Talk for PKSG, 25 May 2007

Geoff Tily

Keynes Betrayed

Above all my argument is that Keynes's life work was primarily concerned with domestic and international monetary policy – or monetary reform. That Keynes came to see prosperity hinged on low interest rates from short to long. And that policy **could** and **should** be aimed at achieving those low rates. He was, as *The Times* Review of General Theory put it, a 'champion of the cheap money policy that has always been associated with his name'.

My interpretation of the General Theory is then aimed at justifying this policy goal. This interpretation is based on post-Keynesian economics, though a re-interpretation and re-arrangement of that economics.

As post-Keynesians recognise, Keynesian economics is a gross misrepresentation of Keynes's economic theory. But, for me, it is not only this, but also a gross misrepresentation of his policy.

This leads me to the other part of my story, which concerns the nature of economic debate over the General Theory, and perhaps, the nature of economic debate in a more fundamental sense.

I argue that Keynesian economics was a rival theory to Keynes's own. And I cannot escape the conclusion that it was promoted because of opposition to Keynes's policy implications.

Keynes's substantial agenda for monetary reform, his international currency plans through to his domestic debt management techniques, was watered down to the desirability of fiscal policy to preserve aggregate demand.

It is obviously not possible to be oblivious to the wider implications of this interpretation.

I am arguing that the nature of economic debate was primarily political, and , for want of a better word, phoney. And, let's face it, our splendid isolation here rather suggests it might still be. So Keynes was betrayed by the economic profession [and more than likely by other forces]. And of course this betrayal is a betrayal too of society. For, if the reading of the theory is correct, there is a very real impact.

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I can offer you no more today than a very brief overview of how I present my argument but will dwell, given the nature of the occasion, on some of the post-Keynesian ideas to which I give prominence. I am more than a little conscious of picking a fight with everyone. Where I have misjudged matters I apologise, and offer in my defence that I do so with the best possible intentions.

I have also handed out my contents page. The book is in three parts.

Contents

The first part sets out a history of monetary economics, examines Keynes's contribution to that body of work and its practical application, and then traces the history of the rival 'Keynesian' theory and practice.

Chapter 2 is a chapter of monetary theory and monetary history. One of my aims is to provide a foundation for the whole discussion that to some extent abstracts from the specific contributions of Keynes. Much of this is very familiar to post-Keynesians. However, I am particularly concerned to propose a fundamental relation between the 'discovery' of banking and the rate of interest.

Too much discussion has dwelled on the relations between banking and a potential vast increase in the quantity of money. For me, far more fundamental, is the relation between banking and great falls in the rate of interest.

I cite John Law and Josiah Child who in the seventeenth and eighteenth centuries advocated the development of banking systems for this very reason; for they saw prosperity hinged on low interest rates. They saw this by looking to the Netherlands where banking had already developed. And I perhaps provocatively argue that the sweep of prosperity across Europe from Italy in the fifteenth and sixteenth centuries, to the Netherlands in the seventeenth century, and finally to Britain in the eighteenth century followed from the historical development of banking.

In eighteenth-century Britain, economists at the time were by no means ignorant of the importance of these monetary considerations.

Smith recognised the implications for prosperity; indeed perhaps the Wealth of Nations was empirical evidence of that prosperity.

Adam Smith from *The Wealth of Nations*

When, therefore, by the substitution of paper, the gold and silver necessary for circulation is reduced to, perhaps, a fifth part of the former quantity, if the value of only the greater part of the other four-fifths be added to the funds which are destined for the maintenance of industry, it must make a very considerable addition to the quantity of that industry, and, consequently, to the value of the annual produce of land and labour.

An operation of this kind has, within these five-and-twenty or thirty years, been performed in Scotland, by the erection of new banking companies in almost every considerable town, and even in some country villages. (Smith, 1812 [1776], p. 236)

In a country, such as Great Britain, where money is lent to government at three per cent. and to private people upon good security at four, and four and a half, the present legal rate, five per cent., is perhaps, as proper as any. (ibid., p. 286)

In C19, Marx went further and identified implications for the class conflict.

