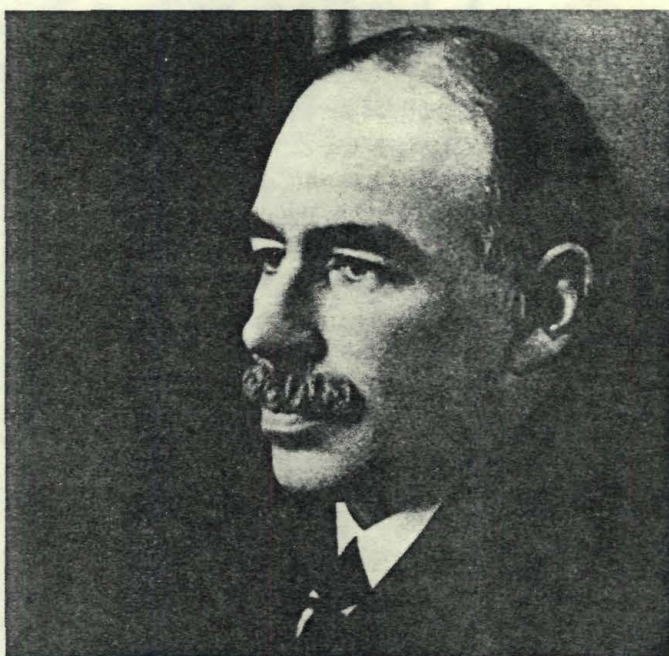


John Maynard Keynes 1883–1946

*June 1983 marks the 100th anniversary of the birth of John Maynard Keynes. Keynes lived brilliantly all the lives to which an economist might aspire. He wrote the most influential economics book of this century, *The General Theory of Employment, Interest, and Money* (1936). His other writings, now being reprinted by the Royal Economic Society, will fill thirty volumes.*

He was a high-level consultant to the British government for more than twenty years and represented his government in international negotiations, including those that led up to the Bretton Woods Agreements. A constant flow of his writings in newspapers and magazines educated a generation of laymen on economic problems and policies. In 1942, four years before his death, he was made Lord Keynes by his grateful sovereign.

No other economist of our times has so much influenced the thinking of so many of his contemporaries. In an effort to convey the nature of this influence, five economists at the American Enterprise Institute who at different points in their ca-



The Bettmann Archive

reers first encountered his work, especially the General Theory, present here informal accounts of the significance of Keynes for them.

Theory As a Tool of Policy,
by Gottfried Haberler
Keynes in the History of Economic
Thought, by William Fellner
Early Memories of a Keynes I
Never Met, by Herbert Stein

Page 2

Page 3

Page 6

Keynes and Recent
Economic Policy,
by Rudolph G. Penner
Impressions of a
Younger Generation,
by Eduardo Somensatto

Page 9

Page 11

Theory As a Tool of Policy

Gottfried Haberler

John Maynard Keynes, undoubtedly the most famous and influential economist of our century, is best known through his book *The General Theory of Employment, Interest, and Money* (1936). This, however, is only the tip of the iceberg. His *Collected Writings*, whose publication is nearing completion, will run to thirty volumes, about 80 percent of which is economics, in the broad sense. The *General Theory* is by no means his only theoretical work; in fact, some would say that it is not his most important theoretical work. I myself would place his *Treatise on Money* (two volumes, 1930) higher, from the scholarly standpoint.

What is generally referred to as Keynesian economics should be distinguished from the economics of Keynes. Keynes frequently changed his views so fast with changing circumstances that many of his followers could not keep pace with him. Two examples follow.

First, in the *General Theory*, which appeared during the Great Depression of the 1930s, Keynes rightly concentrated his fire on deflation, falling prices, and unemployment. As everybody knows, he recommended monetary expansion and government deficit spending to combat unemployment. What is not as well known is that in 1937, one year after the appearance of the *General Theory*, he turned around and said that it was time to shift emphasis from fighting unemployment to curbing inflation, though inflation at that time was not particularly high by postwar standards, and unemployment was still above 10 percent. No wonder that most of his disciples did not follow him and continued to preach monetary and fiscal expansion

"What is generally referred to as Keynesian economics should be distinguished from the economics of Keynes. Keynes frequently changed his views so fast with changing circumstances that many of his followers could not keep pace with him."

throughout the postwar period, which must bear a large share of responsibility for the inflation from which we have been suffering.

Second, Keynes was brought up in the laissez-faire liberal spirit of the nineteenth century and favored free trade and free enterprise. During the mass unemployment

Gottfried Haberler is a resident scholar at AEI and Galen L. Stone Professor of International Trade Emeritus at Harvard University.

and depression of the 1930s, he changed his views and advocated protectionist measures. But his protectionist-nationalistic period did not last very long. When during World War II he became engaged in drawing up plans for postwar economic reconstruction, he returned to his early liberal beliefs and had to defend himself from the attacks of his erstwhile followers who had become his bitter critics. He called their arguments "modernist stuff, gone wrong and turned sour and silly...circulating in our system."¹

When I read the *General Theory* the first time, immediately after its appearance, I was greatly impressed and intrigued by the provocative argument, but not by the policy prescriptions: that in a period of mass unemployment and declining prices, deficit spending and monetary expansion are in order. This view was widely accepted even by many whom Keynes denounced as archclassicals.

What puzzled me from the beginning was Keynes's theory that long-run equilibrium with high unemployment is possible, even under perfect competition in the labor market—a theory widely regarded as Keynes's most important discovery. Keynes accepted the classical proposition that employment rises if *real* wages decline. But he argued in the first part of his book that when *money* wages are driven down by competition, prices fall *pari passu* so that *real* wages and employment remain unchanged.

