From Money Illusion to Money Disillusion*

The currents of critical analysis, debate and controversy swirling around the interpretation of some essentials of Keynes's *General Theory* remain stormy even after several decades since its publication. Such arresting titles as " The Keynesian Counter-Revolution " (Clower, 1965), " Was Keynes a 'Keynesian'? " (Grossman, 1972), " The Crisis in Keynesian Economics " (Hicks, 1974), and " Keynesian Economics: The Search for First Principles " (Coddington, 1976) are but indicative of the depth and breadth of the tempestuous currents. To attempt a comprehensive analysis of the full range of issues in controversy, let alone to seek their general resolution, is a challenge transcending the scope of a single essay. The specific object of what follows is to examine the relationship of money illusion to involuntary unemployment within the framework of the modelling methodology of the *General Theory*. The outcome of this examination is a dual one: (a) Keynes's rationale for distinguishing between involuntary and voluntary unemployment is consistent with the *absence* of money illusion, and (b) such absence implies the notion of money disillusion.

I. What Unemployment is Involuntary?

For Keynes, the fundamental analytical objective was to establish in principle the possibility of the persistence of mass unemployment in an advanced economy. In turning first to Keynes's concept of involuntary unemployment, we adopt a line of approach to Keynes and the Keynesians which Patinkin has at one point put forward in

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regard to the classicists. In summarizing his interpretation of Keynesian versus classical theories of unemployment Patinkin observes, " Our concern has been not with what classical economists 'really' said but with what is logically sufficient to validate their conclusions." (Patinkin, 1965, p. 364). Our concern here is not with what Keynes " really " said but with what is logically sufficient to validate his conclusion that involuntary unemployment in an advanced private-enterprise economy may persist.

Keynes's definition of " involuntary " unemployment is the following: " Men are involuntarily unemployed if, in the event of a small rise in the price of wage-goods relatively to the money-wage, both the aggregate supply of labor willing to work for the current money-wage and the aggregate demand for it at that wage would be greater than the existing volume of employment." (G. T., p. 15) Recently, in seeking to adapt it to growth economics, James Tobin has sought to modify Keynes's definition by stipulating that the involuntarily unemployed be willing to work at real-wage rates compatible with additional employment resulting from expansionary policies. (Tobin, 1972, pp. 1-5) The Tobin modification is intrinsically consistent with Keynes's own emphasis upon the stimulation of aggregate demand as employment-generating in a depression. In contrast to Tobin, in a recent essay on " Theoretical Foundations of the Failure of Demand-Management Policies " as well as in a book directed " Towards a Reconstruction of Macroeconomics," William Fellner mounts an analytical attack upon Keynes's distinction between involuntary and voluntary unemployment. Fellner views this distinction as " a basic deficiency at a very sensitive point of the structure " (Fellner, 1976a, p. 34) of the *General Theory*, and, after detailed consideration, finds that " Given the importance of unions and of Western systems of transfer payments, attempts to distinguish between involuntary and voluntary unemployment are generally unpromising." (*Ibid.*, p. 51; see also Fellner, 1976b, pp. 53-55 and 131-135.)

Yet no sooner having found there to be no useful distinction between involuntary and voluntary unemployment, Fellner ironically proceeds to argue that " What is needed is a distinction between unemployment that can and unemployment that cannot be reduced by expansionary demand policies..." (Fellner, 1976a, p. 51.) But in affirming this *desideratum*, Fellner has come full circle in his critique of Keynes. For the distinction Fellner eventually calls for,

turns out to be tantamount to what Fellner has emphatically pronounced at the start of his critique as the distinction drawn by Keynes. That is, " Keynes's distinction between involuntary and voluntary unemployment is basic to the analytical structure he built because it is the involuntary component that was to be reduced or eliminated by expansionary demand policies." (Fellner, 1976a, p. 36.)

