

THE
GENERAL THEORY
OF
EMPLOYMENT INTEREST
AND MONEY

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#453



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PREFACE

THIS book is chiefly addressed to my fellow economists. I hope that it will be intelligible to others. But its main purpose is to deal with difficult questions of theory, and only in the second place with the applications of this theory to practice. For if orthodox economics is at fault, the error is to be found not in the superstructure, which has been erected with great care for logical consistency, but in a lack of clearness and of generality in the premisses. Thus I cannot achieve my object of persuading economists to re-examine critically certain of their basic assumptions except by a highly abstract argument and also by much controversy. I wish there could have been less of the latter. But I have thought it important, not only to explain my own point of view, but also to show in what respects it departs from the prevailing theory. Those, who are strongly wedded to what I shall call "the classical theory", will fluctuate, I expect, between a belief that I am quite wrong and a belief that I am saying nothing new. It is for others to determine if either of these or the third alternative is right. My controversial passages are aimed at providing some material for an answer; and I must ask forgiveness if, in the pursuit of sharp distinctions, my controversy is itself too keen. I myself held with conviction for many years the theories which I now

BY THE SAME AUTHOR

THE ECONOMIC CONSEQUENCES OF THE PEACE

Pp. viii + 298. 1920. \$2.50

A REVISION OF THE TREATY

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MONETARY REFORM

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"In the long run we are all dead"
p. 88

*"In truth, the gold standard is
already a barbarous relic."*
p. 87



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have the effect of raising p to double what it would have been otherwise. The Quantity Theory is often stated in this, or a similar, form.

Now "in the long run" this is probably true. If, after the American Civil War, the American dollar had been stabilized and defined by law at 10 per cent below its present value, it would be safe to assume that n and p would now be just 10 per cent greater than they actually are and that the present values of k , r , and k' would be entirely unaffected. But this *long run* is a misleading guide to current affairs. *In the long run* we are all dead. Economists set themselves too easy, too useless a task if in tempestuous seasons they can only tell us that when the storm is long past the ocean is flat again.

In actual experience, a change of n is liable to have a reaction both on k and k' and on r . It will be enough to give a few typical instances. Before the war (and indeed since) there was a considerable element of what was conventional and arbitrary in the reserve policy of the banks, but especially in the policy of the State Banks towards their gold reserves. These reserves were kept for show rather than for use, and their amount was not the result of close reasoning. There was a decided tendency on the part of these banks between 1900 and 1914 to bottle up gold when it flowed towards them and to part with it

reluctantly when the tide was flowing the other way. Consequently, when gold became relatively abundant they tended to hoard what came their way and to raise the proportion of the reserves, with the result that the increased output of South African gold was absorbed with less effect on the price level than would have been the case if an increase of n had been totally without reaction on the value of r .

In agricultural countries where peasants readily hoard money, an inflation, especially in its early stages, does not raise prices proportionately, because when, as a result of a certain rise in the price of agricultural products, more money flows into the pockets of the peasants, it tends to stick there; deeming themselves that much richer, the peasants increase the proportion of their receipts that they hoard.

Thus in these and in other ways the terms of our equation tend in their movements to favor the stability of p , and there is a certain friction which prevents a moderate change in n from exercising its full proportionate effect on p .

On the other hand a large change in n , which rubs away the initial friction, and especially a change in n due to causes which set up a general expectation of a further change in the same direction, may produce a *more* than proportionate effect on p . After the general analysis of Chapter I

from actual circulation destroyed one of the elements of reality lying behind the convention, and the suspension of convertibility destroyed the other. It would have been absurd to regulate the bank rate by reference to a "proportion" which had lost all its significance; and in the course of the past ten years a new policy has been evolved. The bank rate is now employed, however incompletely and experimentally, to regulate the expansion and deflation of credit in the interests of business stability and the steadiness of prices. In so far as it is employed to procure stability of the dollar exchange, where this is inconsistent with stability of internal prices, we have a relic of pre-war policy and a compromise between discrepant aims.

Those who advocate the return to a gold standard do not always appreciate along what different lines our actual practice has been drifting. If we restore the gold standard, are we to return also to the pre-war conceptions of bank-rate, allowing the tides of gold to play what tricks they like with the internal price-level, and abandoning the attempt to moderate the disastrous influence of the credit-cycle on the stability of prices and employment? Or are we to continue and develop the experimental innovations of our present policy, ignoring the "bank ratio" and, if necessary, allowing unmoved a piling up of gold reserves far

beyond our requirements or their depletion far below them?

In truth, the gold standard is already a barbarous relic. All of us, from the Governor of the Bank of England downwards, are now primarily interested in preserving the stability of business, prices, and employment, and are not likely, when the choice is forced on us, deliberately to sacrifice these to the outworn dogma, which had its value once, of £3:17:10½ per ounce. Advocates of the ancient standard do not observe how remote it now is from the spirit and the requirements of the age. A regulated non-metallic standard has slipped in unnoticed. *It exists.* Whilst the economists dozed, the academic dream of a hundred years, doffing its cap and gown, clad in paper rags, has crept into the real world by means of the bad fairies—always so much more potent than the good—the wicked Ministers of Finance.

For these reasons enlightened advocates of the restoration of gold, such as Mr. Hawtrey, do not welcome it as the return of a "natural" currency, and intend, quite decidedly, that it shall be a "managed" one. They allow gold back only as a constitutional monarch, shorn of his ancient despotic powers and compelled to accept the advice of a Parliament of Banks. The adoption of the ideas present in the minds of those who drafted the Genoa Resolutions on Currency is an essential