemployment in the US and Europe during the early 1990s made some macroeconomists uneasy with

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[1] See, for example, http://www.paecon.net/PAEReview/issue36/greatest20thcenturyeconomists.htm.

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the rigid real sector equilibrium model. Instantaneous and persistent equilibrium with no involuntary unemployment was difficult to defend in the face of this reality. Hence, within the new framework of general equilibrium a group of macroeconomists started to argue that, due to a number of rigidities in the real world, mainly a lack of price and wage flexibility but also of an institutional kind (referring for example to the welfare state), markets would not and could not adjust instantaneously to external real shocks. This elaborated general equilibrium approach could better explain short-term business cycles and deviations from the level of 'natural' or 'voluntary' unemployment. For reasons which are difficult to explain, this group of macroeconomists called themselves New-Keynesian economists (see Mankiw and Romer 1991). One possible explanation for this contradictory label was their conclusion, expressed in opposition to Robert Lucas's 'policy ineffectiveness' claim, that, in the (very) short run, demand management policies could have an effect on the real business cycle due to these real-life rigidities. Of course, New Keynesians also considered a removal or reduction of market inflexibility as the first-best policy. But, faced with reality (a lack of information, transaction costs and institutional arrangements), short-term rigidities could be given a rational explanation. Hence, Mankiw (2016, p. 11, emphasis in the original) writes in his textbook *Macroeconomics* that '[f]or answering most questions, economists use market-clearing models. Yet, the assumption of *continuous* market clearing is not entirely realistic.'[2]

While the IS–LM Keynesian economists had been dominant during the 1950s and 1960s, from mid-1970 the dominance had shifted to the New-Classical/New-Keynesian general equilibrium economists. But, parallel to these mainstream macroeconomic paradigms, there has been an undercurrent of other macroeconomic schools, which reflected unease with these rather mechanical market-clearing models that were partly detached from reality. Among these schools, the Post Keynesian has been one of the dissenting groups of macroeconomists ever since 1936 (see King 2002). Post-Keynesian economists unite in emphasising the need for theory and methods which give priority to understanding real-world phenomena. This agenda is challenged by the fact that reality is an ever-moving target. Therefore *The General Theory* cannot be considered as a manual for all seasons, but rather an elaborate framework for understanding parts of a dynamic system. The emphasis was on the most pressing social and

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[2] He continues, 'Market-clearing models might not describe the economy at every instant, but they do describe the equilibrium towards which the economy gravitates' (Mankiw 2016, pp. 11–12). The quoted passages are unchanged from the 1st edition (1992) to the 9th edition (2016).

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economic problems of the 1930s. But then parts of *The General Theory* are still as relevant today as they were back in the 1930s. Indeed many of the macroeconomic challenges we confront today originate in the same defects of domestic and international economic architecture that Keynes sought to resolve, and they exemplify the extent of the distortions of this theory that are also not yet resolved. Keynes's emphasis on macroeconomics as an analytical strategy for building knowledge of an ever-moving target was combined with his emphasis on the ontological significance of uncertainty related to the formation of expectations. Keynes's work in economics and philosophy can be read as one painstaking attempt to develop a method of how to analyse reality.

## MAIN THEMES: INTERPRETATION AND METHODOLOGY

The dominant themes of the chapters in this volume are interpretation and application of Keynes's methodology. Scholars approach these questions in a variety of ways. In practical terms, policy emphasis goes beyond the deficit spending that is synonymous with his name. Authors address his deeper understanding of the relations between government spending and the economy, international monetary architecture, interest rates and the wider relation of his work with that of both Marx and Schumpeter. From a theoretical point of view, the dominant undercurrent is methodology. From monetary foundations, Keynes devised a new discipline now understood as macroeconomics. At the very least through the fallacy of composition, macroeconomics was distinct from microeconomics. Moreover, the methodological approach differed from the mathematical orientation of the current mainstream (though his mentor Alfred Marshall had already begun to move in this direction).

