The policy implications of the *General Theory*

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> In my view the whole management of the domestic economy depends upon being free to have the appropriate rate of interest without reference to the rates prevailing elsewhere in the world. Capital control is a corollary to this. (*CW* XXV, p. 149)

In issue 48 of the *Real-World Economic Review*, Paul Davidson (2009) rightly called for great changes to the global financial architecture, including capital control. Rightly he did so in the name of Keynes. But even one of the world's leading Keynes scholars fails to do full justice to Keynes's legacy. For Keynes, capital controls were means to an end: to the low long-term interest rates that he understood as the most important factor in facilitating full employment, stability and a more just distribution of income. Moreover, the theoretical understanding of the operation of an economy from which these conclusions were drawn had many other substantial practical implications that are the reverse of most conventional wisdom.

The purpose of this paper is to make a concise statement of Keynes's policy in its broadest perspective. As the crisis that engulfs the world is addressed, it seems important to understand just how far from Keynes's prescription the policy consensus of the past thirty or even forty years has operated. At the same time, the extent to which all prominent – present and past – interpretations of Keynes fail(ed) to capture the true nature of his conclusions must be confronted.

The discussion proceeds as follows:

1. the statement of policy;
2. the origins of that policy, drawn from the period after Keynes took the decisive step to his *General Theory* (the end of 1932);
3. the outcome of Keynes's challenge to the *status quo*, detailing the great changes to the economic policy environment made from the 1930s and how they were eventually undone;
4. an analysis of how the large part of Keynes's policy is omitted from the present mainstream and even post-Keynesian literature;
5. an examination of how Keynes's position featured in and then vanished from the historic literature; and
6. a brief conclusion.

The interpretation is based on that of Tily (2007), but the policies are set in broader terms. If correct, the implications are surely of great importance: for nearly three quarters of a century, economists have operated with an entirely false understanding of Keynes's conclusions. Three reviewers have broadly supported my interpretations of policy (Hayes 2008, Rogers 2008 and Toporowski 2008). Those who have disputed my conclusions, or their importance, have tended to do so in private correspondence or in referees' reports. My desire is to draw this debate into the open.

Keynes's policy: broad perspective

Keynes's theory led to a wholly different monetary system, where growth was financed by credit creation through the domestic banking system, rather than reliant on international capital markets. The system would be aimed at the low interest rates that he saw as fundamental to a high level of activity and employment, and to stability. Low rates facilitate production, making both business and government expenditures and investments cheaper.

From the domestic point of view the changes first concerned **debt management** and **monetary policy**. In order to set long-term rates of interest on government debt the basic necessity was to allow the public to choose the manner in which it lent to government. The process involved:

1. an extension to the range of securities issued, from long- to medium- and to short-term debt;
2. an extension to the floating debt with 'Treasury deposit receipts' (TDRs), of six month maturity, but not eligible for discount at the central bank. These would be issued along with Treasury bills; and
3. a change in the manner of debt issue, so that 'taps' of the various instruments are held open permanently so the public can purchase when, what and to what extent it chooses.

The central bank's discount rate should simply be set and fixed in line with the structure of the rates that the government sought to establish. Future interest rates would gradually fall over time, as the rate of profit on investment fell. This removed the standard objection to the use of floating rather than long-term debt: that rates may rise in the future. Manipulating the balance between TDRs and Treasury bills would permit regulation over the creation of credit by the banking system, and hence of the money supply.

In 1945, Keynes recommended the following structure of debt and interest rates into the post-war period:

> (a) Treasury Bill rate to be brought down to ½% and Treasury Deposit Receipts to carry 5/8%; probably a special rate of 1% (broadly the present rate) to apply to overseas money now in Treasury Bills and the like.
> (b) Subject to action on (a), 5 year Exchequer Bonds at 1½% and 10 year Bonds at 2% to be issued on tap, a new series to be started annually.
> (c) 3% Savings Bonds to be issued on tap, a new series to be issued annually, with an option to the Treasury to repay after 10 years with, preferably, no final maturity (or if necessary a fixed latest date of repayment after 35 years).
> (b) follows upon (a); (c) could either follow (a) or precede it. (National Debt Enquiry, 1945, para. 30)

Government spending should be complementary to the monetary policies. Keynes came to the view that monetary action alone was not sufficient for full employment. Government investment would make up the shortfall. Moreover, as the rate of profit and hence interest rates fell to a very low level, the role of government would gradually increase: this was the socialisation of investment and the euthanasia of the rentier. According to the *General Theory*, the use of **taxation policy** for the re-distribution of income was economically as well as socially desirable: the marginal propensity to consume and hence investment multiplier would increase. Moreover, with the role of credit understood, there was no justification for particular leniency to wealth holders, and taxes could be increased for example on inheritance.

