The Keynesians

*(A letter from America to a friend)**

by

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... This time I am going to tell you something about the « Keynesians ». I have come in touch with many and diverse kinds of them, first in Chicago, and now here at Cambridge. By talking with them and listening to their lessons one gets a truer idea of their views than by reading their arguments mummified on the printed page.

Keynes's influence in America is great. An incredible number of Keynesian books and articles have been published here, some with titles perhaps hardly suited to the severity of scientific works: « The New Economics », « Economic Research and the Keynesian Thinking of our Times », « The Keynesian Revolution »; and so forth.

In Chicago I became acquainted with the « econometricians », among whom many are (or have been) Keynesians. For a long time Keynes's global quantities, the « liquidity preference » and the « propensities » have supplied the « data » or the « unknowns » for their mathematical exercises. They reached a point, as is known, when Keynes himself found them more than tiresome. The Keynesian zeal of some econometricians is still notable. One of them — and this struck me — during a lesson wrote on the blackboard some little formulae to explain the relations, if I remember rightly, between money wages and employment. He had chalked a line dividing the blackboard in two: on one side he had written « Pre-Keynes », on the other « Post-Keynes ». Two eras, in short. In the first era, the professor explained, it was believed that there was an inverse relation between the two terms; in the second era it was realised that a change in wages cannot modify employment.

Utterly devastating, as you see, has been the Keynesian revolution, in which, as in the French Revolution, many worthy people have lost their heads.

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The Keynesians have a right wing and a left wing; both alike insist on their orthodoxy and both alike make the Master say things of which he never even dreamt. Keynesianism is, in short, a full fledged philosophic school. Instead of theses and anti-theses there are the « propensities ». « Liquidity preference » has replaced the Idea.

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The government departments at Washington are full of Keynesians of all tendencies. Their prescriptions vary with prevailing economic conditions (Keynes's system is wonderfully elastic); it is always easy to demonstrate that the conditions are those one wishes them to be.

Are the trade unions taking a threatening attitude, and do wage rises seem inevitable? Wage rises are advantageous: Keynes says so and so do the left wing Keynesians.

Does it seem possible to withstand the demands for wage rises? Other Keynesians (the right wing) pop up, waving other writings of the Master showing that such rises are an evil.

Is the budget deficit alarming and does the Party in power need to fillip its popularity? It is found that the marginal efficiency of capital is too low to attract savings to investments; it is necessary to tax the rich, whose propensity to save is dreadfully high. But may be the rich show their teeth: it is not advisable to attack them. It will then be discovered that the marginal efficiency of capital is high enough; there is no danger that money remain in the drawers; heavier taxation would be a serious mistake.

Then, there are the « findings » generally accepted, the « conquests » of the new economics.

The economic horizon darkens: is a depression in sight? Well and good: the time has come for wild-cat finance (technically known as « deficit spending »). What should be financed? Public works, armaments, perhaps even social services.

All this of course is garbed in dignified scientific terms, and claims the respect of all, if it is seasoned with estimates of disposable incomes and global savings, with calculations of the various « propensities » and « multipliers »

A student of economics has even discussed in all seriousness and with due importance the multiplier of armament expenditure and has written an impressive article bearing a title which might well intimidate the incredulous.

* Translated from Italian by Olivia Rossetti Agresti.

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One might say: but these are the usual aberrations of followers, who traditionally, or by some law of nature, are always the worst enemies of the Masters.

But, were Keynes still living, could he say: *« moi, je ne suis pas keynesien »?*

I am afraid he could not: there are of course the aberrations of his followers, but to a large extent they can be traced back directly to him.

Keynes takes no cognizance of the problem, on which good classical economists laid so much stress, of what is « productive » and what « unproductive », *i.e.*, what is « luxury », or, we may say, of what is socially productive and what is not. For him one investment is as good as another, since it means spending. The article on the multiplier of armament expenditure is an example of this aberration; and it is not an aberration of a follower; it is one of the Master.

