6. Policy Implications

This chapter considers *G.T.* Book VI, in which Keynes addresses the policy implications of the theory developed in the previous Books. *G.T.* Chapter 22 on the trade cycle (considered in Section 6.1) examines the nature of fluctuations in the level of employment, while *G.T.* Chapter 23 (Section 6.2) reviews pre-Classical orthodoxies and contemporary heterodox thought as to the causes and remedies for the chronic level of under-employment that Keynes perceives to be the normal state of the *laissez-faire* market economy. *G.T.* Chapter 24 (Section 6.3) concludes by outlining the political implications of a policy of full employment and maximum investment.

Keynes's tool for addressing these questions is the equilibrium sub-system or model described in our previous chapter, which maps his three psychological independent variables onto the level of employment at any time. These independent variables are schedules rather than numbers, as Keynes reminds us in the case of the marginal efficiency of capital (*G.T.* 315, n1). As in *G.T.* Book V, we are no longer considering relationships amenable to formal modelling, and have moved outside the domain of equilibrium theory into that of psychology and history. Part of the modern Classical aversion to the last two books of *The General Theory* undoubtedly stems from a refusal to admit the limits of the competitive equilibrium method and the need, beyond a certain point, for a different kind of discussion. A benefit for the new reader of this change in tone is that *G.T.* Book VI is written for the most part in ordinary language and is comparatively accessible.

Three aspects of *G.T.* Chapter 22 deserve particular attention: the nature of the discussion of the dynamics of the trade cycle; the two senses of the term 'over-investment'; and the discussion of policies for managing fluctuations, which sheds light on modern monetary policy. In *G.T.* Chapter 23, the discussion of mercantilist policy is not principally about export-led growth, but about the quantity of money, while the discussion of usury laws and Gesell's proposal is about the state of liquidity-preference. The discussion of Hobson and theories of under-consumption takes up the question of the policy trade-off between present consumption and the date of capital-saturation at full employment, a trade-off that seems remote from present conditions and reminds us how resigned we have become to the failure of full employment policy. This leads in *G.T.* Chapter 24 to the conclusion that free enterprise can be reformed and Classical economic theory can become more useful as a guide to policy, if the three independent variables of Keynes's model can be so influenced as to achieve full employment and the reduction of inequality through the 'euthanasia of the rentier'.

6.1 NOTES ON THE TRADE CYCLE

Of the three chapters of *G.T.* Book VI, the discussion in the first (*G.T.* Chapter 22) of fluctuations in employment appears closest to the formal method and has accordingly been misunderstood from the outset simply as an elementary exercise in dynamic modelling, which can be much improved by the application of more sophisticated techniques. Keynes's definition of a cycle certainly begins with a mechanical analogy, typical of the swinging of a pendulum, and places an emphasis on physical characteristics (such as the length of life of durable assets, the carrying-costs of surplus stocks, the acceleration in the movements of stocks of finished goods and working-capital, and the rate of population growth) as determining the length of the down-swing at between three and five years. These characteristics played a central role in the dynamic theories subsequently developed by Harrod and others, all the way down to real business cycle theory.

Yet to treat Keynes's discussion of the trade cycle as a first stumbling attempt to specify a differential equation is to miss the point entirely. His introductory paragraph emphasises the complexity of the trade cycle and the manner in which all three of his independent variables interact, even if fluctuations in the marginal efficiency of capital are the essential feature. A formal model of the cycle requires an equilibrium position about which oscillations take place, which would mean an equilibrium relationship between the independent variables of Keynes's system which is completely absent (and not to be confused with the equilibrium relation between the independent variables and the level of employment). A formal model requires cardinal numerical variables, but the independent variables all depend upon the state of long-term expectation and especially the state of confidence, which cannot be measured or modelled numerically in any meaningful manner. Finally, a formal model usually requires continuous functions, while discontinuity and crisis is for Keynes an intrinsic part of the cycle, as subsequently emphasised by Minsky (1975, 1983).