I felt that this was not the end of the story, but I soon discovered that Keynes, in the last part of his book, qualified his theory. When money wages decline, he maintained, prices fall, which implies an increase in the *real* quantity of money, which, in turn, pushes down interest rates and stimulates investment and employment. But there are two hitches. First, investment may fail to expand when interest rates decline, because of a *secular dearth* of investment opportunities. This theory, which became very popular among Keynes's disciples, has been completely discredited by later developments. Second, there may be a floor below which interest rates cannot fall that leads to the so-called liquidity trap—indefinite amounts of liquidity, an ever-increasing stock of idle balances piling up, which, according to Keynes, does not result in larger expenditures, either on consumption or on investment.

This accumulation of idle funds obviously cannot go on forever; it raises complicated problems of a dynamic nature, which simply cannot be handled by the essentially static Keynesian theory. Not that Keynes had nothing to say on these problems, but he never let himself be hemmed in by a theory, either his own or that of anybody else.

A serious weakness of the *General Theory* is that there is nothing on the monetary causes of the Great Depression. What I have in mind is the fact that the Federal Reserve, by acts of commission (deflationary measures) and of omission (failure to counteract sufficiently the deflationary effect of the crash on the stock exchange in 1929 and of several waves of bank failures), permitted the quantity of money to shrink by about 30 percent; without this the depression would never have become as deep or lasted as long as it did. Some Keynesians have argued that a more expansionary monetary policy would have made no difference, because the velocity of circulation would have declined so that aggregate expenditures and employment would not have been changed. But Roy Harrod, the great Keynesian and biographer of Keynes, declared bluntly, "Monetary policy had not been tried."

Despite these shortcomings of the *General Theory*, there can be no doubt that Keynes was one of the great men and great economists of our times, but not because, as many believe, the *General Theory* revolutionized economics; it did not. Keynes was not the Newton or Einstein of economics. His claim to greatness is more broadly based. It rests on his astonishing achievements in many areas extending far beyond economics. In fact, Keynes's first major scholarly work, his fellowship dissertation in King's College (Cambridge, 1909) was in philosophy, on

probability as "a branch of logic." The work continued intermittently, but was interrupted by the war. It was finally published in 1921 as *A Treatise on Probability*.

In addition to being a scholar, Keynes was an economic statesman, one of the negotiators and architects of postwar reconstruction, which gave the world decades of almost unprecedented progress and prosperity. (If this sounds exaggerated, compare the two decades after World War I with the first twenty-five years or even with the thirty-one years after World War II.) Keynes was for years the active editor of two important periodicals, director of the Bank of England, and the chairman of a large insurance company whose investment policies and annual speeches surveying economic and financial developments attracted wide attention. He was an active speculator, often successful, in foreign currencies and commodities, a noted collector of books and paintings, and a patron of the arts. Keynes was a brilliant writer, a most persuasive speaker, and a skillful negotiator.

Let me repeat, Keynes was a great economic theorist. But for him theory was always a tool from which to derive policy conclusions, not an end in itself. In other words, he was a man of action as well as a scholar.

1. John Maynard Keynes, "Balance of Payments of the United States," *Economic Journal*, June 1946, p. 186.

Keynes in the History of Economic Thought

William Fellner

Keynes belongs among the great personalities of the history of economic thought regardless of how demanding we are in setting our standards. The same is true, but for very different reasons, of Joseph Schumpeter, who was born in the same year as Keynes, and to my mind the reasons why the statement is true of Schumpeter are at least as weighty as those for which it is true of Keynes. I am glad, however, that on the present occasion we are not supposed to engage in comparisons but can concentrate on one of these two great economists, John Maynard Keynes.

I don't know how many of our younger economists are fully aware that Keynes's worldwide reputation for his professional contributions reaches back to about 1920 and that *The General Theory of Employment, Interest, and Money*, published in 1936, was the latest of several major

works he wrote. The reason Keynes is, to most people, simply the "Keynes of the *General Theory*" is that neo-Keynesianism evolved from this work. How Keynes himself would have reacted to essential features of neo-Keynesianism is a debatable question, one to which I will return. Regardless of how that question is answered, it is reasonable to assert that during the postwar decades neo-Keynesianism became the dominant school of thought in macroeconomics, even if it now may be about to lose this status. The type of Keynesianism in the description of which the qualifying "neo-" needs to be used is quite clearly Keynesianism in the sense of the *General Theory*. Neo-Keynesianism is clearly not Keynesianism in the sense of Keynes's other important writings.

As for the state of macroeconomics in the 1920s and the 1930s, the publication of the *General Theory* early in 1936 was preceded by many years during which the savings-investment approach and its relation to the quantity theory of money had become an analytical problem of

William Fellner is a resident scholar at AEI and Sterling Professor of Economics Emeritus at Yale University.

great interest to economists. I would find it very difficult to interpret the effect of the *General Theory* without taking account of this. What the savings-investment approach places in the center of the macroeconomic process is the relation between withdrawals from the income stream in the form of the public's desire to save and reinjections into the income stream in the form of the

"How Keynes himself would have reacted to essential features of neo-Keynesianism is a debatable question."

public's desire to invest. The quantity theory of money, however, has all along had a "monetarist" slant by placing the emphasis on the stock of money and the rate at which the public decides to spend it (this being the problem of the velocity of money).