Karl Marx from *Capital*, Volume III

The development of the credit system takes place as a reaction against usury. (Marx, 1909, p. 704)

This violent fight against usury, this demand for the subordination of the interest-bearing under the industrial capital, is but the herald of the organic creations, that establish these prerequisites of capitalist production
in the modern banking system, which on the one hand robs usurer's capital of its monopoly by concentrating all fallow money reserves and throwing them on the money-market, and on the other hand limits the monopoly of the precious metals themselves by creating credit-money.

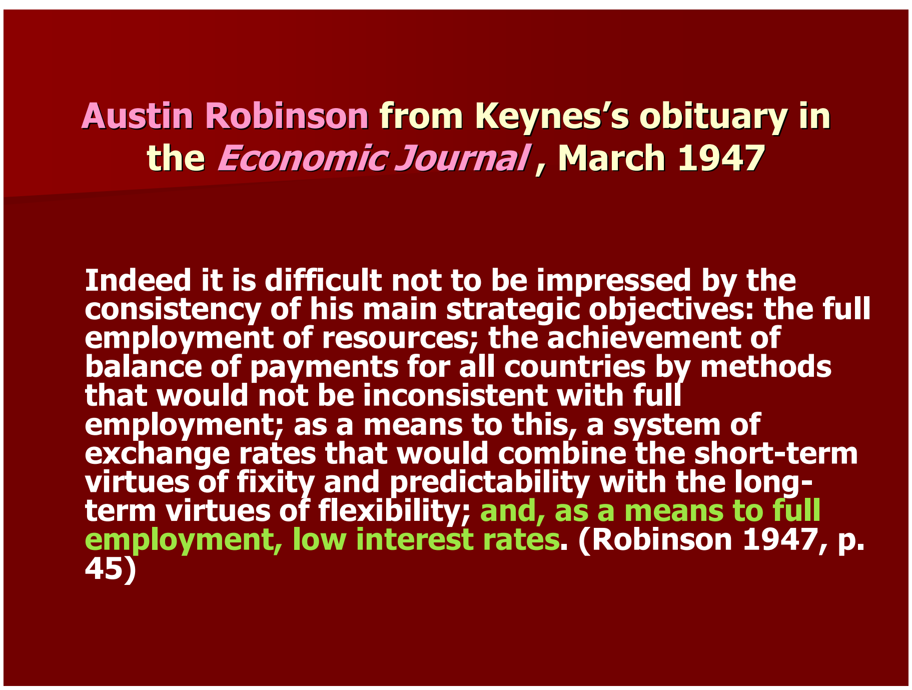
Against the Bank of England all goldsmiths and pawnbrokers raised a howl of rage. [T]he goldsmiths intrigued considerably against the Bank, because their business was reduced by it, their discount lowered, and their business with the government had fallen into the hands of this antagonist. (ibid., pp. 708–9)

I go on to argue that for the left and some liberals – for Hobson, Lenin and Hilferding – finance capital became the ‘villain of the economic piece’.

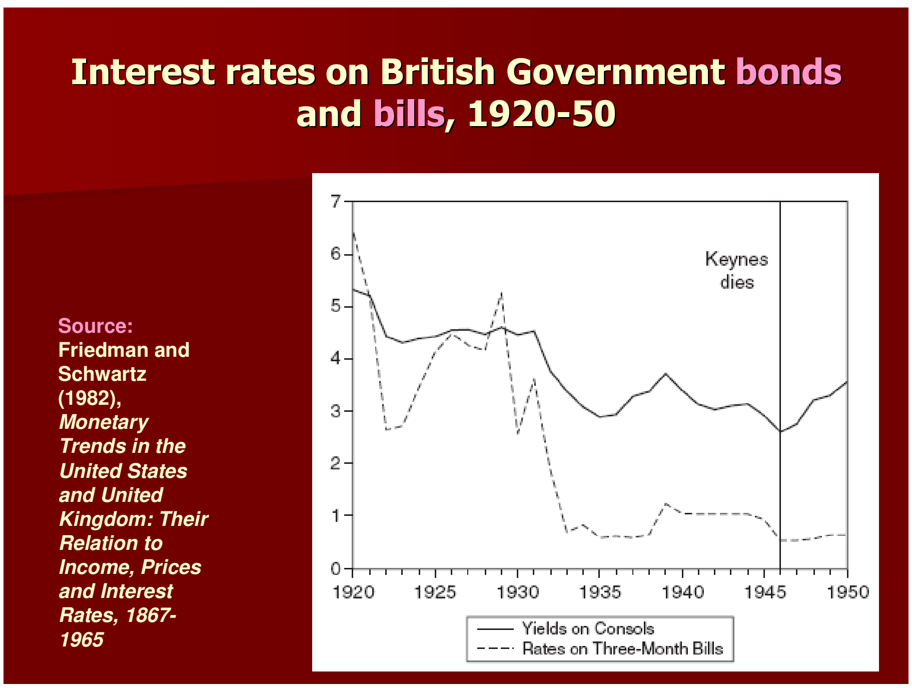
And finally, that policy development in the wake of the Great Depression reflected a gradual bringing to heel of that villain.