All will be well, provided people spend; and should savers keep their money in their drawers, then the government must do the spending. It does not much matter whether the money is spent on building an electric power station or on paying people to carry water from the Atlantic to the Pacific. A Keynesian (an assistant professor of economics at Harvard), to whom I made this objection, answered me: « but, as we know, Keynes's theory only holds good for the short run; and in the short run investment expenditure has the effect of raising the wage level and increasing employment whatever the investment may be ».

This famous « short run » is always brought forward by the followers of Keynes. « In the long run we are all dead ». But before dying we shall be living a rather wretched life if we go on committing a series of « short run » follies.

Keynes ignores not only the problem of social productivity but also, and consistently, that of costs. That costs be high or low, that they be rising or falling, matters little to him. He thinks that, in the short run, technological changes can be quietly ignored; and he has not even a suspicion that these changes may account for many of those disequilibria that he tries to explain by « propensities », « multipliers » and other economic gadgets.

We might well ask ourselves as a premise what use can be made, in the interpretation of economic reality, above all modern reality, of a « system » based on such distortions.

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But we are still outside the system.

Let us enter it.

The point is to seize Keynes's line of thought, and then discuss it while respecting his premises. The task is no easy one, for Keynes's ideas are so many. I resorted to the help of one of the most brilliant of the Keynesians here, Franco Modigliani, and I had with him several talks. I have been led to modify somewhat the picture I had in mind, but I have seen that it was substantially correct. When Modigliani had finished sketching the outline of the Keynesian edifice I raised my objections. To my opponent's honor I must say that he agreed that what seems to me to be the fundamental objection to the Keynes « system » gave him pause for thought and made it necessary for him to review again his convictions.

The fundamental objection is this: Keynes has failed to understand the part played by the banks in modern life, and this failure undermines the whole construction of his logic.

Let me sum up the substance of my conversations with my Keynesian friend, for I should like to have your opinion on the matter.

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Each person, says Keynes, may spend his money-income on consumption goods, or he may save it; if he saves it, he may invest or he may hoard it.

Men are disposed, as a rule and on the average, to increase their consumption as their income increases, but not by as much as the increase in their income. The ratio between the increase in the consumption of a community and the increase of its income — the marginal propensity to consume, $\frac{dC}{dY}$ — is less than unity. If the aggregate income grows, savings grow in actual figures and perhaps also proportionately. (The richer, moreover, have a lower propensity to consume than the poorer. The more unequal the distribution of income, the wider the margin of savings, which may or may not be invested.)

A new expenditure on consumption goods increases aggregate income and employment; new individual savings increase both the one and the other only in so far as they are invested. Those who save are induced to lend only if they obtain an adequately high rate of interest. Interest is the price paid to induce savers to renounce holding liquid money. Now, who pays this interest? It is paid by the firms, whose demand for loans and whose investments vary according to the more or less high marginal efficiency of capital (or, as Lerner corrects, of investments, because, according to another « famous » remark, a *fund* should not be confused with a *flow*).

And here I come to the core of the argument.

If the marginal efficiency of capital falls, the total investment declines. Effective demand (the sum of outlays for consumption and of those for investments) falls below the level ensuring full employment, and therefore the social income shrinks. Under these conditions, Keynes says, no automatic mechanism assures the return of full employment and raises again the income. The decline in the rate of interest, which according to the « classics » might reestablish the balance, does not really do so. The fact is that interest depends on « liquidity preference », which, for various reasons, increases, or does not decline; and as money cannot be « produced » by the individuals, the price of money, *i.e.* the rate of interest, increases, or is reluctant to fall: the « inducement to invest » is hampered. Things, left to themselves, may remain like this for a long time. Nor, under these circumstances, will the reduction in money wages be helpful, as such a reduction may lead to a further shrinkage of effective demand.

There is but one way to react: to stimulate effective demand, that is to say the mass of money flowing into consumption and investments. How? The monetary authority may immit new money, especially by « open market operations »: the additional money lowers the rate of interest and thus encourages investment. Or the monetary authority may directly reduce the rate of interest. Besides, the government itself may raise its expenditures, by financing public works or other « investments ».