When writing a few pages for a symposium such as this, an observer of my age inevitably tries to recall his own state of mind of half a century ago. In particular, I remember how greatly I benefited from the work of D. H. Robertson who, I felt, made it clear to his readers that there existed no conflict between looking at the determination of aggregate income along the lines of the savings-investment approach and looking at it along the lines of the quantity theory of money (that is, in terms of intelligently interpreted "monetarism," if you prefer). The compatibility, or even complementarity, of analytical frameworks stressing desired savings-investment relations with frameworks focusing on money and velocity can be expressed with reliance on the concepts defined by Robertson, and also by using the conceptual framework that Swedish economists of those years introduced in the tradition of Knut Wicksell. In any event, it is important to be able to reconcile the two equally valid propositions that (1) if planned investment plus government expenditures on goods and services exceed planned savings plus tax payments, then this generates expansionary forces, while the contrary discrepancy has contractionary effects, and (2) if the algebraic product of the money stock with its velocity increases, then this marks an expansionary development, while a decrease of that algebraic product is contractionary. Regardless of whether one uses the savings-investment approach or relies on quantity-theoretical reasoning, it is necessary to concern oneself separately with the question of what part of the expansionary or the contractionary force expresses itself in movements of physical output and what part in price movements.

As for Keynes, not only is it true that he had made important contributions to the development of the savings-investment approach years before he wrote the *General Theory*—for example, in the two volumes of his

Treatise on Money, published in 1930—but it deserves to be stressed that in the *General Theory* he developed further and sharpened considerably the tools needed in any adequate version of the savings-investment framework. My reaction to the *General Theory* continues to be strongly influenced by this fact. For example, planned investment results in this book from what Keynes called the marginal efficiency function of capital, on the one hand, and from the rate of interest, on the other—an insight in connection with which he rightly refers to the earlier work of Irving Fisher. Planned savings result from the fact that, for levels of income corresponding to a reasonably high degree of resource utilization, the "consumption function," as defined by Keynes, determines an amount of consumption that falls short of the income itself. It would be very difficult to present any modern version—simple or more sophisticated version—of the savings-investment framework without using essential parts of the conceptual apparatus that Keynes developed in the *General Theory*. In any reasonable appraisal of the *General Theory* this must be regarded as a significant item on the positive side of the ledger.

The *General Theory* also contains views and arguments that many of us found unconvincing from the outset, for one of two related reasons.

Some of the arguments in the book are unconvincing because they are based on the stated assumption that the specific conditions observed during the depressed 1930s would before long become general characteristics of market economies in their advanced stages of development (that is, in "mature" capitalism). In particular, Keynes was inclined to think that in the none-too-distant future, as seen from the mid-1930s, the marginal efficiency of capital would become chronically so low (investment opportunities would have been used up to such a large extent) that additions to the money supply made by means of the usual operations of central banks would fail to raise the level of investment. The public would then leave unspent the additions to its money holdings acquired through any additional sales of securities to the central bank. In other words, in the none-too-distant future the creation of new money by the usual central bank operations would become associated with a fully offsetting decrease of velocity, and since at adequate levels of resource utilization part of the aggregate income is saved (remains unconsumed), government expenditures would have to take over much of the role that private investment used to play.

Neo-Keynesianism of the immediate postwar years was for awhile influenced by this stagnationist prediction, which many of us always regarded as unfounded guesswork. Unconvincing though this argument was, and wrong though it is proving to be, this has not turned out to

be the unconvincing argument by which neo-Keynesianism has *remained* strongly influenced in the longer run. By now I do not consider the stagnationist long-run outlook of the *General Theory* the true bone of contention between neo-Keynesians and their increasingly vocal critics, because I think by now there are not many who would share that outlook. So much for one of the unconvincing pieces of reasoning in the book.

The other unconvincing argument we find in the *General Theory* has turned out to be more influential and, as I see it, to cause real harm. That argument is not based on assumptions about any near-future chronic stagnation of private investment. The other unconvincing argument leads to a statement that, when limited to the period in which the *General Theory* was written, may well have been realistic, but the argument is nevertheless unconvincing because in the *General Theory* it is expressed as if it were a generally valid piece of reasoning, equally applicable to the past, the present, and the future without essential restrictions. Whether a proponent of that argument does or does not limit it to conditions resembling the mid-1930s makes a great deal of difference, but in the

book itself Keynes bypasses that question. It is an essential feature of neo-Keynesian writings that they do not limit the argument to conditions such as those in which the *General Theory* was written but, on the contrary, are applying it to the growth path of market economies in general.

The argument in question, as we find it in the *General Theory*, maintains that employment can be increased by raising the price level. This favorable result is described as a consequence of (1) the increase in the demand for labor at given money wages and at higher prices, thus at lower real wages, and (2) the willingness of workers to satisfy this increased demand for their services even at lower real wage rates if this is an across-the-board lowering brought about by rising prices. The same lowering of real wages would become unacceptable to labor if it took the form of a piecemeal reduction of money wage rates with a great deal of uncertainty about the emerging wage structure.

In the midst of the Great Depression of the 1930s after a significant fall of the price level and with a high proportion of the labor force unemployed, this argument for undoing by price-raising policies some of the consequences of the preceding deflation may well have been realistic. As I said above, whether Keynes would have been willing to apply the essential content of this proposition to the kind of economic growth path that clearly had existed in the past and that has reestablished itself in the market economies of the postwar era is, to say the least, questionable. He undoubtedly did develop an argument suggesting the superiority of a policy attempting to establish by means of higher prices rather than by lower money wages the real-wage level at which employment would become adequate, but it is equally obvious that when he developed this argument Western economies were in deep depression. If the proposition is extended to the normal growth paths of such economies, it assumes different characteristics, and the *General Theory* itself—a theory that calls itself “general”—does not warn against applying the proposition to past or future growth paths of market economies. Keynes’s subsequent writings, up to the time of his premature death in 1946, make me doubt whether he would have endorsed the neo-Keynesian extension of the proposition about the beneficial effect of price increases to conditions different from those of the deflationary mid-1930s. Yet at this point one engages in a guessing game because while in the *General Theory* Keynes did not explicitly limit the argument to that environment, he also did not derive from an extended form of the argument an inflationary theory of economic growth. That latter operation is a neo-Keynesian development of the postwar era.