Overall, policy would be aimed at employment not **inflation**. But inflation was not neglected and the greater regulation of monetary arrangements explicitly recognized these considerations. Keynes's proposals in *How to Pay for the War* showed how much could be achieved without resort to the discount rate as a weapon against inflation, thus avoiding the increases in unemployment associated with high rates.

The purpose of his proposals for the **international financial architecture** would be to facilitate these domestic priorities. Capital controls were necessary to permit domestic autonomy, so that wealth could not seek out better interest terms in other economies; the concern over capital flight is a complementary but *different* perspective. Equally, exchange regimes should not interfere with domestic policy and provide an additional degree of stability as well as flexibility through fixed but adjustable exchange rates. Underlying Keynes's plan for an International Clearing Union was the notion of a 'world bank' that would issue an international currency (Churchill favoured 'Florin' as opposed to Keynes's 'Bancor') to keep pace with international prosperity; the Union would permit lending for temporary current account imbalances. Such imbalances would not be permitted indefinitely, with a board of the bank responsible for agreeing remedial action that would penalize contractionary as well as expansionary policies in respective national economies, and the actions might include revaluation of currencies.

With the above policies, government and the various monetary authorities set the *framework* for economic activity. *Within* that framework activity should be based to as great as an extent as possible on **market principles**. "In matters of economic detail, as distinct from the central controls, I am in favour of retaining as much private judgment and initiative and enterprise as possible" (*CW* XXI, p. 240). But the priority of **trade** was greatly changed from the traditional view. Activity should be dictated by domestic not overseas considerations, i.e. by domestic demand, and trade should be complementary to domestic requirements rather than pre-requisite.

Keynes's policy: origins

Following from his rejection of the gold standard, Keynes was initially concerned with international architecture. His focus was on exchange regimes and discount rate policy. However, very soon after putting the finishing touches to his *Treatise* (published in October 1930), a wider notion of 'the interest rate' assumed a greatly increased importance in explaining the rapidly deteriorating world economy:

> This memorandum brings home to me what I was beginning to forget, namely that I have nowhere introduced into my draft chapters in any clear or emphatic form what I believe to be the fundamental explanation of the present position. My fundamental explanation is, of course, that the rate of interest is too high, - meaning by the 'rate of interest' the complex of interest rates for all kinds of borrowing, long and short, safe and risky. A good many of Brand's factors I should accept as part of the explanation why interest rates are high, e.g. effects of the War, post-war instability, reparations, return to gold, mal-distribution of gold, want of confidence in debtor countries etc., etc.

> Next comes the question of how far central banks can remedy this. In ordinary times the equilibrium rate of interest does not change quickly, so long as slump and boom conditions can be prevented from developing; and I see no insuperable difficulty in central banks controlling the position ... The drastic reduction of the whole complex of market-rates of interest presents central banks with a problem which I do not expect them to solve unless they are prepared to employ drastic and even direct methods of influencing long-term investments which, I agree with Brand, they had better leave alone in more normal times. ...
>
> But I should not be surprised if five years were to pass by before hard experience teaches us to get hold of the right end of the stick. (Keynes to Robert Brand during drafting of Macmillan Report, 7 April 1931, *CW* XX, pp. 272-3)

This was the first substantial evidence of the developments that would ultimately lead to the policy outlined above. Many commentators agree that the substance of the *General Theory* was in place by the end of 1932 (see Hirai, 2007, p. 95), under two years later. I argue that the fundamental theoretical step was the abandoning of the classical theory of interest based on equilibrium between saving and investment, which also – for Keynes – was a defining characteristic of the underlying long-run equilibrium of classical economics. Keynes deconstructed the equilibrium into what he referred to as 'psychological propensities' (though the specific terminologies came a little later):

- the schedule of liquidity preference;
- the marginal efficiency of capital; and
- the marginal propensity to consume.