Chapter 3 tells this story with Keynes at centre stage. The title – JMK and the fourth Grand Monetary Discussion – is a reference to Keynes’s own characterisation of the debates in monetary policy over the eighteenth and nineteenth centuries.

I have cited before and will continue to cite Austin Robinson’s summary, from his obituary essay.



All Keynes's policy initiatives were part of a coherent strategic whole, not some rag bag of ad hoc responses to circumstance. His target was the gold standard. And with its self-destruction he achieved the implementation of exchange management policies that permitted autonomy over domestic monetary policy. - autonomy that he came to realise should be used to implement cheap money policies, of low interest rates across the spectrum. We can of course see interest rates fall



To jump to the end of the story, I believe that his most important legacies to society are his plan for a international clearing union and his domestic debt management policies set out at the National Debt Enquiry; the Report of the latter being reproduced as annex to the chapter.

In **Chapter 4** I outline how I believe Keynesian economics emerged and came to replace Keynes's theory and to supersede the policy discussions that I detailed in Chapter 3.

Let me stress that Keynesian policies are not radical. The right does not shy away from fiscal policy or tariffs when the market fails. And indeed I trace how a large number of the British establishment turned to what they themselves coined 'economic nationalism' in the wake of the Great Depression: one leader or figurehead was Harold Macmillan, future Conservative Prime Minister. The same characters would not countenance Monetary Reform; the great depression demanded change, but economic nationalism (?) was an alternative to what Keynes offered.

But to the layman, and indeed to many professionals, the boundaries seem to have been hopelessly blurred ever since.

In parallel, a number of prominent economists jettisoned dearly held classical beliefs to develop an alternative economics that might support a degree of economic nationalism. I trace this economics through Ralph Hawtrey, to Dennis Robertson and then to the Keynesian economists, with Hicks and Modigliani making the critical contributions. I should remind you all that the title of Modigliani's 1944 paper is 'Liquidity Preference and the Theory of Interest and Money'.

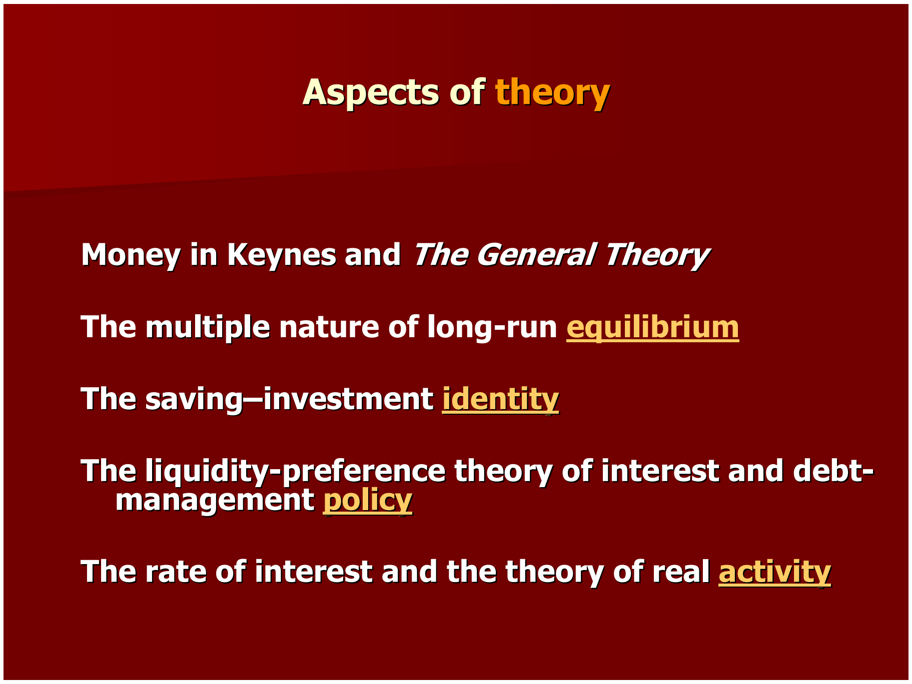
The identification of Keynes with this policy and theoretical agenda was a sleight of hand of staggering implication.