The AEI Economist is a monthly report intended to clarify current issues of economic policy in an objective manner. It is edited and in large part written by Herbert Stein, senior fellow of the American Enterprise Institute and A. Willis Robertson Professor of Economics at the University of Virginia, with the assistance of the Board of Editorial Advisers:

William Fellner, *Yale University emeritus; AEI Resident Scholar*
 Thomas F. Johnson, *Director, AEI Economic Policy Studies*
 Marvin H. Koters, *Director, AEI Government Regulation Studies*
 Paul W. MacAvoy, *Yale University; AEI Adjunct Scholar*
 Paul W. McCracken, *University of Michigan; Chairman, AEI Council of Academic Advisers*
 Rudolph G. Penner, *Director, Fiscal Policy Studies*

American Enterprise Institute for Public Policy Research
 1150 Seventeenth Street, N.W.
 Washington, D.C. 20036


William J. Baroody, Jr., *Publisher*
 Margaret H. Seawell, *Staff Editor*

Subscriptions: \$18 per year. *Single copies:* \$1.50 each.

ISSN 0149-9785

© 1983 by the American Enterprise Institute for Public Policy Research, Washington, D.C., and London. All rights reserved. No part of this publication may be used or reproduced in any manner whatsoever without permission in writing from the American Enterprise Institute except in the case of brief quotations embodied in news articles, critical articles, or reviews.

The views expressed in the publications of the American Enterprise Institute are those of the authors and do not necessarily reflect the views of the staff, advisory panels, officers, or trustees of AEI.

“American Enterprise Institute” and  are registered service marks of the American Enterprise Institute for Public Policy Research.

In its extended neo-Keynesian form the argument maintains that by accepting sustained inflation a more favorable growth path can be established than that which would be available if we tried to stabilize the price level. In other words, more employment can be obtained if our demand policies accommodate the inflationary price trends corresponding to steeper money wage trends than if we adopt a consistent noninflationary demand policy and if thereby we serve notice to employers and workers alike that cost and price trends need to adjust to a noninflationary course.

In such a generalized framework—that is, when not limited to reversing the deflationary distortions of preceding years but extended to growth paths in the neo-Keynesian fashion—this inflationary proposition has rightly aroused the suspicion of critics that the inflationary stimulus will work only as long as the market participants do not see through the strategy of the policy makers and that such a policy line will subsequently have a very uncomfortable aftermath. This criticism has proved fully justified.

Thus, when appraising the *General Theory* it is legitimate to place on the negative side of the ledger not only the stagnationist outlook from which many neo-Keynesians found it relatively easy to retreat after a while, but also the fact that the book does not draw a clear distinction between price-raising programs in the midst of a deflationary period and outright inflationary growth programs. Failure to clarify this difference has exerted a harmful influence on postwar policy regimes by lending some degree of plausibility and even of justification to the claim that inflationary programs have their origin in the analysis Keynes developed in the *General Theory*. Yet to say this is not the same as to suggest that inflationary neo-Keynesian policies would have had Keynes's approval. At any rate the historical merits of the Keynesian contributions with which the first part of my appraisal was concerned should not get lost in the detailed surgical procedures in which one inevitably becomes engaged unless one tries to remain at the level of mere generalities.

Early Memories of a Keynes I Never Met

Herbert Stein

Professor Paul Samuelson, one of the leading American expositors of Keynes, describes the reaction of his contemporaries as graduate students in 1936 when they first encountered the *General Theory*: "Bliss was it in that dawn to be alive, but to be young was very heaven" (the way Wordsworth described his first encounter, at age twenty-one, with the French Revolution).

Samuelson was a graduate student at Harvard in 1936. I was a graduate student at the University of Chicago in the same year. I did not observe the same rapture among my contemporaries there on first opening Keynes's *General Theory*. Undoubtedly we were influenced by our mentors on the economics faculty, whose attitudes were cool and even hostile. Our two giants—Frank H. Knight and Jacob Viner—wrote severely critical reviews.

Our attitude at Chicago, as I reconstruct it now in my mind, was that the *General Theory* had two parts. One was a description of the short-run behavior of the economy that showed how government deficit spending could reduce unemployment in a depression. The other part was a theory purporting to explain that unemployment could

be an equilibrium, permanent condition.

The short-run part of the theory was considered, in Chicago at least, to be old-hat and no contribution. Speaking of the Keynesian policy prescription, of spending more and taxing less in depression and vice versa in booms, Viner later said:

This formula may have been a discovery of Keynes, but I used it at least as early as the summer of 1931, and I don't think I derived it from Keynes, with whose journalistic writings I then had little acquaintance. The idea was then a commonplace in my academic surroundings of the time, and I cannot recall that any of my Chicago colleagues would have dissented, or that they needed to learn it from Keynes, or from me.¹

The long-run equilibrium proposition my professors rejected flatly. They maintained that Keynes's explanation depended on certain rigidities, illusions, and irrationalities that could not be expected to exist in the equilibrium condition.

Subsequent analysis has shown, I believe, that my professors were right about the equilibrium proposition. The interesting question is why both Keynes and his critics cared so much about that. By 1936 it was clear that unem-

Herbert Stein is a senior fellow at AEI and A. Willis Robertson Professor of Economics at the University of Virginia.

ployment could last for a long time, even if the explanation was a “short-run” explanation in economic theory. That is, “short-run” was not necessarily short in clock time. No one knew how long it was. Why was Keynes so insistent on showing that unemployment could be an equilibrium condition? And if my Chicago professors accepted his diagnosis of the existing depression and his prescription for curing it, which would seem to be the operational question, why were they so upset by the rather “academic” argument about what would happen in equilibrium?

