With apologies to Low

Was he a Keynesian?

Policies purporting to be Keynesian are in fashion once more. How many of these the great man would recognise, let alone endorse, is open to doubt

IN MODERN economic debate, the term "Keynesian" conveys two main ideas, usually muddled up together. One is that active fiscal policy (higher public spending, lower taxes) is a good remedy for recession. The other is that individual initiative and free enterprise have their limits; in this vaguest sense of "Keynesian", the term has come to mean little more than "that which is not conservative". In the 1980s, governments in much of the industrial world, but especially in Britain and America, derided these notions. Now Bill Clinton, out of conviction, and John Major, out of lack of conviction, are embracing them anew.

What would Maynard Keynes make of the endurance of "Keynesian" economics? He would be delighted, though not surprised (he was an immodest man), that nearly half a century after his death his name is still being shouted to and fro—in television studios, as well as in the economics departments of universities. But he might also be amused to see how the sides in these arguments line up. Keynes's complicated and often contradictory views have been reduced to simplicities that are often mere leftist prejudices. Keynes was not of the left, and was contemptuous of unexamined prejudice (in others). Looking down, he might be unsure whether to applaud his followers or laugh at them.

Placing Keynes in today's political spectrum would be difficult even if his views had been broadly constant: in any given work, his ideas are such an odd and original mixture that they refuse to fit familiar categories. What makes matters worse, though, is that his views were always changing. Nobody who has read much Keynes can avoid quoting him, because he was such a wonderful writer—but, thanks to his shifting opinions, there is no need ever to resist the temptation. Whatever your view on almost any topic in political economy, somewhere in Keynes is a sentence that puts it better than you could (and, admittedly, another somewhere else that refutes it).

Two-handed

Are you for free trade? Keynes was. To argue that trade barriers reduce unemployment, he said, "involves the protectionist fallacy in its grossest and crudest form". Elsewhere he wrote, with his usual finality, "I believe in free trade because, in the long run [sic] and in general, it is the only policy which is technically sound and intellectually right."

Or do you favour protection—as did Keynes? "I sympathise . . . with those who would minimise rather than with those who would maximise economic entanglement between nations. Ideas, art, hospitality, travel—these are the things which should of their nature be international. But let goods be homespun whenever it is reasonably or conveniently possible; and, above all, let finance be primarily national."

Are you for the common man? Keynes was. On the General Strike of 1926, he wrote: "The strikers are not red revolutionaries; they are not seeking to overturn parliament; they are not executing the first move of a calculated manoeuvre. They are caught in a coil, not entirely of their own weaving, in which behaviour, which is futile and may greatly injure themselves and their neighbours, is nevertheless the only way which seems to them to be open for expressing their feelings and sympathies and for maintaining comradeship and keeping faith. My feelings, as distinct from my judgment, are with the workers."

Perhaps, however, you are on the other side in the class war. So was Keynes. On Russia, he wrote: "How can I adopt a creed which, preferring the mud to the fish, exalts the boorish proletariat above the bourgeois and the intelligentsia who, with whatever faults, are the quality in life and surely carry the seeds of all human advancement?"

Mind you, Keynes was an egalitarian. "I want to mould a society in which most of the existing inequalities and causes of inequality are removed." But he was no leveller. "I do not want to level individuals. I want to give encouragement to all exceptional effort, ability, courage, character. I do not want to antagonise the successful, the exceptional. I believe that man for man the middle class and even the upper class is very much superior to the working class."

Robert Skidelsky, in the newly published second volume of his excellent biography of Keynes, ponders these contradictions*, and asks where Keynes's political sympathies lay. Keynes was certainly an élitist, Mr Skidelsky says. But he wanted clever élitism, with men nearly as able as himself in charge. That is where the Tory party let him down; he felt that it not merely tolerated stupidity, but thought it a virtue. Keynes therefore directed much of his political and economic writing to the Labour Party—expressing his views in suitably friendly language. This may explain some of the inconsistencies.