He had the equilibrium of a macroeconomy defined by these propensities, set against the conditions of supply and the supply of money (which is not straightforwardly defined). The labour market became a determinate rather than determinant of the equilibrium. With these ideas in place, Keynes very swiftly recognised the associated practical implications. He set these out most fully in his essay, published in the *Listener* in July 1933, entitled 'National Self-Sufficiency'. (The essay followed his May 1933 *Means to Prosperity*, which was concerned primarily with immediate solutions rather than longer-term action, though which unfortunately has commanded the greater part of the profession's interest.) The following was as concise as possible statement of his new philosophy:

> I sympathise, therefore, with those who would minimise, rather than with those who would maximise, economic entanglement among nations. Ideas, knowledge, art, hospitality, travel – these are the things which should of their nature be international. But let goods be homespun whenever it is reasonably and conveniently possible; and, above all, let finance be primarily national. (*CW* XXI, p. 236)

His changed understanding of the theory of interest was at the centre of the work:

> … I have become convinced that the retention of the structure of private enterprise is incompatible with that degree of material well-being to which our technical advancement entitles us, unless the rate of interest falls to a much lower figure than is likely to come about by natural forces operating on the old lines. Indeed, the transformation of society, which I preferably envisage, may require a reduction in the rate of interest towards vanishing point within the next thirty years. But under a system by which the rate of interest finds a uniform level, after allowing for risk and

> the like, throughout the world under the operation of normal financial forces, this is most unlikely to occur. Thus for a complexity of reasons, which I cannot elaborate in this place, economic internationalism embracing the free movement of capital and of loanable funds as well as of traded goods may condemn my own country for a generation to come to a much lower degree of material prosperity than could be attained under a different system. (*ibid.*, p. 240)

The great changes in his understanding must have also been influenced by the very fundamental practical developments that were taking place in Britain. Sterling came off gold in September 1931, and the UK government adopted the monetary policies that Keynes had long advocated:

- in April 1932, the Exchange Equalisation Account (EEA) instigated currency management (which had central banks responsible for the management of fixed exchange rates by intervention in foreign exchange markets, rather than by manipulation of discount rates);
- between February and June 1932, discount rates were cut sharply from 6 to 2 per cent;
- in June 1932, direct action was taken on the long-term rate of interest, beginning with the conversion of the war debt from 5 to 3½ per cent; and
- the latter action was supported by the introduction of an embargo on overseas loans, or capital control.

Keynes provided commentary on these events as they happened, both in the media and in academic journals (e.g. *Evening Standard* article on the EEA, 20 April 1932, *CW* XXI, pp. 102-7; 'A note on the long-term rate of interest in relation to the conversion scheme', *Economic Journal*, September 1932, *CW* XXI, pp. 114- 125; 'The future of the foreign exchanges', *Lloyds Bank Monthly Review*, October 1935, *CW* XXI, pp. 360-369). Over the next three years he prepared his *General Theory of Interest, Employment and Money* (the meaning of the title is usually overlooked).

Tragically, his *General Theory* was not so obviously aimed at these policy conclusions. Quite reasonably he chose to aim the work at his fellow academics and conducted the dialogue on a detailed theoretical level. While he forewarned of the central role of the theory of interest before publication (e.g. in the 21 November 1934 *Listener*, 'Poverty in plenty: is the economic system self-adjusting?', *CW* XIII, p. 485-92), the work was not obviously centered in that way. Instead the theoretical argument was built up through a contrast with the classical theory and, in great part, according to the logic of the classical theory. Policy was by no means ignored but was addressed only as suggestive points after the substance of the theoretical argument was laid out; moreover, he often pre-supposed familiarity with the actions being referred to. That said, Chapters 23, 'Notes on Mercantilism, the Usury Laws, Stamped Money and Theories of Under-Consumption', and Chapter 24, 'Concluding Notes on the Social Philosophy towards which the General Theory might Lead', did include fairly bold statements of the theoretical and general practical implications of his work, if not a detailed assessment of specific policy action.

After publication, Keynes kept up a steady commentary on events, offered suggestions for practical initiatives and engaged in a detailed theoretical dialogue with his colleagues in private correspondence and in journals. At his annual speeches to the National Mutual Building Society he offered a commentary on monetary developments and pressed

vigorously for extensions to the cheap money policy (*CW* XXI, pp. 375-9, 401-4 & 440-6). In his 'How to Avoid a Slump' (*The Times*, 12 -14 June 1937, *CW* XXI, pp. 384-95), Keynes discussed alternatives to discount rate manipulation as the economy recovered. He warned "If we play with dear money on the ground that it is 'healthy' or 'natural', then, I have no doubt, the inevitable slump will ensue. We must avoid it, therefore, as we would hell-fire. …" (*CW* XXI, p. 389).