Thus, despite shunning the adjectives " involuntary " and " voluntary " for the unemployed, Fellner ends up embracing Keynes's distinction between unemployment that can and unemployment that cannot be reduced by demand-expanding policies. Accordingly, Fellner's proposed abandonment of the terms " involuntary " and " voluntary " detracts nothing from the irony that, quite contrary to his express intent, he has actually made a case for Keynes's purpose of conceptualizing involuntary unemployment. Thus, by the test of Fellner's analytical attack 40 years after publication of the *General Theory*, the rationale for Keynes's distinction between involuntary and voluntary unemployment has stood the test of time.

That such Keynesians as Tobin find Keynes's treatment of labor-market performance in the *General Theory* as relevant even to the 1970's (Tobin, 1972, p. 2) is significantly reinforced by the comprehensive recent critique of modern explanations of the behavior of unemployment in the American economy, both within and outside the Keynesian tradition, contributed by Robert E. Hall (1975, pp. 301-335). As Hall finds, " all of the theories that appear to have any explanatory power concur that unemployment is the result of inadequate demand for labor," with virtually none of these theories being liable to being " accused of making persistent unemployment a voluntary phenomenon arising from the supply side of the labor market." (Hall, 1975, p. 303.)

Nevertheless, Keynes's distinction between involuntary and voluntary unemployment remains a controverted one and, indeed, has detracted from the *General Theory*'s power of suasion. This outcome arises from a combination of two analytically separable reasons. One reason involves Keynes's modelling methodology; in particular, his specification of model equilibrium. The second reason involves the role of money illusion in the *General Theory* as presented in various interpretations of it. The first reason is a minor one, the second is major. The combination of the two has proved formidable if not forbidding in establishing what is logically sufficient to validate the *General Theory*'s conclusions.

II. Model Equilibrium

In terms of Keynes's modelling methodology, as J. A. Kregel (1976, pp. 209-225) has shown, the *General Theory* for the first 18 of its chapters utilizes the model of stationary equilibrium for the exposition of the principle of effective demand as the key determinant of the level of employment. In later chapters, the *General Theory* also includes the model of shifting equilibrium, which post-Keynesian growth theory has further developed. The modelling context of Keynes's distinction between involuntary and voluntary unemployment is clearly that of a stationary equilibrium in which expectations are given. Accordingly, with short-period expectations of entrepreneurs realized, involuntary unemployment is an equilibrium phenomenon despite the fact that some markets, including the market for labor, may not have cleared.

Although internal consistency is not compromised by Keynes's inference of the possibility of underemployment equilibrium, such inference contrasts with the neoclassical formulation in which market clearing is inherent in the stationary-equilibrium position. It is this contrast between distinctive formulations of the stationary-equilibrium model, as Kregel points up, that gives rise to a reconciliation problem between Keynes and the neoclassics. Indeed, this contrast, or clash, is one between alternative modelling methodologies, paralleling the contrast between the Marshallian and the Walrasian methods. For the analysis of a monetary-production economy the doctrine of the neutrality of money is out of place (Aschheim, 1973, pp. 75-83; cf. Hicks, 1973, pp. 3, 6). It is essentially in recognition of the non-neutrality of money that Keynes's specification of model equilibrium allows for markets that may not have cleared.

That Keynes's modelling methodology was conditioned by his rejection of the neutrality-of-money doctrine is underscored by his conception of underemployment equilibrium as essential to the basis for his derivation of macroeconomic policy implications. The deducing of policy implications, as the ultimate goal for Keynes's analysis in the *General Theory*, leaves no room for the casuistry of the neutral-money theorem. In particular, Keynes's attribution to workers of averseness to cuts in money-wage rates in the face of unemployment clashes with the notion of neutral money. The usual interpretation of such averseness, as directed at Keynes in the *General Theory*, has been that of the existence of money illusion. We now turn to the problematics of this line of interpretation.

III. Money Illusion Problematics

It appears that the term " money illusion " is not to be found anywhere in the *General Theory*. Of course, the mere absence of the term from the text of the *General Theory* is no decisive *a priori* argument for denying an intent by Keynes to impute money illusion to wage earners. There can be little doubt that Keynes's attribution to workers of averseness to cuts in money-wage rates tends to negate the real-balance effect. For Keynes explicitly couples this attribution with the argument that even if workers were to accept such cuts, there is no assurance that the labor market would clear. (G. T., pp. 257-271.) In other words, Keynes rejects downward flexibility of money-wage rates, even if it were practical (which he denies) as a corrective for involuntary unemployment. Yet whether the implied negation of the real-balance effect is tantamount to an endorsement by Keynes of the phenomenon of money illusion is a question yet to be addressed.