Having identified fluctuations in the marginal efficiency of capital as the essential feature of the trade cycle, Keynes proceeds to distinguish two senses of the term 'over-investment'. In a so-called 'real business cycle', the fluctuations in the marginal efficiency of capital would represent disequilibrium oscillations about a long-term long-period equilibrium position in which the return on investment equals the (normal) rate of interest. In a steady state dynamic equilibrium with continuous investment, over-investment can be understood as running ahead of the warranted rate, leading to a depression of the rate of return on investment, then recovery and cyclical oscillation. Keynes has already emphasised that the marginal efficiency of capital is an expectation, which is not a simple function of the current rate of return or existing stock of capital-goods (*G.T.* 141). Expectations are destined to disappointment, partly because they become over-optimistic and speculative at the height of the boom. The benchmark, against which expectations must be judged, itself moves with the fluctuations in the marginal efficiency of capital and the consequent level of employment, so that both optimism and pessimism are self-fulfilling to a degree. While doubting that full employment had ever been experienced outside time of war, let alone a state of full investment, even at the height of the 'roaring twenties' in the US, Keynes is remarkably sanguine about the prospects of capital-saturation within a generation, given full employment, returning to his theme at the end of *G.T.* Chapter 16.

Given his diagnosis, Keynes is pessimistic about the prospects for managing the trade cycle in a market economy by monetary policy alone. The range of fluctuation in the marginal efficiency of capital is too great to be offset by changes in the rate of interest; like the rudder on *Titanic*, monetary policy can cope only with small deviations from a straight course and only with sufficient notice. His discussion of Robertson's view (*G.T.* 327) sheds an interesting light on modern monetary policy based on an inflation target. Keynes holds that the ideal remedy for the boom is not a higher, but a lower, rate of interest, but grudgingly accepts the force of Robertson's argument (Robertson, 1926) that the only practical policy for stability (if 'dangerously and unnecessarily defeatist') *may* be to check the outbreak of speculative and inflationary conditions by restraining the pace of expansion by a rise in the rate of interest; although he doubts this would have worked in the conditions of 1929 in the US.

Modern conditions appear to vindicate both Keynes and Robertson to some extent. On the one hand, the growth of government employment, both directly and through contractors, has 'socialised' and stabilised a substantial part of the propensity to consume and the inducement to invest, reducing the range of fluctuation arising from the private sector alone. On the other hand, monetary policy has once again become concerned primarily with the trend in the price-level, and regards the level of employment as determined essentially by Classical forces. With long-term stability (rather than full employment) now considered the only politically feasible objective, the helmsmen on the Bank of England's Monetary Policy Committee attempt to scan the horizon two to three years ahead, through the fog that enshrouds the future, giving a touch on the tiller to keep the economy on course, as it is buffeted by unexpected squalls.

Keynes's vulnerable spot is his admission, in the course of this argument with Robertson, that the cost-unit tends to rise in terms of money when output increases (*G.T.* 328). Robertson's argument anticipates the doctrine of the 'non-accelerating inflation rate of unemployment' (NAIRU) which underpins modern policy and has displaced the concept of involuntary unemployment. When Keynes writes that 'no-one has a legitimate vested interest in being able to buy at prices which are only low because output is low', he underestimates the persuasiveness of the view that low unemployment leads to wage-push inflation, to which the later experience of stagflation lent credibility. So was the Classical linkage between money-wages and employment restored, and NAIRU became the new definition of full employment.

Nevertheless, the existence of a barrier to full employment in the form of the NAIRU does not mean that the theoretical analysis of *The General Theory*'s equilibrium model is flawed, still less that we should revert to the Classical theory of employment and describe any observed level of employment as full employment. A linkage between the cost-unit and the level of employment simply represents a relation between the independent variables (including the cost-unit) of Keynes's system that he did not fully develop. It may be that a 'rigid money-wage' is a practical condition of achieving full employment through demand management alone, but this does not mean that the money-wage can ever clear the labour market. The relation between employment and the cost-unit is not amenable to equilibrium analysis, as those have found who have tried to place a figure on the erratic NAIRU as a 'natural rate' of frictional unemployment.

6.2 OTHER REMEDIES FOR CHRONIC UNDER-EMPLOYMENT

Having considered in *G.T.* Chapter 22 the nature of *fluctuations* in employment, *G.T.* Chapter 23 moves on to consider the *level* of employment, and reviews pre-Classical orthodoxies and contemporary heterodox thought as to the causes and remedies for the chronic under-employment that Keynes perceives to be the normal state of the market economy. He sets out an intellectual heritage for his insights while retaining a critical eye for the weaknesses as well as the strengths of the views of his non-Classical predecessors. His literature review falls into three parts, two dealing with investment from the perspectives of mercantilism and of measures against usury and hoarding, and the third with theories of under-consumption.