Highlights of his theoretical contributions might be:

- the famous 1937 QJE paper, 'The General Theory of Employment' (CW XIV, pp. 199 -23), regarded by some – rightly in my view – as his response to and rejection of the emergence of the 'Keynesian' simultaneous-equation model;
- his contributions to the 1937-1939 'Alternative Theories of the Rate of Interest' debate in the *Economic Journal*, where Keynes defended his liquidity preference theory against the loanable funds theory advocated by Robertson, Ohlin, Hicks and Haberler (e.g. *CW* XIV, pp. 183-234); and
- the debate with Tinbergen on the emergence of econometric modelling, which had found great favour amongst his rivals (*CW* XIV, pp. 306-20; Tinbergen, 1939, 1940).

With the war Keynes became a central player in the practical implementation of his own theory. He began the formalisation and instigation of the debt management and monetary policies that were outlined in section (2.). In his *How to Pay for the War*, he sought to limit the inflationary impact of greatly increasing government expenditure (and hence increased aggregate household income against reduced output of consumer goods) through deferring pay until after the end of the war.

As is well known, he also returned to the practical management of foreign exchange. Over the 1930s much of the world had adopted his system of exchange management. Roosevelt's contribution to the World Economic Conference is usually presented in a negative light. But the agenda for the conference was seemingly dictated by financial interests who wanted to re-instate the gold standard. Roosevelt rejected this approach, and on 3 July 1933 issued the following message:

> I would regard it as a catastrophe amounting to a world tragedy if the great Conference of nations, called to bring about a more real and permanent financial stability and a greater prosperity to the masses of all nations, should, in advance of any serious effort to consider these broader problems allow itself to be diverted by the proposal of a purely artificial and temporary experiment affecting the monetary exchange of a few nations only. … [O]ld fetishes of so-called international bankers are being replaced by efforts to plan national currencies with the objective of giving to those currencies a continuous purchasing power which does not greatly vary in terms of the commodities of modern civilization. (Reproduced in *The Economist*)

His action set the world economy decisively away from the gold standard towards Keynes's system – a system that permitted the reduction of interest rates across the world and set the backdrop for recovery from the depression. During the war Keynes attempted to go further. He devised his International Clearing Union, which applied the principles of banking to the financing of international trade and any associated imbalances.

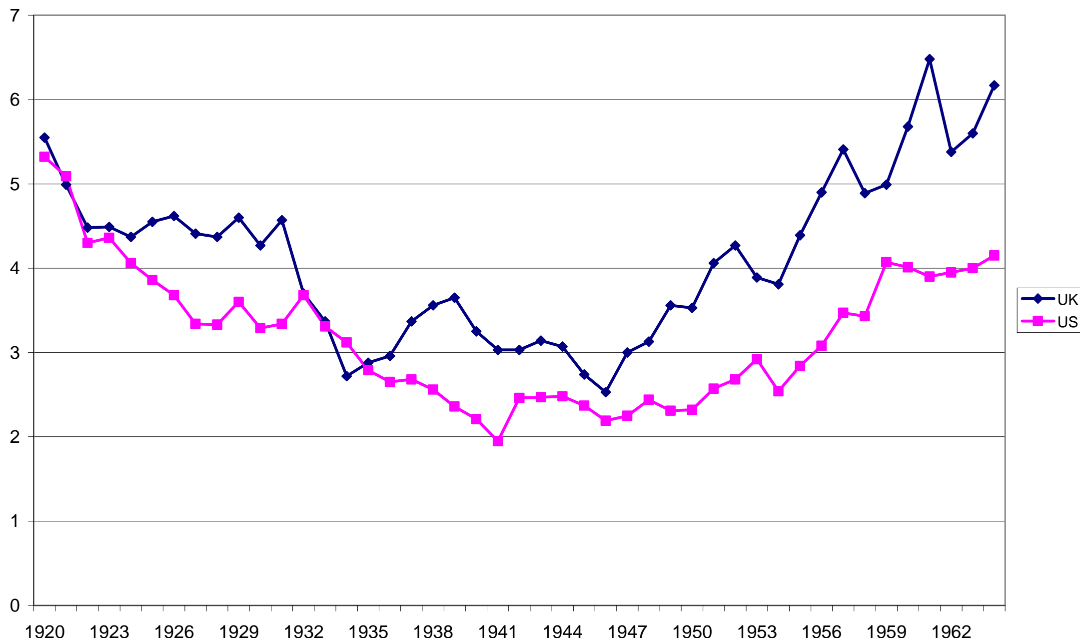
At the end of the war in the May/June 1945 National Debt Enquiry (NDE) at HM Treasury, he brought together his monetary proposals and set out a concise yet profoundly valuable statement of his theoretical and practical perspective, from where the above interest rate proposals were drawn. The official report by the Permanent Secretary to the Treasury, Sir Richard Hopkins, firmly endorsed Keynes's argument:

> General desirability of low rates. There is a wide measure of agreement, though not complete unanimity, in the present Committee in the view that on the whole, subject to the qualification dealt with in paragraphs 11 to 15 below, the desirable ideal for this country for a long time to come is not merely the continuance but even the reduction of the existing relatively low levels of interest rates both for long term and for short. (NDE, 1945, para. 6)

The existence of this report refutes the position of those who argue that Keynes wavered from cheap money towards the end of his life. But the Keynesians were a different matter. James Meade opposed Keynes's position at the NDE: Howson (2000, p. F132) notes that Meade "found himself defending interest-rate flexibility against Keynes" and "personally never really gave up the idea of using variations in the rate of interest as one of the macro-economic controls". As above, Hicks contested Keynes's interest theory; he also challenged Keynes's prescriptions for post-War policy (see *CW* XXII, p. 32-4) and was in the vanguard of the assault against the policies after Keynes's death.

Outcome

Figure 1: The long-term rate of interest on government bonds,



Source: Homer (2005 [1963]), Tables 48, 51 & 59.

From the 1930s, the new policies led to the successful reduction of the long-term rate of interest; the US went even further than the UK. In the UK, Bank rate was fixed at 2 per cent from 1932 to 1951. Financial arrangements were put on a domestic footing over much of the world. Moves to trade protectionism had tended to precede such initiatives, in part as a

response to the deflationary impact of the imploding gold standard. They were certainly not a considered change in the manner that Keynes came to envisage.

As is well known, government spending was aimed to aid recovery (though too timidly). In the war, Keynes's monetary and fiscal systems were deployed in full, and the UK and US economies operated at full employment. The process was incredibly successful, and constituted a great contribution to the allies' war effort.

After the war, for a very brief period, similar systems continued to be deployed, especially under the first majority Labour Government in British history. But the move against Keynes had already begun: the Bretton Woods Agreement was a pale reflection of his Clearing Union plan. Opposition to cheap money emerged rapidly from within the academic economics profession, the financial sector and the newspapers.

Keynes had already encountered the opposition to his monetary policies at the National Debt Enquiry. After his death, the *Economic Journal* included a series of contributions raising the spectre of inflation, advocating a rise in interest and attacking the theory of liquidity preference (e.g. by Hubert Henderson, Hicks and Robertson). Henderson's 'Cheap Money and the Budget' is a good example. He argued that the pressure of aggregate demand could not "be allowed to persist indefinitely without disaster" (Henderson, 1947, p. 265). He sought to undermine both the feasibility and the purpose of Dalton's cheap-money policies:

> A few months ago there was a disposition among financial experts to lay much if not most of the blame for this over-strong aggregate demand upon the cheap money policy of the Chancellor of the Exchequer. … Well, my personal opinion is that the cheap money policy has only been a very minor factor in the inflationary complex, so unimportant relatively to other factors as to be scarcely worth considering; and yet I am convinced that Mr. Dalton has carried this policy much too far. I do not believe that it will be possible to keep interest rates down over the next few years at anywhere near the low level of a few months ago; and I fear that it will prove that in trying to establish a long-term rate of 21/2%, or even less, Mr. Dalton may have missed the opportunity of turning a large part of what is now either floating or comparatively short-term debt into really long-dated securities on a 3% basis.
>
> I see no good reason to suppose that the strength of demand in the general economic system would be materially reduced by somewhat tighter conditions in the money market or by somewhat higher interest rates, whether short or long. I do not believe that a single industrialist or trader would be deterred thereby from a single act of real investment, whether this be the purchase of additional stocks of materials or the renewal or extension of his plant. (*ibid.*, pp. 265–6)