> It is a great fault of symbolic pseudo-mathematical methods of formalising a system of economic analysis . . . that they expressly assume strict independence between the factors involved and lose all their cogency and authority if this hypothesis is disallowed; whereas, in ordinary discourse, where we are not blindly manipulating but know all the time what we are doing and what the words mean, we can keep 'at the back of our heads' the necessary reserves and qualifications and the adjustments which we shall have to make later on, in a way in which we cannot keep complicated partial differentials 'at the back' of several pages of algebra which assume that they all vanish. Too large a proportion of recent 'mathematical' economics are merely concoctions, as imprecise as the initial assumptions they rest on, which allow the author to lose sight of the complexities and interdependencies of the real world in a maze of pretentious and unhelpful symbols (Keynes 1936, pp. 297–8).

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He described his critical conceptions – liquidity preference, the marginal efficiency of capital and the marginal propensity to consume – as 'psychological propensities'. Rymes (1989, pp. 2–4) captures a student grappling with Keynes's explanation in the lecture theatre: 'Again, the notes reflect the continued inference of Keynes that expressions such as $M = A\,(W, \rho)$ are not formal relationships but rather methods of thought. The listeners were sometimes disconcerted by such philosophical grazing by Keynes. In Tarshis's notes at this point we find: "What the Hell".'

Later, in his celebrated 1937 *Quarterly Journal of Economics* article, Keynes elaborated substantially on the role of uncertainty. Plainly he did not successfully convey (or perhaps not even fully conceive) the methodological substance of his new scheme. It is possible that conventional interpretations originate in a lack of sympathy with this emerging theoretical approach and hence to his associated practical schemes. Perhaps even now the idea that a theory in non-mathematical form might be rigorous in a logical sense is still not proven. Though we might still wonder whether his interpreters approached Keynes's work with 'that measure of "good will" which an author is entitled to expect of a reader' (as he complained of Hayek; see Keynes [1931] 1973, p. 243). He resolutely and tirelessly defended his theory, despite his energies being absorbed by illness and the War – after which he was surely entitled to feel that he had won the day in the economic arena.

In the opening contribution, Vicky looks forward, leaving aside questions of interpretation for questions of relevance. She puts forward the argument that any economic theory that is relevant to the real world is always a product of its time, taking for granted the institutions and behaviours that characterise that time. On this basis, old books, not least *The General Theory*, present a conundrum: how much is still pertinent today and what revisions are necessary to bring the theory into line with changes in the economic system since the book was written? Her answer is that the principles of effective demand and liquidity preference go through almost unchanged, but that globalisation and changes to banks' behaviour pose serious questions for the theory, as do our new awareness of resource constraints and climate change. The underlying methodology remains the best on offer and should be retained in any revision.

Maria Cristina Marcuzzo argues that the controversial nature of *The General Theory* means there are still questions about the nature of its assumptions and conclusions. The answers to these questions have led to different interpretations which were not mutually compatible and gave rise to controversies and, in some cases, even to distorted interpretations, which transformed the message of *The General Theory* into something completely different. This chapter (Chapter 2) discusses a few of the

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distortions to which Victoria Chick, together with many others, has drawn attention over the years and puts forward a suggestion for why *The General Theory* might have been liable to being misinterpreted.

Robert Skidelsky (Chapter 3) asks why Keynes's (fiscal) policy was accepted when, as Vicky has shown, his theory was rejected. He argues that in the 1930s existing political solutions to unemployment were blocked. Keynes offered an unblocking intellectual alternative, in which both capitalists and workers would gain. *The General Theory* can be read on at least two levels: one responding to the institutional facts of the time, the second a more general rebuttal of the neoclassical road to full employment. Though the first reading has been more popular – the orthodox economics profession has always preferred Keynesian policy to Keynesian theory – Vicky's work and our experience of the Great Recession require us to build a better macroeconomics based on the second.