In **Part 2**, I set out my interpretation of Keynes's theory. The order of presentation and points of emphasis differ from both Keynes's own presentation and post-Keynesian interpretations.

Keynes sought to present a substantial and detailed theoretical statement of his General Theory as rival, and therefore in contrast, to the classical economics. My aim is primarily to present the theory in a manner that justifies the implementation of a secular cheap-money policy. First, I seek to explain why and how cheap money can be set; and second, why cheap money should be set.

I incorporate theory and policy discussions from both before and after the General Theory. The ordering and emphasis comes through the Chapter titles.

Time is my enemy, so I shall only draw attention to the aspects of this theory that might be more contentious in present company.



First, money, or rather endogenous money in Keynes and the General Theory

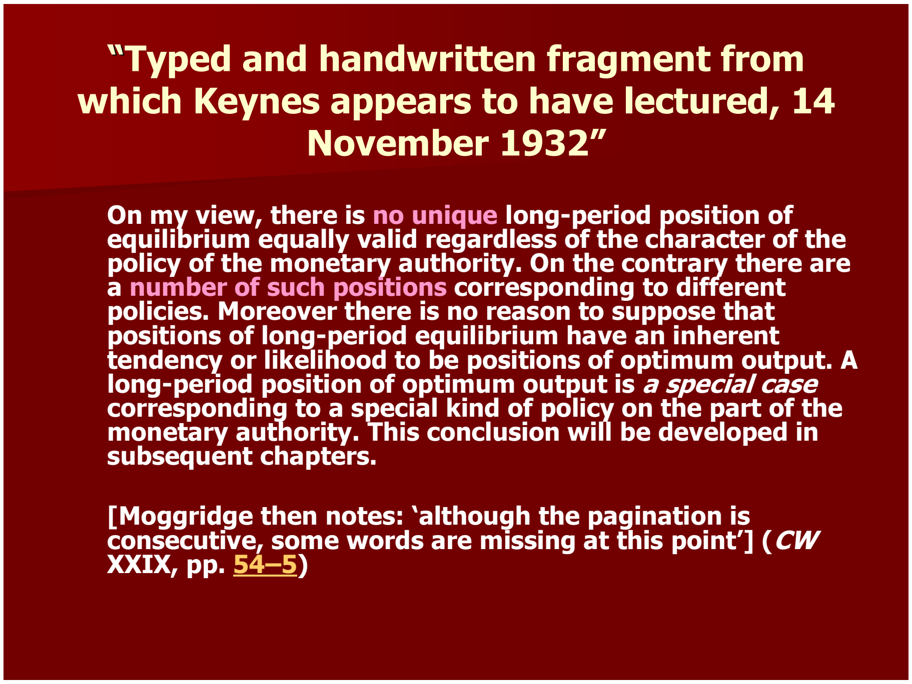
All of Keynes's contributions from Indian Currency and Finance on were motivated by his understanding that a credit or bank money economy operated differently to the economy described in classical economics - an understanding, I feel obliged to point out today, that had been fostered by Alfred Marshall. From the start, he saw that the gold standard was flawed because it was based on a theory that was only applicable to commodity money economies.

Jumping on. In the General Theory, Keynes set the theory of credit aside as well known. To take this as forgetting credit, as Basil Moore claims in his latest book, is for me absurd. Dow's and Chick's line that he took credit as given, and was instead concerned about the processes after money has been created is spot on. I argue that the General Theory concentrated on the theory of money as a store of value; his previous contributions were concerned with money as a means of exchange. Ultimately it was these store of value considerations that led to the debt-management policies that could bring the rates of interest under control. Certainly Keynes should have better addressed the links between the two theories, but for me, most post-Keynesians have been excessively pre-occupied by the means of exchange function to the detriment of the other.