I think that both positions are understandable. Since 1924 Keynes had been arguing for curing unemployment by fiscal as well as by monetary measures to increase demand. Many economists agreed with this, as Viner and his Chicago colleagues did. But the idea was not fully, enthusiastically, and single-mindedly accepted in the economics profession, and Keynes thought that had something to do with its half-hearted implementation by governments. One reason for the resistance of economists was their belief that unemployment could not be an equilibrium situation, that there were natural forces, specifically the decline of wage rates, that would correct it, and that Keynes’s demand-management measures were somewhat illegitimate interferences with these equilibrating forces. So he had to provide the profession with the equilibrium theory that would legitimize their endorsement of the Keynesian prescription. And he turned out to be right about that. His “general” theory—however flawed—mobilized a school of enthusiasts to carry his banner and fight his fight. No such supporters had responded to his previous ten years of argument, or to the similar argument of the Chicagoans.

Yet, the Chicago critics saw a policy danger in the long-run argument that turned out to be real, not immediately, but still in our time. Keynes’s long-run argument was that unemployment would not necessarily be cured by the adjustment of wages and prices, no matter how far that adjustment went. This belittled policy positions that the Chicagoans had emphasized along with demand-stimulating measures, such as support for antitrust policy and opposition to the price- and wage-raising actions of the New Deal. But in the longer run it implied a policy of generating sufficient demand to maintain full employment regardless of the behavior of wages and prices. And that, as Viner said in 1936, invited “a constant race between the printing press and the business agents of the trade unions.”²

As Albert G. Hart, then a young instructor at Chicago, said in 1936, one could be pro-Keynesian or anti-Keynesian, but one could no longer be pre-Keynesian. Despite the critical coolness of the faculty, most of us graduate

students left Chicago in a year or two with a kind of eclectic, nonexclusive Keynesian model in our heads. Real output and employment would be strongly influenced by demand in nominal terms. Prices, wages, and the relation between them also mattered, and we tended to be antitrusters and skeptical of labor unions, but we didn’t think much could be done about that. So demand-man-

“For an idea to be accepted enthusiastically and implemented, must the idea be expressed in such extreme and exaggerated form that it becomes dangerous when finally accepted and implemented?”

agement was the big ball game. The government could affect total demand by its expenditure, tax, and monetary policies. Government expenditures were part of total demand. Taxes affected the amount of income households had left after paying taxes, and thus their consumption. Monetary policy mainly affected interest rates and so affected private investment. But the government could also affect private investment by its tax policy and in other ways. We did not think that permanent deficits or permanent fiscal stimulus would be necessary to maintain full employment. We thought that if the government maintained reasonable stability and avoided antibusiness policies the long-run demand for private investment would be more than sufficient to absorb all available saving. We did not think of ourselves as monetarists or fiscalists. That distinction was blurred at Chicago. Henry Simons, who was my particular hero, regarded budget deficits as a way to increase the money supply in circumstances where increasing private debt to the banks was impossible or undesirable.

In 1938, certainly not thinking myself anti-Keynesian, I came to Washington and there encountered the people who would later be known as “Keynesians,” though I didn’t think then and don’t think now that they had more claim to that designation than I or my Chicago colleagues did. Basically they carried Keynes’s argument to the extreme that his early critics had feared and that was not a necessary interpretation of the *General Theory*. What Keynes had visualized as a *possible* long-run situation they took as a description of here and now. They thought that money did not matter—ever. They thought that private investment would not, in general, be adequate to absorb the savings that would be made at full employment, and so they regarded fiscal demand-stimulating measures as permanently necessary. That meant creating permanently high government expenditures and deficits for the purpose.

What turned out in the end to be the distinctive differ-

ence between these Keynesians and the others like me was in the attitude to the function of specific prices and wage rates. Keynes had argued that the free market adjustment of wages and prices could not be counted on to restore full employment during the depression and possibly not to maintain full employment in the long run. He did not deny the value of the free price system as an instrument for guiding the allocation of resources among alternative uses—which is the heart of the economic process. He wanted to improve the overall monetary conditions within which the free price system worked, not to suppress the free price system. Thus he could be interpreted, as I did interpret him, as helping to preserve the free economic system by helping to solve its macroeconomic problems without suppressing the free price system.

The Keynesians went beyond Keynes to belittle the value of the free price system as a way to organize production and distribution. Their prescription did not include any great weight on procompetition measures, and they had no aversion to government measures that limited the free market—like farm price supports, minimum wages, and the promotion of labor unions.

The differences of view about free markets became personally significant to me in 1940 and 1941. In 1940 the United States was beginning to feel the economic effect of the war in Europe, and President Roosevelt set up the National Defense Advisory Commission to deal with the resulting problems. One part of the NDAC was a Price Stabilization Division, headed by Leon Henderson, a prominent New Deal economist and official. Henderson had acquired, by some accident, an economic research staff consisting of conventional, classical economists, of whom I was one (and during one summer George Stigler was also one). We busied ourselves in trying to develop policies that would prevent inflation without resort to price controls. One day I found myself, for a reason which I have forgotten, riding in a car with Henderson when we were joined by a friend of his, an economist not then in the government and whom I had not previously seen. That was J. K. Galbraith, who proceeded to explain to Henderson why he should go for price controls, despite the reluctance of his economists.

After the November 1940 election Henderson put together a second economics staff, consisting mainly of people who had been assisting in Roosevelt's election campaign. These were devout New Dealers, hard-line Keynesians, and advocates of price and wage controls. For about a year Henderson had two economic research staffs, one against and one for price controls. The position of the anticontrol people came to seem more and more quixotic, and they had mainly gone to other pursuits within a few months after Pearl Harbor.