For Geoff Harcourt, Peter Kriesler and John Nevile (Chapter 4), *The General Theory* showed that the main determinant of the level of output and employment at any point of time was the level of effective demand. It did so in an environment of uncertainty, using analysis in historical time. As with other authors, they agree that most of Keynes's insights were soon lost to the profession. They trace the loss to a far-reaching controversy around a textbook. The most concerted and sustained attack on Keynes's position was by Milton Friedman. Friedman argued that his work on permanent income as the major determinant of consumption invalidated Keynes's use of the consumption function in *The General Theory*, with important implications for the multiplier and the efficacy of fiscal policy. The attack by the conservative right wing in America on Lorie Tarshis's excellent 1947 Keynesian textbook also played an important part in the dilution of the Keynesian message, as did the resultant rise to dominance of Samuelson's *Economics: An Introductory Analysis*. Given the great influence of Samuelson and the increasing tendency of American economics to dominate English language economics, this contributed decisively to the undermining of Keynes's method, theory and policy.

The next three chapters emphasise methodological barriers. Teodoro Dario Togati (Chapter 5) addresses two key questions: *why* did Keynes lose his generality battle and *what can* be done to restore his generality claim? In answer to the first, Togati argues that Keynes did not develop a substantive articulation of his 'research programme' in Lakatosian terms. For example, unlike the Arrow–Debreu microeconomic model underlying general equilibrium macro, *The General Theory* does not provide a unifying vision of the economy. In answer to the second question, Togati seeks to identify the conditions under which the generality claim can be restored. The most important of these is the one identified by Pasinetti, namely the full-blown

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articulation of a 'monetary theory of production' research programme. This requires developing a distinct and autonomous macroeconomic perspective, placing the emphasis on the role of conventions, institutions and aggregate variables as emergent, persistent features of the economy.

Anna Carabelli and Mario Cedrini (Chapter 6) emphasise the role of time in macroeconomics. In spite of its fundamental importance, time is rarely portrayed as a prominent theme because of the sharp contrasts that have historically divided economists using alternative conceptions of time and the conundrums brought about by incorporating time into economic models. They provide an interpretation of Keynes's methodological reflections on the concept of time as a complex and manifold magnitude. Economists must therefore carefully avoid inconsistent logical reasoning about its characteristics and instead focus, as Keynes did, on change and transition.

Alessandro Vercelli (Chapter 7) investigates the *rational* foundations of liquidity preference theory as sketched by Keynes in *The General Theory*. Mainstream theory focuses on two determinants of liquidity preference related to weak uncertainty: (1) risk aversion, and (2) transaction flexibility. Keynes, on the other hand, focused mainly on the nexus between liquidity preference and strong uncertainty, and Vercelli distinguishes two basic determinants: (3) strong uncertainty aversion, and (4) strong intertemporal flexibility. Though each of these determinants has been the object of specific interpretations of liquidity preference theory, this chapter suggests that we may encompass their analysis within a more general conceptual framework. To this end, Keynes's concept of *weight of argument* plays a crucial role. In particular, Vercelli shows that its variations along different phases of the business cycle alter the impact of each of the components of liquidity preference.

Tim Congdon focuses on monetary processes (Chapter 8). His chapter describes the equilibrium of the banking system in a modern economy, with both a central bank and a commercial banking system. Equilibrium conditions are set out for the markets in, first, base money issued by the central bank and, second, money in the form of bank deposits ('the quantity of money') created by commercial banks. The heart of the chapter is a geometrical construction demonstrating the money-creation process in a modern banking environment. A four-quadrant diagram is suggested, because quadrants with isosceles triangles neatly represent the equality of assets and liabilities in financial institutions that is also a necessary feature of bank balance sheets. The resulting 'apparatus of thought' is intended to facilitate discussion between economists with different views on both the money creation process and the role of money in the determination of macroeconomic outcomes.

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In the next two chapters Radhika Desai (Chapter 9) and Sheila Dow (Chapter 10) offer differing views motivated by Keynes's interventions on global monetary architecture. Desai challenges the tendency to see *Indian Currency and Finance* as anticipating Keynes's later work on international monetary issues, including his proposals for the Bretton Woods conference. She sees any such apparent continuities as purely technical, relating to ideas and methods of managing money, and not original to Keynes's economic thinking. Instead she sees a vast political chasm and thirty years separating the two endeavours. This chapter seeks to demonstrate how unoriginal the common technical elements of these two sets of work were, while also showing how politically different they were. Hereby, the chapter seeks to provide an appreciation of just how great a distance Keynes travelled from the Marshallian convictions of his earliest days to the critical account of capitalism at which he eventually arrived.