The very characterization of workers' averseness to cuts in money-wage rates as money illusion is a loaded one. The representation of an economic-decision maker as gripped by an economic illusion is suggestive of irrational economic behavior.[1] Certainly at the hands of its originator, Irving Fisher, money illusion is put forward as ignorance of price-level variability: " the failure to perceive that the dollar, or any other unit of money, expands or shrinks in value." (Fisher, 1928, p. 4.) That Keynes in particular seeks to avoid an irrationality implication is evident from his explicit rejection of downward flexibility of money-wage rates as an antidote for unem-

[1] In a comprehensive and searching review of the corpus of literature on the theory of optimum currency areas, EDWARD TOWER and THOMAS D. WILLETT (1976, p. 17) ascribe to Fellner the idea that money illusion may not be irrational. Yet Fellner, in the specific context cited by Tower and Willet, points out that " One needs to attribute no money illusion whatever to the public to conclude that the terms of money-wage or salary contracts almost wholly determine each income recipient's place in the real-wage structure and that in this regard *money* wages have a special status in any analysis relating to *real* incomes." (FELLNER, 1973, p. 227.) Thus, rather than avoiding the view that money illusion is irrational, Fellner seems expressly to avoid the attribution of money illusion altogether in the context of Tower and Willett's reference.

ployment. Thus, Keynes states, " ...it is fortunate that the workers, though unconsciously, are instinctively more reasonable economists than the classical school, inasmuch as they resist reductions of money-wages, which are seldom or never of an all-round character..." (G. T., p. 14.) Likewise, in a passage appearing in the third proof of the *General Theory*, Kenyes states " ...any group of workers may be extremely sensible... to resist a fall in money wages through a revision of the wage bargain." (Keynes, *Collected Writings*, Vol. XIV, p. 365, cited by Trevithick, 1976, p. 328.)

Hence, it is clear that the irrationality implication is expressly avoided by Keynes. One need not (though this writer would incline to) go as far as the trenchant analysis by J. A. Trevithick in reconciling the Keynesian labor-supply function with empirical evidence in support of the relative-wage hyphothesis. (Trevithick, 1976, pp. 327-332.) In other words, though Trevithick's essay meets the Patinkin test of showing what is logically sufficient to validate Keynes's conclusions, Keynes's own written words explicitly dissociate him from the attribution of illusory behavior to workers. This outcome harmonizes with Lord Kahn's interpretation of Keynes when Kahn states that Keynes " argued emphatically that lower wages simply meant lower purchasing power, and that so far from unemployment being reduced it would be increased if a fall of wages resulted in an expectation of further falls of wages and prices." (Kahn, 1975, p. 18.)

It is significant that, as a critic of the *General Theory*, Fellner also concedes the practical unreliability of the real-balance effect as a deflationary equilibrating method. Associating himself with Haberler, Pigou, and Patinkin, Fellner stresses that " Those who had the best understanding of the process by which deflationary adjustment could put an end to underutilization were clearly opposed to reliance on such a process in the thirties, and they have not revised their views thereafter." (Fellner, 1976a, p. 48.) Thus, as in the case of the distinction between involuntary and voluntary unemployment, in the case of Keynes's negation of the reliability of the real-balance effect as well, the *General Theory* after 40 years has stood the test of time.