Two, the multiple nature of long-run equilibrium

That the economy can operate outside its classical long run has not been controversial since at least David Hume. Such short runs were a feature of Keynes's economics from his earliest contributions. But, up to and including the Treatise, he held to the classical long run.

With the General Theory he abandoned it; **not** the **notion** of long-run equilibrium, but the notion of a **unique** long-run equilibrium. Instead he saw the possibilities of multiple equilibrium, as follows



The activity in an economy depended both on the long-run equilibrium and short-run movements relative to that equilibrium.

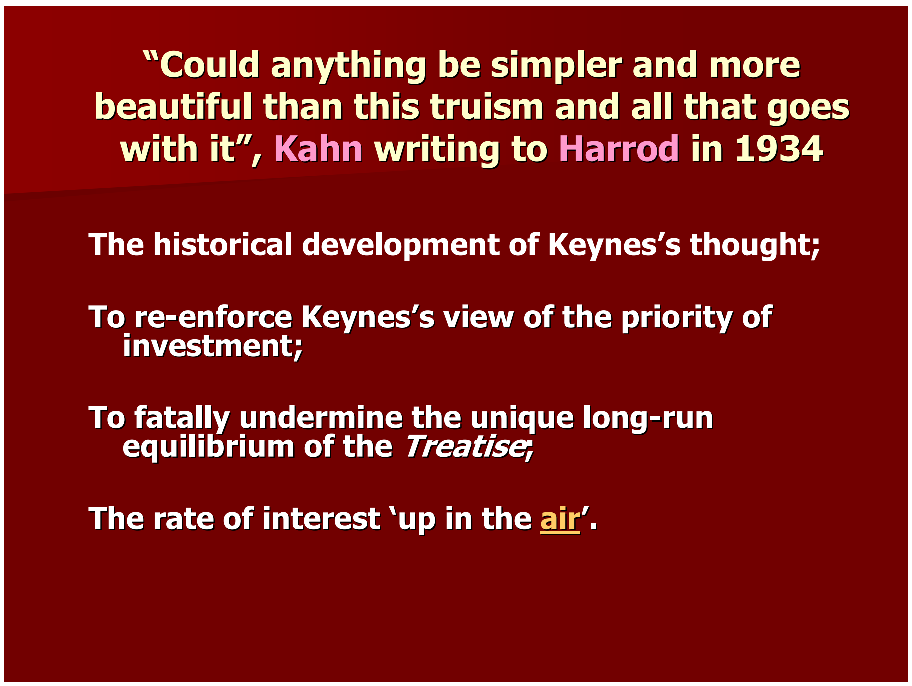
To over-simplify, the key determinant of the long-run equilibrium is the long-term rate of interest, and of the short run, animal spirits. In this way expectations are incorporated, but long-run equilibrium not abandoned.

I shall return to this.

Three, the saving-investment identity

I accord great importance to the saving-investment identity as **the** discovery that set Keynes away from his Treatise and became the foundation of all his subsequent theoretical developments. The General Theory is perhaps not obviously so motivated; Kahn for me captured it best (in private correspondence) “could anything be simpler and more beautiful than this truism and all that goes with it” (166)[1].

The identity is a monetary phenomenon. As Chick has demonstrated, it is the existence of credit and the freeing of income from a saving constraint that guarantees the identity.



I identify four consequences.

- The first is historical. If the identity is important, then the historical account of the transition between the Treatise and General theory requires revisiting.
- Second, re-enforcing the primacy of investment rather than saving in the economic process.

[1] This and the other page references refer to my book.

- Third, the fatal undermining of his Treatise argument, which depended in short-run disequilibrium between saving and investment, and long-run equilibrium with equality.
- Fourth, just as the long-run equilibrium was undefined, so was the rate of interest, and so the classical theory of interest had to be rejected. (‘Saving and investment balance at any rate of interest, … any analogy with demand and supply analysis does not work’, 164).

Four, the liquidity preference theory of interest and debt management policy

The theory of liquidity preference provided an alternative to the classical theory. As I have emphasised, I believe liquidity preference should be seen primarily as a theory of money as a store of value: with wealth held as money – or rather, and this is critical – in more liquid form, because of uncertainty about the future rate of interest.