Sheila Dow looks instead to Keynes's international interventions to identify some general principles which can be carried forward to the present day. In order to address problems arising from the domestic and international monetary systems, the focus is on the principle of effective demand and the theory of liquidity preference, applied to analysis of a monetary production economy. Yet for Keynes, theorising started and ended with context. The analytical process started with identifying the problem and looking to relevant theory for illumination. It was crucial to consider the nature of the context in order to assess the validity of the assumptions and, if necessary, to change them. She therefore considers the differences in monetary systems between the 1930s–1940s and the present day in order to form a Post-Keynesian view of monetary reform.

The final four chapters confront Keynes's work with that of other scholars, including alternative ideologies.

Gerhard Michael Ambrosi (Chapter 11) addresses the Gibson Paradox: that interest rates and the price level are often positively correlated. This contradicts the doctrine that high interest rates dampen economic activity and the price level. In 1930 Keynes names, confirms and emphasises this phenomenon in his *Treatise on Money*. In 1936, in *The General Theory*, it is totally ignored. But Keynes's new concept of (given future) effective demand as being related to entrepreneurs' present outlay at a given degree of competition requires that higher discounting costs are compensated by higher prices. Macroeconomic modelling has to be wary of the contradictory influences of interest rates. As producers' costs they affect the 'supply channel'. As financing costs they affect an opposite 'demand channel'. Recent empirical literature confirms the relevance of both channels. The chapter accentuates these issues in a minimalist simultaneous equations model. It stresses the problem of finding the balance between the two

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channels and mentions Keynes's appeal to maintain low interest rates for a continuous 'quasi boom'.

Mark Hayes (Chapter 12) pursues Joan Robinson's view that the task of Post Keynesians is to reconcile the work of Keynes and Sraffa. The central difficulty is to reconcile equilibrium with uncertainty and the solution lies within Keynes's distinction between short-, medium- and long-term expectation and furthermore between the long term and the technical long period. Recognition that the 'expectations' of Keynes's state of short-term expectation are equilibrium prices, in a carefully defined and qualified sense, makes it possible to replace his Marshallian concept of normal prices with Sraffa's prices of production. There is a definite case for seeking to recast the principle of effective demand without the Marshallian theory of value. The task is to achieve this without losing either an empirically useful concept of equilibrium or the concept of fundamental uncertainty.

On the wider ideological view, Andy Denis (Chapter 13) confronts Keynes and Marx, while Heinz Kurz (Chapter 14) confronts Keynes and Schumpeter. Marx and Keynes approach the analysis of capitalist economies from distinct standpoints, by starting with the investigation of the production of value and surplus value, and of its realisation, respectively. For Andy, this implies complementarity, evidenced in several points of contact. Both writers adopt a labour theory of value, with goods prices varying around prices of production, and both affirm a tendency for the rate of profit to fall, underpinned by a tendency for organic composition to rise. The conclusion reached is that the thesis that Marx and Keynes are utterly opposed, expounded for example by Pilling, Mattick and Potts, is incorrect.

Heinz Kurz discusses Schumpeter's reception of *The General Theory* and the criticisms he levelled at it: 'No Invitation to "Alles Walzer!"' He asks to what extent Schumpeter's criticisms are pertinent and to what extent they are based on misunderstandings and cannot be sustained. But on the basis of the heretic elements in the analyses of the two authors, Kurz shows that, important differences notwithstanding, they had more in common by temperament and vision than is typically acknowledged.

This volume and its companion, *Money, Method and Contemporary Post-Keynesian Economics*, illustrate vividly the richness and sophistication of Keynes's theory. Authors find resonance not only across time, but also across the whole of the political and economic landscape. But are we left with a theory offering only a bridge to these alternative ideologies, or does it still define a distinct and still viable worldview of its own?

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