Nevertheless, there remains at least one notable opponent to Keynes's rejection of the course of falling money-wage rates as a corrective for depression. On the basis of ingenious research of modern American wage determination, Hall maintains that in opposing the route of falling wages in a contraction Keynes was quite

mistaken (Hall, 1975, pp. 315-6). Yet Hall also finds that modern research strongly supports Keynes's emphasis that a reduction in money wages has no effect on real wages, and that in Keynes's words as quoted by Hall " the wage unit might have to fall without limit until it reached a point where the effect of the abundance of money in terms of the wage-unit on the rate of interest was sufficient to restore a level of full employment. At no other point could there be a resting place." (G. T., p. 253; quoted by Hall, 1975, p. 316.) Hence, when we juxtapose Hall's corroboration that a reduction of money wages will not necessarily lower real wages to Hall's above noted conclusion that persistent unemployment in the American economy is not a voluntary phenomenon, little significance can be ascribed to his observation disputing Keynes. Even within Hall's own framework of analysis, the route of falling wages hardly suggests itself as a commendable alternative to the course of expansionary monetary and fiscal policies.

The question still confronting us in connection with money-illusion interpretations of the *General Theory* is how these have continued not only in macroeconomics textbooks [2] but in some seminal writings as well.[3] To cite but one recent illustration of an author providing a particularly penetrating analysis of the nature of money illusion, Nicholas Georgescu-Roegen writes, " We recall that Keynes (1936, p. 9) introduced the term 'money illusion' to denote the fact that 'whilst workers will usually resist a reduction of money-wages it is not their practice to withdraw their labor whenever there is a rise in the price of wage-goods.' " (Georgescu-Roegen, 1976, p. 159.) (On the page of the *General Theory* cited by Georgescu-Roegen the term " money illusion " is not to be found, but the full sentence he quotes is there.) One reason for this line of interpretation persisting is, as cited by Hall, that " the General Theory lacks any fundamental explanation for the failure of the wage to vary in order to clear the labor market." (Hall, 1975, p. 316.) It will be suggested below

[2] For textbook examples of money-illusion interpretations of Keynes, see: Dernburg and McDougall, 1976, pp. 201-2; Ott and Yoo, 1975, pp. 331-2, 334-5; Poindexter, 1976, p. 253.

[3] A notable exception is Don Patinkin who firmly denies that Keynes assumed that workers suffer from money illusion in " the strict sense of the term." (Patinkin, 1976, p. 109.) Yet Patinkin also maintains that there is an " implicit (and, I would conjecture, unintentional) assumption that there is money illusion in the speculative demand for money " as expounded by Keynes. (Patinkin, 1976, p. 119.) A further notable denial that Keynes attributes money illusion to anyone is provided by James Tobin (1972, p. 3).

that it is more plausible to turn Hall's argument around and recognize that various interpretations of the *General Theory* lack sufficient probing of that which they seek to convey, while also noting that Georgescu-Roegen is not open to this charge.

A second and more widely mentioned reason, emphasized by Trevithick (1976, p. 329), is the resounding success of the Hicks-Hansen IS-LM model of income determination in which the money-wage rate is posited as institutionally given. Yet a third reason may be offered as outweighing the combination of the first two. It involves the line of argument, forcefully stated by Keynes and widely noted in the interpretative literature, that focuses upon the asymmetry paradox in workers' wage behavior. We turn next to this paradox.

While he points to worker resistance to the cutting of money wage rates, Keynes avers the acquiescence by workers in a gradual and automatic lowering of real wage rates resulting from a rising price level. Keynes views the resulting asymmetry in workers' wage behavior as constituting a rational course of conduct in that worker acquiescence in a rising price level is conducive to raising the level of employment in the wake of an expansion of aggregate demand. Thus his resolution of the asymmetry paradox reinforces his negation of the irrationality implication that the acceptance of money-illusion interpretations involves. Yet the cogency of his resolution is compromised by his explicit postulation of worker acquiescence in declining real-wage rates concomitant with a rising price level.

In expounding his acquiescence postulate, Keynes makes reference to the real world as he perceives it. Ultimately it is his perception of the real world by which he tests the validity of his fundamental postulates. For example, in rebutting Wassily W. Leontief, when Keynes denies the validity of the homogeneity postulate in general equilibrium theory, he states that " there was abundant evidence from experience to contradict this postulate; and that it is for those who make a highly special assumption to justify it, rather than for those who dispense with it to prove a general negative." (Keynes, 1937, p. 209; quoted by Minsky, 1975, p. 22.)