The war was a hothouse for hard-line Keynesianism. It was not only the price controls. Monetary policy was totally subordinated to keeping interest rates low, in preparation for the postwar world in which low interest rates would presumably be necessary for full employment. There were the first exercises in fine-tuning—that is, in efforts to estimate quantitatively just what combination of expenditures and taxes would yield the level of aggregate demand that was required for maximum production. Keynes, who was already aware of the unrealistic lengths to which enthusiastic disciples might carry his theory, “chaffed a group of experts assembled to meet him on his first war visit [to Washington] for being more Keynesian than he was himself.”³

By the end of the war one could identify three schools of thought about economic policy:

1. The hard Keynesians were fine-tuners, relying on fiscal policy, belittling money, and tolerating price controls.

2. The soft Keynesians combined fiscal and monetary policy, sought rules rather than fine-tuning, and were devoted to the free price system. (The Committee for Economic Development, where I worked in the postwar period, was a good example.)

3. The anti-Keynesians thought, erroneously in my opinion, that Keynesianism of all varieties was the enemy of capitalism and freedom. (The most bizarre expression of this was William Buckley's shriek of horror, in *God and Man at Yale* [1951], at discovering that some of his professors were Keynesians.)

Twenty years later these disagreements had moderated. In 1965 Milton Friedman could say, “We are all Keynesians now,” and also, which no one seems to remember, “and nobody is any longer a Keynesian.”⁴ I interpret his remark to mean that we had all adopted certain language, methodology, and concepts from Keynes but that we no longer took literally the ultimate conclusions first drawn from the *General Theory*.

(It seems impossible to keep people from believing that Richard Nixon said, “We are all Keynesians now.” What President Nixon said in 1971 was “now I am a Keynesian.” He meant that he was a Keynesian of the kind that by 1971 all of us were but not of the kind that by 1971 none of us were any longer.)

One hundred years after the birth of Keynes the identification of economists as Keynesian or non-Keynesian no longer serves any purpose. Everyone has Keynesian ideas in his head, but they are diluted and modified almost beyond recognition. We now see a president who seemed to be almost pre-Keynesian warning against raising taxes in a recession despite a huge deficit. And economists who we thought were devout Keynesians tell us that deficits

could abort the recovery.

It has become a cliché among economists to say that our “science” is in deep confusion. We look to the horizon for a new Keynes to show us how to think about the problems of our time. But there is this haunting question left by the triumphal story of Keynes: For an idea to be accepted enthusiastically and implemented, must the idea be expressed in such extreme and exaggerated form that it becomes dangerous when finally accepted and implemented?

1. Jacob Viner, “Comments on My 1936 Review of Keynes’ *General Theory*,” in Robert Lekachman, ed., *Keynes’ General Theory after Three Decades* (New York: St. Martin’s Press, 1964), p. 263.

2. Jacob Viner, “Mr. Keynes on the Causes of Unemployment,” reprinted in *The Critics of Keynesian Economics*, Henry Hazlitt, ed. (Westport, Conn.: Arlington House, 1980), p. 49.

3. Roy Harrod, *Life of John Maynard Keynes* (New York: Harcourt Brace, 1951), p. 525.

4. The first half of the sentence was quoted in *Time*, December 31, 1965, p. 65. In a subsequent letter to the editor of *Time*, Friedman pointed out that he had also said the second half of the sentence (*Time*, February 4, 1966, p. 13).

Keynes and Recent Economic Policy

Rudolph G. Penner

When I was an undergraduate between 1954 and 1958, Keynes’s *General Theory* was probably at the height of its influence over the economics profession. Our job as economics students was to try to find out what Keynes really meant, and that difficult chore left little time to be critical.

I do not fondly remember my struggles with the *General Theory*. Then I thought that it must be a very profound book. Now I think it is a very badly written book. It was not until much later when I read *Essays in Biography* that I learned how eloquent Keynes could be.

As a young teacher of elementary economics in the early 1960s, I taught pure Keynes as described by Samuelson. The monetarist challenge to Keynes was mentioned, but I used to teach that as the *General Theory* with only slight modifications in the structure of the basic model. I felt guilty about this, because I thought that the monetarist black box might contain something more sophisticated than I did not fully understand. But then Milton Friedman opened up the monetarists’ black box, and who was inside but Keynes with only slight modifications in the structure of the basic model. There is probably no better testimony to Keynes’s contribution than the fact that even critics find it convenient to use the basic tools he provided in order to attack him.

Indeed, through my whole professional life, macroeconomics has been nothing but Keynes with modifications and elaborations on the basic theme. The modifications and elaborations may have policy implications that differ profoundly from those of Keynes; nevertheless, it is hard to imagine a similar intellectual giant coming along today and having as profound an effect on the profession.

Given his effect, it is not surprising that two Keyneses seem to have evolved in the 1960s and 1970s. There was

the Keynes of economic theory and the Keynes whose name was associated with so-called Keynesian policies. I often think of him tumbling in his grave over some of the things done in his name.

At the time, it was thought by many, including me, that the Kennedy-Johnson tax cut of 1964–1965 constituted the true triumph of Keynesian thought over the know-nothingness of previous policy making. The Congress was actually persuaded to cut taxes when we already had a deficit.

With the perspective of history, it is not as clear that that tax cut was a Keynesian triumph. In 1981, some thought that a massive tax cut constituted the true triumph of supply-side economics over Keynesian know-nothingness. Perhaps the real message is that politicians enjoy cutting taxes, and any theoretical excuse will do as a rationalization.