The Labour Government were committed to Keynes's programme, but the extent of the opposition made conduct of the policy very difficult. Eventually, as Dalton put it, "The forces against me, in the City and elsewhere, were very powerful and determined, … I felt I could not count on a good chance of victory. I was not well armed. So I retreated" (Dalton, 1954, p. 239). In his final contributions to policy, Keynes advised Dalton against the Bank/Treasury advice on debt management policy. His final statement on the matter indicated complete exasperation: "If we offer a further funding loan now, whom do we expect to

subscribe? Where do we expect the money to come from? And why do we want it?" (1 April 1946, PRO file T 273/428; these contributions have not been published).

In the US, the attitude and approach of the economics profession was no different. For example the penultimate page of 'The Changing Significance of the Interest Rate' by Henry C. Wallich (1946) included a *footnote* (!): "In the long run, I have no doubt but that economic forces rather than policy are determining for [sic] the level of interest rates". Wallich hence dismissed the central theoretical conclusion of the *General Theory*. In parallel, Samuelson's textbook rejected the importance of low interest rates: "A number of questionnaire studies of businessmen's behaviour suggest that the level of the interest rate is not an important factor in their investment decisions" (Samuelson, 1948, p. 353). The year of Keynes's death marked a turning point for long-term interest rates on government bonds in both the UK and US (Figure 1).

The Bank of England also constantly agitated for the re-activation of the discount rate. By 1950 the tap system had been discontinued and TDRs were being phased out of existence. In November 1951, following the election of the Conservative Government, the Bank got their way. The same step was taken all over the world, exemplified by the March 1951 Treasury/Federal Reserve Accord, which paved the way for across the board rises to US interest rates. Nonetheless, for the next twenty years or so, compromise still prevailed: policy did not follow Keynes, but it was a vast improvement on the classical policies that had prevailed in the inter-war years.

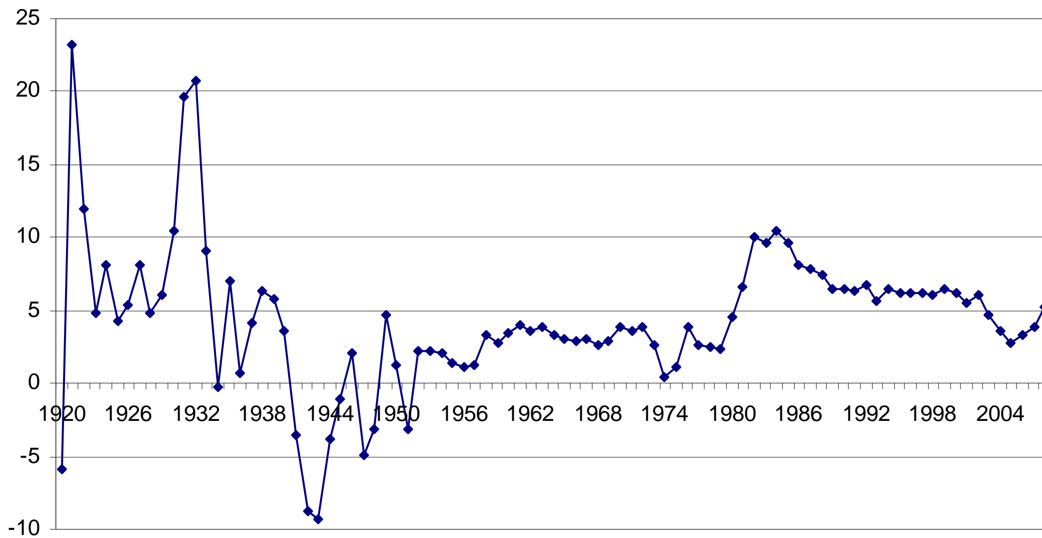
A policy of compromise with no solid intellectual foundation was never likely to have endured. The mainstream 'Keynesian' system supported only policies of government spending; it did not rule in or out any particular financial arrangement.

Hyman Minsky (2008 [1986]) has financial liberalisation beginning in 1966. The permitting of the Eurobond market was a vital statement of intent (or passive non-intent) on the part of policymakers. But domestic credit markets were also liberalised; in Britain, matters culminated in 1971 with 'Competition and Credit Control', which came into force just as the Bretton Woods Agreement was unwound and as supply shortages in the wake of the Great Society programme and the war against Vietnam were biting. It is astonishing that only outside the economics profession can anybody be found arguing that these developments and the associated and vast increase in the money supply were the main cause of the subsequent inflation (see Strange, 1986).