Yet as Hyman Minsky points out, the principal domain of Keynes's experience was the forum of finance: the operations of the City — or Wall Street. Indeed, " The knowledgeable view of the operation of finance that Keynes possessed was not readily available to academic economists..." (Minsky, 1975, p. 130.) And just as Keynes turns to evidence from experience in contradicting the homogeneity postulate, Keynes refers to experience for his asymmetry postulate. Thus, he states, " Now ordinary experience tells us, beyond doubt, that a situation where labor stipulates (within limits) for a money-wage rather than a real wage, so far from being a mere possibility is the normal case... whether logical or illogical, experience shows that this is how labor in fact behaves." (G.T., p. 9.) But it can be demonstrated that Keynes's knowledgeable view, while encompassing the realm of finance, did not embrace the domain of wage determination under collective bargaining. Keynes's business exposure was to financial institutions rather than to union halls or picket lines.

Specifically, when John T. Dunlop, in his classic maiden article in the *Economic Journal* of September 1938, under the editorship of Keynes, presented his research finding on the basis of contemporaneous English data on " The Movement of Real and Money Wage Rates ", they tended to refute Keynes's acquiescence postulate. And, in the *Economic Journal* of March 1939 (pp. 34-51) Keynes acknowledged the significance of Dunlop's refutation. [In the same article, Keynes also acknowledged a parallel refutation in terms of American data by Lorie Tarshis (1939, pp. 150-154).] We offer the vulnerability of the acquiescence postulate as the principal reason for the general attribution of money illusion to the *General Theory* despite Keynes's express refusal to disapprove of worker resistance to money-wage reduction as an antidote for involuntary unemployment. Although there is by now close to consensus among economists that Keynes's rejection of downward wage flexibility as a route to full employment is well founded, it is the vulnerability of the acquiescence postulate that underlies the abundance of money-illusion interpretations of the *General Theory.* Such interpretations have persisted in the face of Keynes's disavowal of an irrationality implication of his modelling methodology in expounding the basis for his concept of involuntary unemployment.

IV. Money Illusion Countervailed

Deflation economics is not the only context for the analysis of money illusion. Under the stimulus of contemporary encounters with inflation, some further new light has recently been shed on the phenomenon of money illusion.

Proceding from the *General Theory*, Georgescu-Roegen notes

that money illusion is not limited to workers alone. Any university professor, he observes, will display it, if, like the worker, he has no other source of income than his salary. Accordingly, " In effect, money illusion is on the whole stronger for the salaried personnel than for workers, the main reason being that an increase in the cost of living hits the people with lower income harder. At bottom, money illusion, is a particular instance of *money fetishism*, a fetishism that affects every member of a money economy." (Georgescu-Roegen, 1976, p. 159.)[4]

Georgescu-Roegen goes on to depict how under the impact of inflation individuals rid themselves of money illusion but with unequal speed. The speed varies with such objective conditions as outstanding obligations under current contracts, the necessity of being gainfully employed in the absence of other alternatives, etc. What Georgescu-Roegen envisages as the abandonment of money fetishism in the course of ongoing inflation can be further elucidated as the impact upon economic-decision makers of their perception of inflation.

Thus, even with reference to passages in Keynes's *General Theory* to which the attribution of money illusion is typically made, as for example by Georgescu-Roegen himself, the term money illusion (as well as Georgescu-Roegen's own use of the term, money fetishism) in the final analysis turns out to be a misnomer. As awareness of a rising price level emerges, money illusion recedes. The perception of inflation renders money illusion into money disillusion.

Empirical validation of the occurrence of money disillusion, is, of course, not limited to the contemporary scene. Such evidence is traceable at least as far back as Dunlop's above noted 1938 repudiation of Keynes's ascription to English workers of acquiescence in the erosion of real purchasing power concomitant with a rising price level.

The pervasiveness of the phenomenon of money disillusion as it affects workers has been given its most effective expression by Sir John Hicks in the context of the contemporary British economy.