More generally, much of the perversion of Keynes is due to the fact that Keynesian stimulative policies are a lot of fun, whether they involve cutting taxes or increasing spending. The most serious misuses of Keynesian theories probably occurred in response to the recession of 1974–1975. Noneconomist politicians were heard debating the size of the multiplier that should be attached to different policy changes, and the liberal majority of the time concluded that spending was much more stimulative than tax cutting. It was even argued that spending was so stimulative that adding to spending on employment programs would actually lower rather than raise the deficit. Keynesianism was thought to provide a free lunch. I suppose it was only natural that anti-Keynesian conservatives would counter later with their own free lunch when it was claimed that general tax-rate cuts would raise rather than lower total revenues.

Although Keynes undoubtedly would have opposed much of what was done in his name and, in fact, once

Rudolph G. Penner is a resident scholar at AEI.

announced that he was not a Keynesian, his theories cannot be held entirely blameless for the excesses of the 1970s. As interpreted by Meltzer, Keynes believed that the most important conclusion of the *General Theory* was that "employment is subject to fluctuations around an average level that is less than full employment."¹ I think it fair to say that present-day Keynesian scholars, who may also shudder at policy makers' interpretations of Keynes, nevertheless accept this basic proposition. They are, in other words, skeptical that free markets, left to their own devices, gravitate naturally and quickly toward full employment. There are probably also ideological biases that cause Keynesian economists to define full employment to imply a lower unemployment rate than would be chosen by more conservative economists.

Generalizing further, I think that there is a resulting tendency at the troughs of recessions for Keynesians to forecast a later and a slower recovery and to argue that there is plenty of room in the economy for both monetary and fiscal stimulus before inflation becomes a problem. We certainly hear such arguments now, and earlier such arguments were the justification for President Carter's ill-conceived stimulus program of 1977.

I do not wish to imply that I am so confident of my own biases that I think that Keynesian-type forecasts are always wrong or even, on average, less accurate than those of monetarists or of anyone else. Indeed, generalizations are always dangerous in that at any one time there is a rather wide range of forecasts made by people known as Keynesians and those known as monetarists. Moreover, the ranges frequently overlap. But, if I am correct that Keynesians on average forecast slower recoveries, they do create a problem. Forecasts of slow recoveries are very seductive to politicians because they provide an excuse for following expansionary policies and, as already noted, expansionary policies are a lot of fun in the short run. Often, that is the only run that exists for policy makers.

Does that mean that the tremendous intellectual

"Through my whole professional life, macroeconomics has been nothing but Keynes with modifications and elaborations on the basic theme."

achievement represented by the *General Theory* has done more harm than good? To argue that would make one something of a Luddite concerning technological improvements in the quality of economic thought.

It is impossible for intellectuals to prevent the misinterpretation and the misuse of their theories by others. What have come to be known as Keynesian theories probably did bias policies in an overly stimulative direction in the

1960s and 1970s. But stimulative policies are so popular that, were it not for Keynes and Keynesians, politicians may have found some other excuse for following such policies. In fact, they did when Keynes became less reputable. The policies were called "supply-side economics" for the purposes of tax policy and "deregulation" in justifying current monetary policy. Such rationalizations do not work unless they contain a large grain of truth, and all do. Unfortunately, that does not guarantee that they result in appropriate policies.

No existing economic theory is so good that one can make money on the stock market using it. But all of the good ones enhance our understanding of some aspect of how the economy functions. I would argue that the *General Theory* is a particularly good one. Its main contribution was to provide a comprehensive structure for the analysis of macroeconomic relationships. Many of the elements of that structure may not have been original, and many may have been quite wrong, but it provided a foundation for building almost all that has followed in macroeconomics. The insights provided by monetarists, rational expectationists, and a host of others may have been possible without the structure, but it certainly made it easier to understand the implications of such theories more easily and more quickly.

One might respond that all of that effort has not gotten us anywhere. Economists in general and macroeconomists in particular are in ill repute. But as a free market economist, I take heart in the fact that economists' salaries are pretty good, and there is no heavy lifting. We may not know how to cure the ills of the economy any more than physicians know how to cure the common cold, but I do think that we know a lot. In particular, I think that we know a lot about avoiding complete disaster. The monetary and fiscal policy errors that led to the Great Depression are unlikely to be repeated. That does not mean that disasters will not occur. There are still vast areas of ignorance that could lead to serious errors, but if disasters occur it is more likely to be because politicians find the preventative measures advocated by economists to be unpalatable in the short run. Keynes cannot be held responsible for the incentives facing politicians.

In *Catcher in the Rye*, Holden Caulfield said that he knew he was reading a good book if he experienced a strong urge to call the author on the phone and have a discussion. Economists may differ in their evaluation of Keynes's contribution, but I bet that all would like to call him up and have a discussion.

1. Allan H. Meltzer, "Keynes's General Theory: A Different Perspective," *Journal of Economic Literature*, vol. 19, no. 1 (March 1981), p. 61.

Impressions of a Younger Generation

Eduardo Somensatto

Those of us who were first introduced to Keynesian economics in the 1970s have a slightly different perspective and appreciation of Keynes from those of earlier generations. One may say that this is only natural, given the effect of time and space on perceptions, but in this case I believe more than just the passage of time is involved. Several factors that have helped shape our impressions and judgment of Keynes probably account more for the degree of esteem accorded Keynes by today's younger generation than the actual aging of his teachings and writings.

Our current views on Keynes have been heavily influenced by the standard classroom interpretation of Keynes, by the evolution of economic thought, by our experience with Keynesian policies, and by our ignorance of history. Together these factors contribute to a contemporary image of Keynes that is both incomplete and impressionistic.

It should be noted at the outset that very few of us have read Keynes in great detail. Most of what we know of the man, his thoughts and contributions, has been learned from sources other than Keynes himself. Our knowledge of his teachings comes mostly from the received doctrine as conveyed by our university professors and the authors of numerous textbooks and articles. They are the interpreters of Keynes, responsible for shaping a whole generation's view of him.