Nonetheless, he doubted that "the intellectual elements in the Labour Party [would] ever exercise adequate control; too much will always be decided by those who do not know *at all* what they are talking about". And, with age, he became more tolerant of the inherited privilege that had once struck him as so harmful to Tory brains. Thus, Mr Skidelsky observes, "Starting as a Liberal, Keynes ended up a Whig."

Reductio ad nostrum

In matters of economic theory, Keynes was scarcely any clearer. His most famous work, "The General Theory of Employment, Interest and Money", published in 1936, is a difficult and confusing book. Keynes deliberately misrepresented the views of his opponents, crudely lumping their ideas together and calling them, mockingly, "classical" (ie, obsolete). That angered many of his peers—few of whom were the purblind scholastics of popular mythology. The resulting recriminations made clear-headed debate about the new theories nearly impossible. And since Keynes expounded the new ideas partly by contrasting them with a caricature of orthodox thinking (ie, with a theory that nobody actually believed), it made it harder to be sure what the new ideas were.

Keynes, you might say, therefore got what he deserved. His own theories were almost immediately reduced to a variety of competing caricatures. And avowed disciples, not critics, undertook this task.

*"John Maynard Keynes: The Economist as Saviour, 1920-1937". Macmillan; £20

The diagram on this page appears nowhere in the "General Theory", but is much the most familiar reduction of Keynesian thought. Anybody who has picked up an economics textbook since 1950 will recognise it. That this caricature takes the form of a diagram is no accident. The need to distil from the "General Theory" something that could be taught to one's students—few of whom could be expected to read or understand the great book itself—was paramount, especially for American academics. So, from the late 1940s, economists such as Paul Samuelson began to spread the Keynesian gospel in this form—the gospel according to the income-expenditure diagram.

The big question in macroeconomics is whether and how long high unemployment might persist in an economy. Whatever else Keynes believed, he undoubtedly believed that high unemployment can linger indefinitely if left untreated. And the income-expenditure diagram can indeed portray such an "equilibrium". Those who require no convincing of this point can skip the next three paragraphs.

The chart plots aggregate income (ie, output) on the horizontal axis, and the components of aggregate expenditure (consumption, investment, government spending less taxes) on the vertical axis. For the economy to be in equilibrium, the diagram supposes, income must equal expenditure—which is true at all points on the line sloping up from the origin at 45°.

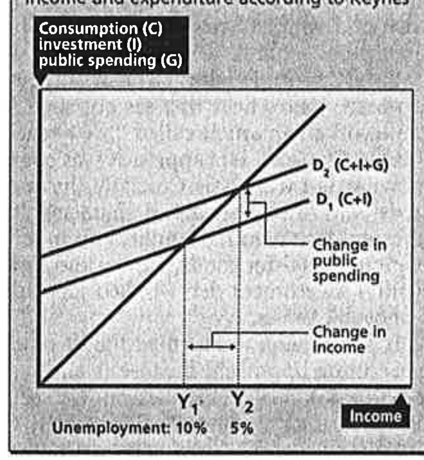
The line D1 shows that consumption rises with income. (Investment is decided in some other way; for simplicity's sake, just add it on.) Even if income were zero, there would still be some consumption, paid for out of savings. So D1 crosses the vertical axis somewhere above the origin. Then, as income rises, consumption rises as well—but not one-for-one. This is again because of saving habits: out of every pound of extra income, people will spend, say, only 80p. So the line D1 slopes upwards at less than 45°, crossing the 45° line to give an equilibrium income of Y1.

In this "model" of the economy there is no reason to suppose that an income of Y1 will be high enough to sustain full employment. Suppose that the unemployment rate at Y1 is 10%. What could be done about that? The answer is simple: increase expenditure by means of fiscal policy. Lower taxes and/or higher public spending will push D1 up to D2. The new equilibrium would then be at Y2, where the unemployment rate is 5%. Note that the slopes of the lines depend entirely on the assumption about how much income is saved. Note also that, because of those slopes, a given change in public spending (the vertical distance between D1 and D2) will elicit a change in income (the horizontal distance between Y1 and Y2) that is bigger. This is the Keynesian "multiplier" at work. The greater the propensity to spend (ie, the steeper D1 and D2), the bigger the multiplier and the more powerful the effect of fiscal policy.