> " The wage-earner's test for fair wages is not simply a matter of comparison with other people's earnings; it is also a matter of comparison with his own experience, his own experience in the past. It is this which makes him resist a reduction in his money wage; but it also makes him resist a reduction in the purchasing power to which he has become accustomed. Thus, there is a backlash of price on wages — a Real Wage Resistance, it may be called." (Hicks, 1975, p. 5. See also Kahn, 1976, pp. 1-2.)[5]

[4] Georgescu-Roegen's use of " money fetishism " can be juxtaposed to the Marxian application of the concept of " commodity fetishism " (Sweezy, 1956, p. 129) in which money is but another, albeit the general, commodity (Marx, 1952, p. 391). Commodity (and, therefore, money) fetishism in the Marxian analysis refers to the generic proposition according to which " The product governs the producer." (Marx and Engels, 1968, p. 421; p. 432.)

For the modern American economy, Hall's own theory of wage behavior, drawn from his empirical research finding, reinforces, in effect, Hicks's notion of Real Wage Resistance. In Hall's view, American workers would rather queue up for higher wages in the downwardly-rigid wage sector than accept lower wages in the flexible-wage sector. (Hall, 1975, p. 329).

What we call money disillusion harmonizes with Hicks's phenomenon of Real Wage Resistance. The term " money disillusion " may be slightly preferable not so much for the directness of its inversion of " money illusion " as for its implied applicability to all economic-decision makers rather than to wage-earners alone. It is the latent pervasiveness of resistance to a rising price level throughout the economy which the notion of money disillusion is meant to convey.

In turn, both Real Wage Resistance and money disillusion are concepts that harmonize with Keynes's acknowledgement of the plausibility of workers' averseness to a reduction of money-wage rates. Such averseness, Keynes reminds us, " might not be so illogical as it appears at first; and ... fortunately so." (Keynes, 1936, p. 9.)

V. Conclusion

In sum, although Keynes erred in his acquiescence postulate that he used as a basis for the definition of involuntary unemployment, he clearly argued against the irrationality implication of money illusion in analyzing worker averseness to money-wage cuts. Thus, the economic perception that Hicks terms Real Wage Resistance and that we here term " money disillusion " logically harmonizes with Keynes's rejection of the variation of the money-wage level as an

[5] It is noteworthy that Hicks's analysis is foreshadowed in his earlier essay " The Hayek Story " (Hicks, 1967, pp. 203-215), in the context of what he identifies as the Hayek " slump ": " It can happen that there is unemployment even while there is inflation. It can be that labour is insisting on a minimum *real* wage, and that that wage is higher than what is consistent with full employment, whatever happens to prices " (Hicks, 1967, p. 214.)

antidote for unemployment. Accordingly, despite a defective definition of involuntariness, Keynes is internally consistent in interpreting the possible persistence of mass unemployment as involuntary.

The internal consistency of the modelling methodology of the *General Theory* derives from the generality of Keynes's theory of effective demand. Involuntary unemployment is explainable as the outcome of a deficiency of aggregate monetary demand, a deficiency that expansionary monetary and fiscal policies can counteract.

Tobin has, perhaps humorously, averred that " An economic theorist can, of course, commit no greater crime than to assume money illusion." (Tobin, 1972, p. 3.) Conversely, Ronald I. McKinnon has seriously argued that " In the field of *domestic* economic policy, theorists and policymakers alike have become distressed with the decline in money illusion as it affects the labor and commodity markets." (McKinnon, 1971, p. 343.)

The notion of adaptive expectations can be applied to the formation of reservation prices for such diverse transactions as typify labor, commodity and financial markets. On the basis of such application, McKinnon suggests that money illusion has recently diminished significantly in consequence of the adaptation of individual expectations to sustained price-level movements. (McKinnon, 1971, pp. 339. 343-4, p. 352.) We suggest in turn that if economic theorists and policymakers are distressed by a decline in money illusion, it is at least partly because Keynes has been misinterpreted as a money-illusion theorist.

The notion of adaptive expectations accords with the postulate of money disillusion supplanting that of money illusion. If, as McKinnon's argument would imply, the phenomenon of money disillusion is distressing to theorists and policymakers, they must have been seeking to capitalize on other people's affliction with money illusion, of which affliction these theorists and policymakers presumably were free. In any event, Keynes is not to be counted among either such theorists or such policymakers.

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