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This reasoning is based on the assumption that the volume of money is constant. This assumption, Keynes says, is legitimate because, in the case of a gold-standard currency, metallic money can be produced by private enterprise in gold-mining countries in a measure which, for the world as a whole, is negligible; in the case of an inconvertible managed currency, paper money can be « produced » only by the monetary authority, that is to say by the central bank under public control, and not by private enterprise. Should the liquidity preference grow, and with it the rate of interest, the production of money cannot increase, as, for instance, the output of motor cars can increase if their price rises.

Here is the fallacy. The « production » of means of payment, in the modern economic process, did not and does not depend, substantially, on the mines or, respectively, on the monetary authority; it did and does depend on the banks (and among them there is the central bank itself in so far as it does not operate under public control), which all emanate from private enterprise, that is to say from the firms. It is not true that the firms cannot « produce » money: they can and do produce it: not directly, but through the banks, which in their turn are themselves firms. This means that the banks, continuously, create means of payment on behalf of the non-banking firms (we do not say that they « create credit », an expression which has given rise to many misunderstandings); and these means of payment have only a very elastic connection with individual savings. Strictly speaking, the means of payment « created » are not and do not represent the savings of anyone (regarded from the social standpoint, they may lead to « forced » saving, in as much as they bring about a rise in prices; or they may hypothetically hinder an expansion of consumption in as much as they prevent a price fall). The commercial banks — I am referring to these — obtain on loan 100 monetary units from individual savers and have to pay a certain rate of interest to overcome — let us use this expression — their « liquidity preference »; but they make loans for 200, 300 units or more; and to obtain these loans the entrepreneur has not to overcome any « liquidity preference » of the banks, which indeed (subject to certain ample limits taught by experience and the circumstances of the time) prefer « illiquidity », they are there just for this.

Liquidity preference, which is a leading personage in the Keynesian drama, only plays the part of a super in the drama of modern economic life; he appears in one scene only, says his lines and disappears.

Keynes's arguments could hold good, if at all, in an economy with a purely metallic currency, or in one in which the circulation consisted of bank-notes with a full metallic cover, in which the banks merely acted as middlemen for private savings. But, two centuries ago at least, such an economy ceased to exist.

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My Keynesian friend reflects; and then says that my objection might be valid in the case of circulating capital, which is financed by bank loans; but not in that of fixed capital, which is financed by shares and debentures. These are purchased by individual investors; and here we are forced to take into account their preferences and propensities.

This line of defense cannot hold. A net distinction between the two sources of financing, corresponding to the two types of capital, is a purely scholastic one. It is well known that firms often finance long-term investments with short-term bank loans, which they renew several times. Moreover, share and debenture issues are usually financed, at least in a first stage, by the banks, either directly or by loans made to brokers.

My friend rebuts: but in the last resort those securites must be purchased by individual investors. Agreed. But we are justified in supposing that these investors purchase those securities with means of payment which in the period under consideration, brief though it may be, have been created by the banks and have come into their hands by various ways. From this point of view also, the assumption that the volume of money is constant would seem to be unfounded, or, rather, deceptive. Such an assumption creates bottle-necks, required passages, which in reality do not exist.

In short, what Keynes at the conclusion of his drama wants the banks (or the government) to do, *i.e.*, to augment the volume of money in circulation, is what the banks are normally doing. If at a given moment the banks find difficulty in continuing to do so, if, against their will, they see their liquid reserves increasing, this does not depend on ill-will on their part, and still less on the unwillingness of the individual savers, to loan money. It depends on the fact that the prospects of profits decline, and are replaced by prospects of losses; it depends on the fact that the « marginal efficiency of capital » falls. Why does this efficiency fall? This still has to be explained: the wreckage of the Keynesian edifice offers no answer.

Does this mean that in periods of depression all monetary management should be condemned? Or that all forms of government intervention should be banned? Of course not. It only means that as a matter of correct reasoning Keynes's theory must be discarded; let he who will try to build up another. But if we aim at correct reasoning, then we cannot accept Keynes's theory, even if we like his political conclusions.

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And here the discussion widens. Why did Keynes's ideas become so popular?