With the full liberalisation of capital markets beginning in 1979, the global economy was returned to a financial environment pretty much exactly as it was when Keynes began his work. And accordingly long-term interest rates returned to the level of the 1920s. Contrary to popular opinion, *the past thirty years have been remarkable not for low interest rates, but for high rates.* From the point of view of aggregate economic activity, the rate of interest of most importance is the long-term rate that governs the cost of corporate borrowing for fixed capital investment. Figure 2 shows a derived long-run series, based on rates on US corporate bonds (according to Moody's BAA ratings). The effects of inflation are removed using the US GDP deflator.[1] It seems reasonable to claim that these rates are a guide – if not a lower bound – to interest rates facing firms across the world.

[1] Source: websites of the Federal Reserve and the Bureau of Economic Analysis; deflators prior to 1929 were taken from Friedman (1982).

Figure 2: Long-term interest rates, adjusted for inflation



Source: see text

According to this interpretation – even in the absence of any theoretical discussion – parallels between the present crisis and the Great Depression should not be so surprising.

The literature on Keynes's policy: the present

The vast majority of the literature has been preoccupied only with Keynes's policies for the cure of economic depression. Most accepted the Keynesian distortion under which monetary policy, being ineffectual in depression, became the view that Keynes considered monetary policy unimportant *per se*. Others extended the role of fiscal policy so that demand could be managed under all circumstances, so-called 'pump priming' and / or 'fine tuning'. More recently others have made a complete about-face, so that Keynes is the justification for demand management with the discount rate and hence for the 'new consensus' (see Backhouse and Bateman, 2006, especially Bateman's own essay in the collection). A tendency is plainly evident to co-opt Keynes to whatever policy cause is fashionable, and the wider profession seems willing to tolerate any such manipulation and distortion. Such an approach is hardly likely to shed any real light on what Keynes's position might actually have been.

Krugman's (2007) introduction to the *General Theory* takes this approach to an extreme. He condemns Keynes's alleged view of the ineffectiveness of monetary policy and celebrates the modern (= new consensus) technique. He shows that interest rates were low when Keynes wrote, and so has Keynes correct in his judgment about the ineffectiveness of monetary policy. However poor Keynes "mistook an episode for a trend" (*ibid.*, p. xxxv). Since the 1950s, when the "era of ultra-low interest rates ended" (*ibid.*, p. xxxvi), interest rates were higher and therefore monetary policy not so ineffective. Krugman entirely overlooks the fact that interest rates were low as a consequence of the deliberate policy action advocated by Keynes.

The present edition of the *General Theory* therefore includes an essay by a Nobel Prize-winning economist that contains a substantial distortion of Keynes's views concerning monetary policy and that celebrates too the escape of modern economics from his flawed doctrine. To complete the job, Krugman sees modern policy as achieving adequate levels of aggregate demand in the US and Britain; EU failings are regarded as rooted in supply-side issues, which is hardly 'Keynesian'. The rest of the world is not mentioned, nor is there any sense that crisis might have been imminent. Furthermore, Krugman appears to dismiss any broader policy implications: the very important final chapters of the book are dismissed as "a little fun", and of "an impish quality". He asks: "Did he really believe these things, or was he simply enjoying tweaking the noses of his colleagues? Probably some of both" (*ibid.*, p. xxviii).

More recently Krugman has come out in support of a less liberal financial regime.[2] In doing so he brings himself into line with Joseph Stiglitz, who has maintained both mainstream and 'Keynesian' credentials. Stiglitz deserves great credit for his long-standing cautious approach to financial liberalisation, and he is one of the closest of all prominent economists to Keynes's broad position. He justly observed: "Keynes would be rolling in his grave were he to see what has happened to is child [the IMF]" (Stiglitz, 2002, p. 13). However, his argument is couched in terms of his preferred approach of 'market failure' (which is also attributed to Keynes, e.g. *ibid.*, pp. 196 & 249), rather than through the argument of the *General Theory.*

Of the post-Keynesians, Paul Davidson has long been an advocate for Keynes's policies on international financial architecture (as in issue 48 of this journal, Davidson, 2008). However, while the rate of interest might be involved, it is not central to his argument. And the connection between capital control and interest rates is not made explicit. Instead, Davidson emphasizes how the post-war systems permitted sufficient 'liquidity' and from a theoretical perspective the manner in which the clearing union plan was expansionary by putting pressure on surplus as well as deficit countries.