Much of the terrain is familiar. A liquidity preference curve can be drawn up on the basis of speculators’ views of the long-term rate of interest versus a ‘safe’ or ‘normal’ rate. For post-Keynesians, the curve can shift with changing views of the safe/normal rate. But what has been overlooked is that:

- One, the safe or normal rate can be manipulated by a monetary authority determined to bring the long-term rate of interest under control.
- And, two, the means to do so is debt-management policy.

This debt-management policy was developed gradually, beginning with the conversion of the war debt in 1932, hinted at in the General Theory, built substantially in the war and then formalised at the April/May 1945 NDE. An enquiry formally set up to examine how to reduce burden of post-war debt, but that fully addressed the cheap money policy.[2]

In theoretical terms the rate of interest on illiquid assets, bonds, was set against the quantity of liquid assets, bills. As Keynes put it in his notes ‘Authorities make rate what they like by allowing the public to be as liquid as they wish’ (202).

Policies to do so were:

i. The tap issue, under which rates of interest on bonds of varying maturities were announced, but no limits were set to the cash amount of any issue.

[2] My view is now (October 2007) that its main remit was to challenge the Employment White Paper’s take on monetary policy.

The Report of the National Debt Enquiry

30. We suggest the following programme of initial procedure – the date of its introduction is discussed below.

> **(a) Treasury Bill rate to be brought down to 1/2% and Treasury Deposit Receipts to carry 5/8%; probably a special rate of 1% (broadly the present rate) to apply to overseas money now in Treasury Bills and the like.**
> **(b) Subject to action on (a), 5 year Exchequer Bonds at 11/2% and 10 year Bonds at 2% to be issued on tap, a new series to be started annually.**
> **(c) 3% Savings Bonds to be issued on tap, a new series to be issued annually, with an option to the Treasury to repay after 10 years with, preferably, no final maturity (or if necessary a fixed latest date of repayment after 35 years).**
> **(b) follows upon (a); (c) could either follow (a) or precede it.**

ii. On the bill side, policy required an extension of the issue and range of the floating debt and hence the rejection of the 'funding complex'. Involving the introduction of Treasury Deposit Receipts, of six month maturity, but not reservable against cash at the central bank. Interest rates as above.

iii. Bank rate redundant as an instrument of policy.

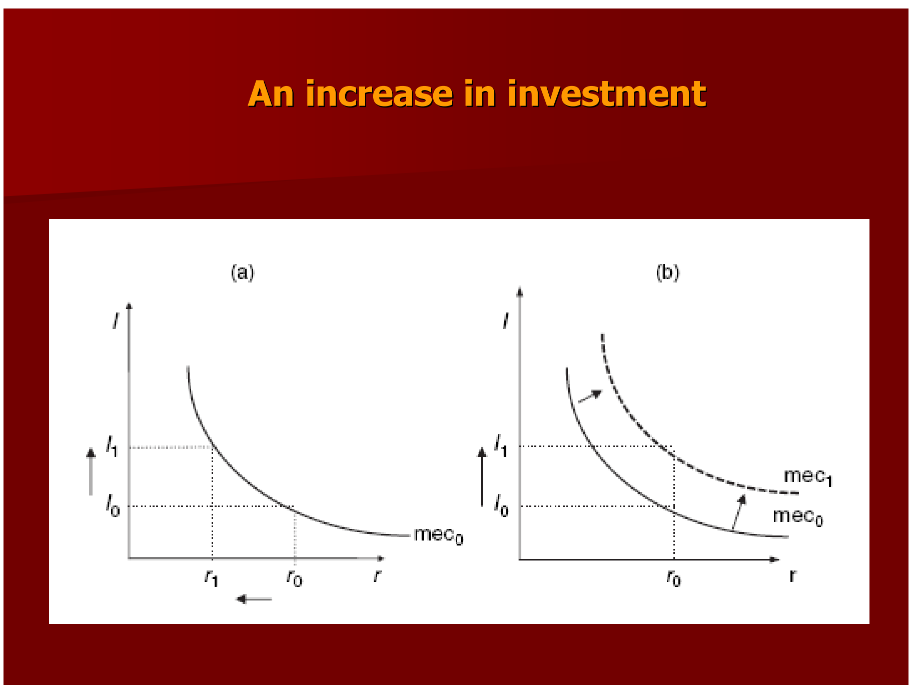
iv. I should emphasise too that these policies were set against a backdrop of capital control.

Liquidity preference helped define and justify these policies; and that is why it is a theory of the most substantial importance.