In the Middle Ages heretics used to be burnt, but in our century they are applauded, Frank Knight says jokingly; and this explains the success achieved by Keynes. Undoubtedly, in his *General Theory*, Keynes endeavours by all means to be taken for a heretic, and expresses his lively sympathy for heresies of all kinds.

Joseph Schumpeter attributes the popularity of Keynes to his « ideology », which he considers substantially as a political ideology of radical type.

For my part I am inclined to accept this second point of view: for one reason or another it is the political conclusions of Keynes, rather than his line of argument, that please.

So many people, above all with us, in Italy, declare themselves to be Keynesians, not because they really approve (or know) the questions of « propensities », « preferences », and the like, but because they see in Keynes's ideas the justification of an « investment policy ». The mere expression exercises today a strong attraction; it alone confers on those who use it a really up-to-date tone.

We may ask: do we really need Keynes in order to justify such a policy? Would it not be better, for those who advocate it, to study closely the specific investments it would be advisable to encourage, rather than to descant on disputable « propensities » and problematic « multipliers »?

But, one may object, if we give up Keynes we fall back on the classical economists who believe in « *laisser faire* ». This is a distortion. An analysis that claims to be scientific is neither for *laisser faire* nor for any other type of economic policy. If many classical economists, *after* making their analyses, point out the expediency of liberal economic policies, that is something additional that has nothing to do with the analysis. The distortion consists in believing that the acceptance or rejection of the additional conclusion implies the acceptance or rejection of the whole; that, in short, political conclusions and economic analysis are one and the same thing. If there is any hope that economics may be or may become a *corpus* of scientific doctrines, or, let us say more simply, of reasonings intended to interpret economic life and to make it comprehensible, then we must have the courage to free ourselves of political sophistry. It is not a question of renouncing our political or ideal preferences — which is impossible —, but of being honest with ourselves and always watchful to see if we accept a given line of argument because the political conclusions please us, or because we must really consider it to be logically correct. If we accept or present a certain argument for political reasons, we should say so clearly, and not play the ignoble comedy of science.

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They say: to Keynes belongs the credit of having stimulated the study of « macroeconomics », the study of the relations existing between global quantities, between « aggregates », such as the national income, investments, and savings; and of having suggested new conceptual instruments, foremost among which the « propensity to consume ».

But, when we want to see deeply into things, the movements of these global quantities, of these « big boxes », can tell us very little; they often muddle things up instead of clarifying them. This mode of considering economic problems (here it is called the « aggregative approach ») is found again in those studies of « dynamic macroeconomics », of which the so-called « dynamic schemata » or « models » are conspicuous examples. It is claimed that through these « models », describing, as they do, the imaginary actions and reactions of a certain number of big boxes (actions and reactions duly separeted by « lags ») the business cycle can be explained. At the economic meeting held at Cleveland, Haberler wittily remarked that now-a-days, with these « models », every sophomore is able to « produce » any kind of cycle. « Give him a couple of lags and initial conditions and he will construct systems which display regular, damped or explosive oscillations, or exponential movements up or down, as desired. However, the more models we have, the less we seem to know of the real business cycle »

As to the « propensity to consume », substantially it is connected with a notion already known: the income elasticity of demand. The novelty consists in applying this notion (which, like the price elasticity of demand, has a definite meaning when referred to individual goods) to a huge box: the total expenditure of the community on consumption goods. Should we be pleased with such a novelty? I fear not. The new notion is one which apparently simplifies the reasonings but in reality it reduces them to empty exercises. To convince oneself of this, one need only examine the results of the statistical studies dealing with it: each of the periods studied shows different changes of the « propensity to consume »: the « theoretical » uniformity or uniformities appear to be mere illusions.

Enquiries into cyclical movements based on the propensity to consume or, as is now commonly said, on « consumption function », which were fashionable during and immediately after the last war, are now discredited even in this country, especially after the failure of the forecasts — which several Keynesians expressed by extrapolating « disposable incomes »,

« savings », and, of course, consumption — of a catastrophic depression that should have followed close on the war.

The « propensity to consume » had already given rise to another *monstrum* which seems now to be developing: the « propensity to import ». But of this I will not even speak to you.