The received wisdom, as we noted in Chapter 3 of this book, is that *The General Theory* is a special case in the sense that its model describes only a closed economy: no explanation is offered as to why Keynes would devote a major part of his discussion of policy to mercantilism, using a theoretical model that cannot accommodate international trade. As we noted, Keynes's concern is with the employment consequences of decisions to consume and invest, so that the identity of the consumers and investors is not of fundamental importance. The demand of the foreign sector for consumption goods, and the domestic demand for imports, are both accommodated within the aggregate propensity to consume. The discussion of mercantilism is not an informal extension, but an application, of the model developed in the main body of *The General Theory*.

Keynes defines mercantilism as, broadly, the view that the balance of trade is not in self-adjusting equilibrium and is a legitimate object of policy. His main concern is not with practical policies, over which there is in fact much common ground between the mercantilists and the Classical school, but with the intellectual basis of mercantilism that Classical thought firmly rejects. Keynes's interpretation of mercantilist thought does not, as might be expected by a modern reader, focus primarily on the contribution of net exports and export-led growth to aggregate demand, but on the effect of the balance of trade on the quantity of money, the rate of interest and the inducement for domestic investment. 'Foreign investment' does not refer to investment by foreigners, but mainly to the acquisition of foreign bullion, so that 'aggregate investment' does not here correspond to the value of the output of the domestic capital-goods industries. In the absence of developed international capital markets and central banking, a favourable balance of trade thus promotes investment under both kinds, since it is identical with the net acquisition of bullion and simultaneously increases the domestic monetary base, tending to reduce the rate of interest. The policy can be taken too far, so that the domestic rate of interest is reduced below rates elsewhere and the domestic cost-unit rises at high levels of output; the former may encourage foreign investment in the form of loans rather than bullion, reducing the increase in the domestic monetary base for a given balance of trade, while the latter will reduce the balance of trade itself. Keynes cites the history of imperial Spain and Edwardian Britain as examples of these counter-effects, and India as an example where a chronic trade surplus failed to translate into a reduction in interest rates because of excess liquidity-preference. Yet a moderate application of mercantilist policy will increase the wealth of the nation, and not merely its hoards. By contrast, the gold standard was based on the assumption, partly on the strength of the quantity theory of money and the price-level, that the balance of trade was self-adjusting, and that the balance of payments could be held in (full-employment) equilibrium by the domestic rate of interest.

Neither the gold standard nor mercantilism have much relevance to the modern world of fiat money and flexible exchange rates. Yet Keynes's review of these past controversies remains relevant for its argument that throughout most of recorded history 'practical men' have been rightly aware of the dangers of liquidity-preference and of the chronic tendency for the propensity to save (i.e. not to consume domestic output) to exceed the inducement to invest (in newly-produced domestic capital-goods). According to Keynes, this was also true of those, most of whom the Classical school would scarcely admit to be economists, the ancient and modern writers on usury.

Keynes pays tribute to the medieval scholastics for their recognition of the distinction between the marginal efficiency of capital and the rate of interest, and the need for measures to counter the high degree of liquidity-preference resulting from the risks of life in the medieval world. While Bentham argued that usury laws were counter-productive because they led to the rationing of potential borrowers with legitimate investment projects, such restrictions may equally encourage a holder of money to invest directly rather than to lend, as Adam Smith noted. Keynes praises Gesell for recognising the importance of low carrying-costs as one of the essential properties of money, while noting his failure to provide an explanation of a positive rate of interest and to recognise that liquidity is a matter of degree, hinting once again at the historical importance of land as the dominant liquid asset.

Having considered the arguments of other opponents of the Classical view of investment, Keynes turns to consider the theories of under-consumption put forward in particular by Mandeville, Malthus and Hobson, returning (in the latter cases at least) to the language and terminology of modern economic thought. Keynes defines under-consumption strictly, as a propensity to consume insufficient to sustain full employment in a state of capital-saturation, and thus not simply a low level of consumption resulting from under-employment. Keynes notes with approval the awareness, underlying

Mandeville's poetry, of the fallacy of composition in the relation between saving and current investment, together with his advocacy of full employment as the means to prosperity. Keynes's discussion of Malthus ('the first Cambridge economist') and Hobson makes explicit their joint opposition to Say's Law, including the archetypal quotation from Ricardo that

> Productions are always bought by productions or services; money is only the medium by which the exchange is effected. Hence the increased production being always accompanied by a correspondingly increased ability to get and consume, there is no possibility of Over-production. (*G.T.* 369)

Keynes notes with approval Hobson and Mummery's recognition that the demand for capital-goods cannot be separated from the demand for future consumption; of the nature of capital-goods as the reflection of production through time; of the nature of interest on money; of the tendency of a highly organised industrial society to excessive thrift relative to the need for investment; of the relation between consumption and income; and that production and employment are limited by effective demand and not by the Classical endowment. He finds flaws in their understanding of the relation between saving and current investment (so that they believe excess saving is realised in the form of excess accumulation) and their lack of an independent theory of interest and the state of expectation.