Finally, the rate of interest and the theory of real activity

A low rate of interest leads to a high volume of capital investment, higher activity, and higher employment. I believe this to be the central relation between Keynes's monetary theory and the 'real world'. The G.T.O.E.I.M.

The one specific aspect of the theory of effective demand that I would like to touch on here is the respective roles of the rates of interest and expectations.



Investment can increase following a shift in the mec (b) or a reduction in the rate of interest (a). The two are not equivalent. The distinction comes out in Keynes's trade cycle chapter. Here he defines a correct mec, which implies that a **correct** level of investment exists for any given interest rate.

Investment in excess of that level of investment is a 'boom', and is the cause of the business cycle. And that leads to the danger of dear money. Under dear money excessive expectations of the yield of investment – facilitated by credit – will lead to high investment, but investment that will not deliver the yields expected, and moreover the yields required to meet the costs of the Investment. I have tried to take the story on and argue that the consequence will be debt inflation and capital market inflation, to borrow Jan Toporowski's phrase. And, furthermore, the bursting of these inflations leads to recession.

This characterisation of events is potentially very relevant to the world today. I shall return to this world at the end.

And at this point my theoretical discussion is concluded. The remaining chapters belong to **Part 3**, Macroeconomics after Keynes, which I shall deal with very briefly.

Chapter 9 is concerned with the myth that Keynes approved IS-LM. For me, with the monetary nature of the theory and monetary policy conclusions identified, the notion must be absurd. He certainly did not approve what came to be known as Keynesian economics, but equally he never saw the scale of the threat.

In the clumsily titled **Chapter 10**, I follow the rapid rise to dominance of the 'Keynesian interpretation', and the development of a new academic economics, that returned to microeconomic welfare foundations and was bloated through econometrics. The key mechanisms were the lecture theatres and textbooks, of the latter none more important than Samuelson's. Chapter 10 watches too the rejection of the post-war CMP, as specified by Keynes and Hopkins at the NDE, and implemented by the first majority Labour government in British history.

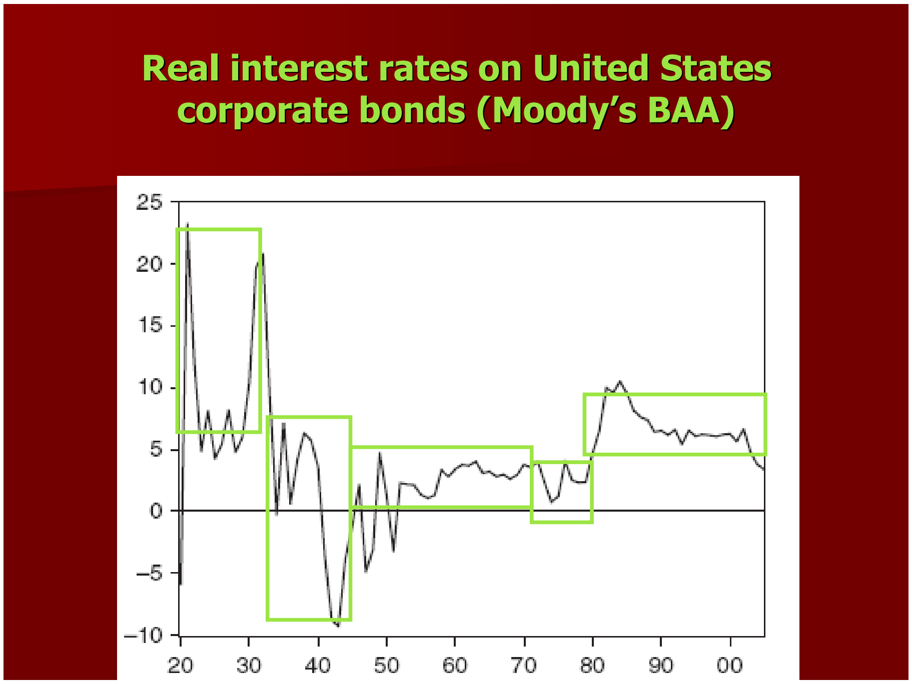
Eventually the Keynesians would surrender their own more and more bastardised constructs to the monetarists.