Prepare for government

For generations of undergraduates, and for more than a few finance ministers, here was all the macroeconomics you would ever need: the "consumption function", public spending and the multiplier. A Keynesian revolution indeed. The problem of unemployment solved—and so easily. Nothing about prices (assumed to be fixed) or inflation. Nothing about the labour market. Nothing about interest rates, credit or the money supply. Nothing about the effect of changes in fiscal policy on public borrowing, on private wealth, or on anything else. Nothing about exchange rates, foreign investors or trade. Truly, Keynes was a genius.

An old friend
Income and expenditure according to Keynes



The trouble is, the income-expenditure diagram does not examine or elucidate the claim that Keynes was at pains to make—namely, that high unemployment can be an equilibrium phenomenon. It just asserts it, sweeping the quarrel between Keynes and the "classics"—ie, the bulk of the "General Theory"—aside.

Much worse, the diagram implanted a dangerous prejudice firmly in the minds of countless economics students down the years. If economics is to help anybody make sense of the world, its first task must be to convey the extraordinary ability of the price system (ie, the market economy) to regulate itself in a variety of ways. Much the most important thing in economics is the miracle of the invisible hand, whatever its failings, and however much it may need to be assisted by government intervention. Punk-Keynesian theory imbued many students with a brainless contempt for markets. Unemployment does not correct itself, they noticed: let's all be socialists.

The economists that Keynes derided in the "General Theory" had ideas about the market processes that ought to deal with unemployment. For instance, unemployment reduces wages, thereby stimulating the demand for workers. Or an excess of saving (ie, too little consumption) will cause interest rates to fall, thereby stimulating investment. A large part of Keynes's mission was to explain why these "classical" mechanisms might fail to work—and why the slump of the 1930s might therefore fail to go away, unless the government itself took direct steps to cut unemployment and spur demand.

Thought of in this way, however, the "General Theory" begins to seem rather less general. It looks more like a special theory—a theory of depressions. According to this view, Keynes was saying: market mechanisms, which plainly do assert themselves as a rule, can fail under certain circumstances, or fail to work quickly enough. A truly general model would place such ideas within a framework that let market forces play their part, with some theory to explain when and why "Keynesian" factors might gain the upper hand.

In 1937, soon after the "General Theory" appeared, John Hicks first set out such a framework in an article called "Mr Keynes and the Classics". His approach was soon known as IS-LM analysis. Crucially, the new model was "neoclassical" in character. In other words, it required equilibrium in different markets—for goods, money and (implicitly) government debt—linked together by movable prices.

It was a better model than the income-expenditure approach, because it allowed some of Keynes's main ideas to be seen alongside their "classical" alternatives. It said that neither view was logically superior to the other; each might be true, according to circumstances. It therefore directed attention to vital areas of disagreement. For instance, how sensitive is investment to interest rates? If it is insensitive, the Hicks model says that fiscal policy is more powerful than monetary policy—a "Keynesian" result.

The IS-LM theory took a long time to catch on, but eventually did, and from the 1960s became the standard way of teaching intermediate macroeconomics. (The theory could be summarised in another diagram, which you can be spared.) In the 1960s and 1970s it was the platform on which mainstream economists built their new ideas, and the starting-point for most macroeconomic research. It underlies most big computer models of actual economies.

IS-LM analysis still influences the way most professional economists think about macroeconomics. But the model has defects. It uses a method of theorising called comparative statics, which relies on comparing one equilibrium with another and examining the differences. Much modern economics, in contrast, has become extremely interested in dynamic processes—the evolution of economies over time.

For Keynes's most zealous followers, IS-LM analysis simply missed the point. Hicks had reduced the argument between Keynes and the rest to a quarrel, in effect, about how you calibrate a single model: hardly the stuff of revolutions. These economists therefore see IS-LM analysis as a far more misleading caricature of Keynes than the income-expenditure diagram.