In conclusion, what these theories have in common with *The General Theory* is their diagnosis that the under-employment observed in a monetary economy reflects structural characteristics of society that are impervious to market forces, in contrast with the Classical view that free competition will deliver full employment. The political corollary is that labour, individually or collectively, is not usually to blame for its under-employment, in contrast with the Classical view that unemployment is, apart from frictional unemployment, essentially voluntary (where this usage follows Keynes in covering defects in labour market institutions of any kind that impedes competition).

6.3 POLITICAL IMPLICATIONS

Only just below the surface of *G.T.* Chapter 24 lies Keynes's passionate commitment to the Liberal view that the purpose of economic activity is to allow every person to exercise their liberty and to pursue happiness, free from the scourge of under-employment, even if the fulfilment of this objective entails a reduction in the return to accumulated wealth. This view remains as relevant and as controversial as ever today, in a world of poverty and inequality on a global scale.

Keynes's prescription was no more than to take the necessary steps to make the Classical parable a reality. Few, at least in a modern liberal democracy, would openly question as undesirable or inappropriate the implications of Marshall's long-period equilibrium, that no-one would need to work more (or less) than they chose, and that the return on capital and to individual talent would reflect only genuine sacrifice, enterprise or skill. What raises hackles is the brazen claim that the parable describes the world in which we live, or would live if labour was more docile.

The enduring technical contribution of *The General Theory* is to refute the Classical view of the 'nature and necessity of interest' (*G.T.* 176), and show that the avowedly shared aim of full employment and maximum investment is thwarted, not aided, by policies such as the Gold Standard and its modern equivalents; and that the misery to which working people were subjected during the 1920s and 1930s (and not only then) in the form of welfare and wage cuts was not only regrettable, but futile. The political contribution of Keynes's book was to legitimise the use of monetary and fiscal policy and the provision of goods and services by the State in order to secure full employment. Keynes won the political argument and helped to secure the unparalleled prosperity of the post-war period until the cost-unit finally broke free in 1973. The breakdown, first of the 'cheap money' policy which died with Keynes and much later, of demand management as the basis of full employment, has led to the resurgence and current dominance of Classical ideas in the academy, although the attitudes of policy-makers as revealed by their monetary and fiscal policies continue to be far more eclectic.

In reviewing Keynes's political vision with the benefit of 70 years of hindsight, it is important to recall that the policy measures associated with Old Keynesian economics were but one way of 'adjusting to one another the propensity to consume and the inducement to invest' (*G.T.* 380). The partial failure of one particular set of policy tools is not an excuse for reverting to an obsolete theory of the competitive monetary economy; nor for accepting inhumane and wrong-headed policies on labour rights and international trade, based on a confusion of the Classical parable with reality; nor for admitting defeat in the search for a better understanding of the workings of the economy, and for structural reforms capable of improving its performance in the service of genuine human freedom.

6.4 CONCLUSION

G.T. Book VI is a classic demonstration of the powerful use of economic theory in the hands of a master. The limitations of equilibrium analysis do not mean that nothing can be said about change over time (dynamics in the wider sense), but we need to take our heads out of the engine compartment, stop tuning up the equilibrium model, and take the model for a spin through a social landscape embedded in history. There can be wisdom in the insights of practical men and thinkers, who see the world without the aid of equilibrium analysis, and have often perceived enduring social realities more clearly than the economists. Full employment is a necessary condition of human liberation, but remains elusive; yet it will not help to pretend that we already have it. Keynes offered some specific proposals which have largely been put into practice with unparalleled success, but these have not proved adequate for the securing of permanent full employment on a global scale. The next chapter will consider, by way of epilogue, what the interpretation of *The General Theory* developed in this book now suggests, in the light of the events and debates of the last 70 years.