But there are brave heroes who watched such events with some disgust. I examine contributions from Kahn, Joan and Austin Robinson, Roy Harrod, Leon Keyserling, Sidney Weintraub and Abba Lemer. And I am obviously eager to emphasise that many of these contributions often addressed the monetary aspect. In the last sections I look at the Keynesians' retraction of their own construct and the emergence of post-Keynesianism, and in particular those post-Keynesians who I find close to my own theory and policy perspective.

Finally, in **Chapter 11** I turn to my application of the General Theory to the facts of experience.

To stretch a point, underlying everything are movements in global long-term rates of interest.

I would regard these real rates on US corporate bonds as a reasonable guide to global long-term rates.

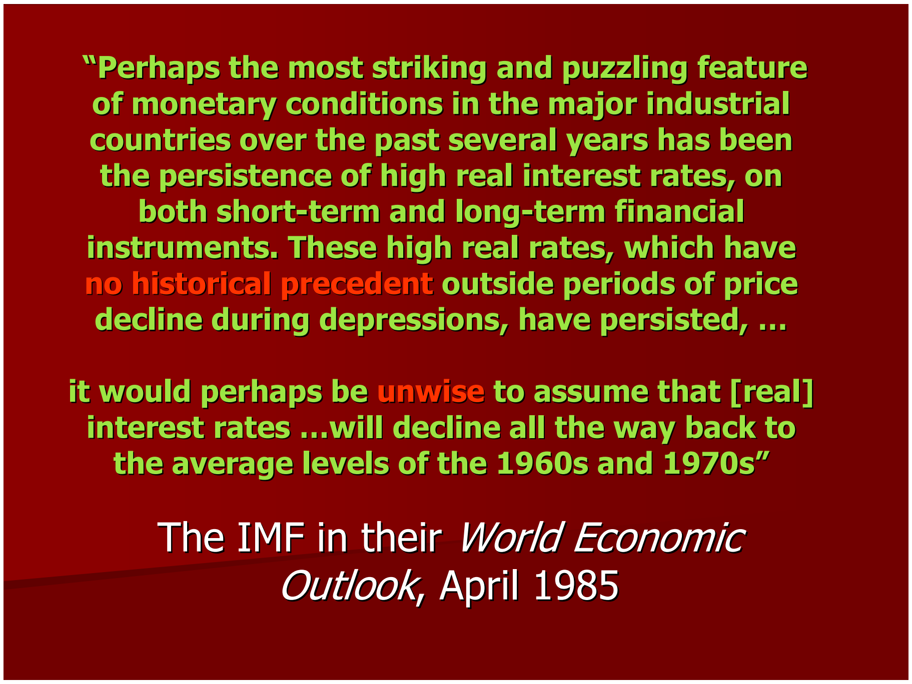


And I characterise economic dynamics since 1920 in 5 periods as follows:

1. dear money of 20s under Gold Standard
2. advent of currency management and cheap money policy in 30s
3. post-war golden age under Bretton Woods and cheapish money
4. 70s when money became too cheap (e.g. negative real rates on government bonds)

Then (5), when, from the beginning of financial liberalisation, the world economy entered an era of dear money of perhaps unprecedented duration.

This is how the IMF saw it at the time.



Clearly it would have been very unwise.

We are left in a world polarised between extreme wealth and extreme poverty, characterised by chronic unemployment and inactivity. This is a world reliant, ironically, on fiscal policy, as well as monetary expansion supported by house price inflation. It is based on debt and capital market inflations of an order that I suspect has never been known.

Some cannot help but acknowledge this.

> **"The build-up of debt levels over time, both domestically and internationally, can eventually also lead to economic problems with attendant and often substantial costs. … Any or all of these numbers might well revert to the mean, with associated implications for global economic growth. Such an unwinding might be gradual, and possibly benign, but it could also be rapid and disruptive. In large part, what happens will be determined by real–financial interactions that we should not pretend to fully understand."**
>
> The BIS in their *75th Annual Report*, 2005

One has to admire their honesty; but plainly the BIS have no hope of understanding matters with a theory that rules out significant real-financial interaction from the beginning.

It is my belief that Keynes's economics offers the only solution to the world's 'Economic Problem'. For decades this 'problem' has been analysed with an economics that Keynes identified as 'disastrous if applied to the facts of experience'.

The question is how on earth can we get anybody to listen? The same facts of experience might advise us to fear very greatly what it might take.