Sadly, though, the greatest weakness of IS-LM has been that it is harder to learn than the simple income-expenditure model. Those who achieve only a nodding acquaintance with economic principles—the group from which most politicians are drawn—are unfamiliar with it. They retain a belief in the Keynesian multiplier and a suspicion of the price system, and not much else. That has done a lot of harm.

In the long run, we are still confused

What did Keynes himself think of these rival interpretations? It is surprisingly difficult to say. Although he lived for ten years after publishing the "General Theory", he failed to settle the quarrels between his rival re-inventors. Today all of his followers seem clear, at least, that Keynes believed in activist fiscal policy as a routine tool of economic management. Even this seems doubtful.

Keynes certainly favoured a fiscal remedy for depressions—but that is not the same as advocating fiscal fine-tuning through the course of a normal business cycle. A theme that recurs in his work is a preference (echoing Hayek, please note, whose work he praised) for rules over discretion in economic policy; this sits uncomfortably with the "kick-start" approach to economic management that modern Keynesians espouse. In wartime memos Keynes argued against attempts to introduce "Keynesian" budget policies. And, by modern standards, he was always extremely conservative on inflation, railing against its evils as passionately as any monetarist. The idea, popular now in Britain, that a bit of inflation is just the thing for an economy in recession finds no support in his work.

Keynes's response to the seminal article by Hicks is especially puzzling. In a long letter, Keynes offered lukewarm praise and a few quibbles, but no criticism of substance. He seemed to have no sense at all of how important the Hicksian interpretation would prove to be. Reviewing this correspondence, Mr Skidelsky asks "Was he too tired to realise [the] importance [of Hicks's approach]? Was he too personally remote from Hicks to find the right words? Whatever the answer, he let the Hicks 'generalisation' of the 'General Theory' through on the nod."

This, remember, is the approach that unrevolutionises Keynes, casting his theory merely as a special case of a system that accommodates "classical" ideas, too. It is the interpretation that zealous Keynesians regard as an outrageous parody of their master's thought. If Keynes himself had considered it a parody, you would think he migh have said something.

It cannot be to Keynes's credit, or to that of economics, that 56 years after the publication of the "General Theory" there is still no consensus on "what he really meant". If economics is to be any sort of science, it can do without layers of hidden meaning; testable hypotheses are more the thing. It would be possible to push this criticism further, arguing that Keynes, for all his extraordinary skills as a writer-bureaucrat, made less of a contribution to economic science than he is generally credited with. You might even argue that Keynes's very obscurity was a chief reason why his name became an ism. He gained the public's attention as an essayist and commentator; claimed to be offering a theory for which, in the 1930s, there was plainly a need; but provided, in the event, a vessel for others to fill with their own ideas.

That would be going too far. For sheer originality of thought, Keynes was indeed one of the greatest economists of the century—perhaps even the greatest. But his achievement was not, as he claimed, that he refuted price theory and other classical conceits, replacing them with an equally coherent view of how economies work. Keynes's "General Theory" was not, in fact, a general theory. And much modern macroeconomic research, in trying to explain persistent un employment and other "Keynesian" phenomena, is again using price theory in a way that the "classics" would recognise.

Keynes's achievement, rather, was to inspire a change in the character of economics. By force of intellect and personality, he altered its priorities—and thus its methods. The questions he sought to answer were about economics in the large: aggregate consumption, aggregate employment, aggregate investment and so on. This way of thinking, though hardly new, did not come naturally to those schooled in traditional price theory, where the task is to understand, say, the demand for one good rather than another, not the demand for all goods in the economy.

By making such great claims for his own ever-changing ideas, and by ridiculing the straw man of classical orthodoxy to such devastating effect, Keynes moved the economics of aggregates—macroeconomics—to centre-stage. For decades, there it remained. It was a mixed blessing—but, undeniably, a remarkable achievement.