Unfortunately, for a variety of reasons—some stemming from Keynes's own writings, others from the perspective given by the interpreters—the received doctrine is now a distilled essence of the original work. Keynes's explanation of the workings of the aggregate economic system has been condensed into a few equations and collapsed into a set of simple graphs, mostly for the sake of brevity and simplicity. As a result, the most vivid image we have of the Keynesian fixed-price, short-term disequilibrium system is the Hicksian IS-LM framework.¹ Whether that depicts what Keynes intended to portray is debatable, particularly in the face of the recent resurgence of interest in the dynamics of his theory. But the fact is that by now his framework is so well embedded in our thinking that we can no longer divorce ourselves entirely from the mode of thought best described as Keynesian.

Keynes is today part of the received orthodoxy. His teachings are established in the accepted body of literature, his concepts well entrenched in the profession's

lexicon. That is his legacy.

There are drawbacks, however, to being in that position. As with any other accepted explanation, the Keynesian framework is susceptible to the natural tendencies of economic research to accumulate anomalous findings, in the process of hypothesis testing, that make it increasingly difficult to continue to accept the received doctrine.

In fact, when we were first introduced to the Keynesian system we also learned of the existing evidence and the available competing new theories. This served to dispel quickly the original reaction that as an alternative to the "classical" system, the Keynesian explanation appeared to be a much more realistic description of the way the economy works. It conformed more to our naive observations that the economy never reached full employment. But, as we learned the monetarist theory, the accelerationist hypothesis, and then the neoclassical models of rational expectations, it became evident that there were analytical gaps in Keynes's own theory. Some of the distinguishing features of his system, such as the rigidity of money wages or the liquidity trap, lacked universal validity.

Some of those gaps have since been filled, and there have been numerous attempts to reconcile all models. As a result, it has become quite apparent that, contrary to what Keynes argued, his system is basically a short-run, more rigid version of the long-run neoclassical models. And for us, the newer, more dynamic, neoclassical versions are more realistic depictions of the complex macroeconomic system we are trying to understand.

It is also important to note that we today have the benefit of hindsight. We have lived through a period of considerable economic growth and ever-increasing inflation rates, both said to be associated with Keynesian policy prescriptions. This environment is far different from that which prevailed when Keynes wrote the *General Theory*, a time of declining growth and prices.

Our recent experience with Keynesian policies has taught us many lessons. We know now how a modern economy responds to certain policy shifts, to the point that we are able to derive rough estimates of the static multipliers and the key elasticity measures that were so important to Keynes's arguments, but at the time unknown to him.

More important, however, we have learned that an announced Keynesian policy stance can be self-defeating in the long run. It generates a process that places the authorities in the vulnerable position of having to accom-

Eduardo Somensatto is assistant director of economic policy studies at AEI.

moderate ever-increasing nominal income demands by the private markets, if the stated policy is to increase employment through a general rise in the price level or through higher aggregate demand.

After fifteen years of rising inflation, we know that workers will resist systematic reductions in real wages brought by the change in the purchasing power of money.

"Contrary to what Keynes argued, his system is basically a short-run, more rigid version of the long-run neoclassical models. And for us, the newer, more dynamic, neoclassical versions are more realistic depictions of the complex macroeconomic system we are trying to understand."

The most that can be expected are temporary benefits on the output side from positive unexpected deviations in policy trends.

But this is our knowledge as of 1983, not 1936. It seems that the recent tendency to blame all of our failures on embedded Keynesian notions, and thereby implicating Keynes, fails to recognize the power of the learning experience. We, as a younger generation, scarred by past mistakes, cannot truly appreciate the significance of the trauma brought about by the Great Depression and the effect it had on the psyche of the nations affected. Keynes was addressing a different generation at a different time. His teachings were not universal or, for that matter, timeless. We today have the benefit of having learned from him and from our own experience.

Finally, in the same vein, it seems to me that in order fully to appreciate Keynes, his effect on the profession and on thinking in general, we must learn more about the political, social, and intellectual setting that gave rise to the *General Theory*. As a generation, we know little about the intellectual framework and turmoil that both preceded and followed Keynes's most important contributions.

Unfortunately, the history of economic thought has been relegated to a secondary position in our education, mainly because of the volume of new material that must

be assimilated and the time-absorbing nature of the more technical new economics. This has had the adverse effect of obscuring our knowledge of Keynes's original contributions. In fact, very few of us know what is truly novel in Keynes's theory or, for that matter, can tell what has been added to Keynesianism by the interpreters of Keynes.

This shortcoming may preclude us from properly judging Keynes, but it does not prevent us totally from presenting our views of the scholar and our impressions of his contributions.

Keynes is perceived today as one of the most significant contributors to the advancement of knowledge of macroeconomics and undeniably one of the most influential economists of all time. He is credited, rightly or wrongly, with having shed the light of policy activism that has been responsible for so many of our recent successes and failures—an enlightened activism that, at the time, must have seemed an illuminating ray amidst the darkness of the depression.

More important, we know that he provided us with a different perspective on the macroeconomic system—one which led to a few insights and to a number of new and troublesome questions. This is probably his greatest contribution, for the evolution of our knowledge does not come from further explanations but from posing previously unasked questions. Such is the essence of our intellectual development, and whatever the merits of his arguments we cannot deny that Keynes contributed immensely to that development.

We know more today, thanks to him. But we also know that there is a lot more to be learned, given the immensity of the problems confronting us. On this 100th anniversary of his birth, those of us who are just starting in this profession can only stop to reflect and to show deference to Keynes for that portion of our knowledge that he helped to create, since it gives us the tools to solve the riddle and it allows us to have a clearer vision.

1. In this framework the national income and interest rates are determined at the levels that make saving equal to investment and the demand for money equal to the supply of money.