They say: Keynes has the merit of having drawn attention to economic disequilibria, that the « classics », concerned above all with the long run, practically ignored.

We may admit that the chapters devoted by the classical economists to the « market gluts », to the « abuses of credit », or, by some, to the « tendency of the rate of profit to fall » (with all the consequences and the reactions connected therewith) are not very satisfactory. But what about the work of Sismondi, of Clément Juglar, not to go beyond the nineteenth century? And how about the work of Marx himself? But, it is true, the two first are not « classics » and are moreover scholars who wrote in French; it would seem that of such scholars Keynes only knew Montesquieu to praise him, and Say to criticise him. As to Marx, it would seem that Keynes had not a great opinion of him; once he mentions him as a heretic not to be neglected; and another time he ventures a daring prophecy: « I believe that the future will learn more from the spirit of Gesell than from that of Marx ». One may be bitterly critical of Marx; but to rank him below a Gesell (a good man, a monetary reformer perhaps less perspicacious than our Trucco) seems to me to be going really a little too far. Such a judgment should suffice to define the man who expressed it. (Gottfried von Haberler, with whom I was talking of these matters, remarked smilingly that the Keynesians have always prudently ignored this judgment of Keynes on Marx and his weakness for Gesell.)

They say: Keynes deserves credit for breaking the spell of classic orthodoxy, and renewing economics. If that opinion refers to economics and not to politics, and if it refers specifically to the problems of business depression, the answer is that given above: the merit may be ascribed to him by those unacquainted with the works written in the last century and in our own on depressions. If it refers to politics, then economics is not concerned.

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But here, as I am on the subject, I should like to say a few words to you on the political side of Keynesianism.

Whether we like it or not, a process of economic unification is taking place in our day. It is a process that seems to be leading towards an economically unified society, towards a « socialistic » economy. This (rightly Schumpeter says) is becoming a wide-spread conviction, although not openly expressed, even among conservatives. Keynesianism is perhaps the form in which this tendency finds expression in a large section of the academic world.

The growing power of the labour organisations makes it more and more difficult for private enterprise to function. Should things go on like this, the transformation of the economic system into one of a different kind (which may be described as « socialistic ») would seem to be inevitable. It would be interesting to enquire how it is that this simple truth is not generally understood or recognised. The explanation may perhaps be this: that the Marxism, capsulated by the theory of the progressive impoverishment of the working classes, could not recognise — or at least could not attribute due importance to the growing power (both economic and political) of the workers' organisations. And it was difficult for the « orthodox » economists to admit it; in any case they preferred to lecture the working classes on the need of allowing the system to work. Then came Keynes, who gave *de jure* recognition to the power of the labour organisations. It is not expedient to reduce wages during depressions, he said; and even if it were expedient, he added with involuntary irony, it would not be possible. Full employment is not assured by the automatic working of the economic system; it must be assured by the government; and if, to do so, it should be necessary to tax the higher bracket incomes, so much the better: it is there that the danger of hoarded savings is greatest. Such, in substance, is Keynes's message. But we may well ask if this is indeed a « message », or if it is not rather the formulation, in more or less rational terms, of a reality that was imposing itself and would in any case have forced itself on the attention of all. We may ask whether Keynes's « message » has helped to clarify people's ideas, or has not rather helped to muddle them. (But, let us say it to our credit, at least with us, in Italy, the *vis « confusionaria »* of Keynes has been denounced in time by scholars who knew something about economics.)

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The left wing Keynesians try to make the impossible match between Marx and Keynes.

Those of the right wing see in the message of Keynes a means for saving the tottering capitalistic system. Some do not admit this; others, like the incomparable Seymour Harris, openly say so. Yet others, with naive Machiavelism, go so far as to say: « Well, maybe the Keynesian theory is not altogether satisfactory; but better Keynes than Marx; better government interventions à la Keynes than leaps in the dark ». These artful ones also — perhaps indeed they more than others —, without realising it and without wishing it, contribute (in so far as they count for anything) to the transformation of the economic system founded on private enterprise into a different system, a different society, at whose character we can now only make very uncertain guesses.

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