Arestis and Sawyer (e.g. 2006) set out a serious challenge to financial liberalisation. They very rightly observe substantial shortcomings in outcome relative to the prior claims of its advocates (for the record, they identify Shaw, 1973 and McKinnon, 1973). In particular they stress that the higher interest rates that followed financial liberalisation have not led to higher investment or higher saving. However, Keynes is not explicitly associated with arguments for or against financial liberalisation. The only material mention of his work is as support for low interest rate policies from a (seemingly domestic) re-distributional perspective: "This analysis clearly corroborates Keynes's (1973 [*CW* VII]) argument that increases in interest rates enhance the degree of income inequality significantly" (Arestis and Sawyer, 2006, p. 23). They put the argument into a global setting: "Higher interest rates at a global level are accompanied by an increase in third world debt, which implies redistributional effects across countries"; so policies "which aim at *a stable and permanently low level of interest rates*, should be supported" (*ibid.*, p. 24, their emphasis).

This follows a broader post-Keynesian approach that has emerged in recent years. Giuseppe Fontana (e.g. 2002) has rightly been alive to the need to apply the post-Keynesian theory of endogenous money to monetary policy. The approach followed the mainstream in focusing on manipulation of the discount rate in the wake of inflationary constraints. By 2007, in a symposium in the *Journal of Post Keynesian Economics* (JPKE), a good number of post-Keynesians (including Randall Wray, John Smithin, Mark Setterfield and Louis-Phillipe Rochon) favoured 'parking' the discount rate at a low level, and letting more traditional

[2] http://www.nytimes.com/2009/03/27/opinion/27krugman.html?_r=3&partner=rssnyt&emc=rss

'Keynesian' fiscal policy take up any slack. However, the revived interest in monetary policy has not led to a return to the *General Theory* itself and especially to considerations of *long-term rates and debt management policy*. In fact Keynes's approach has been explicitly rejected, as indicated by the following extract from the introductory piece to the *JPKE* symposium:

> Now we can reject Keynes's logic on the interest rate–investment link and his contentious use of a marginal efficiency of capital schedule, but we can still promote the necessity of low interest rates for other reasons, such as for income distribution. (Rochon, 2007, p. 7)

In this way, Rochon supports cheap money on re-distributional grounds, as do Arestis and Sawyer. There is no sense of Keynes's warning that dear money should be avoided like 'hell-fire' (p. 6 above). These types of contributions mean that many post-Keynesians did not anticipate the dangers of the new consensus policies that are now plainly apparent (see Tily, 2009 for a fuller discussion). It should be added that the wider vision of 'National Self-Sufficiency' is not obviously evident, though post-Keynesians would generally favour less - rather than more - market-based approaches.

The literature on Keynes's policy: the past

Of modern post-Keynesians, John Smithin has perhaps been most alive to Keynes's own monetary policy initiatives. In his *Macroeconomic Policy and the Future of Capitalism*, he drew attention to Keynes's pronouncements on cheap money and hence the paucity of the mainstream interpretation:

> This view [that Keynes's policy was not just a 'counter-cyclical fine-tuning strategy'] is also consistent with the idea that Keynesian policy should be particularly identified with 'cheap money' or low interest rates. More specifically, though Keynes and many of the early Keynesian writers did not make much distinction between real and nominal interest rates, Smithin and Wolf (1993: 373) have argued that in contemporary conditions 'Keynesian' policies should generally be associated with attempts to bring about low real rates of interest on financial instruments. Although this point may not be stressed in the standard textbooks it can none the less be argued that this is the interpretation which is most consistent with Keynes's own writing. It is supported, for example, by Kaldor (1986: xxi) and at the other end of the professional spectrum by Meltzer (1988), in a book length study. (Smithin, 1996, p. 57)

The reference to Kaldor harks back to aspects of a UK literature that is now almost entirely neglected, the specific instance being Kaldor's famous assault on monetarism, and the 'introduction' to the first edition of *The Scourge of Monetarism*:[3]

> The appearance of Keynes's General Theory in 1936 gave the [UK] cheap money policy [in the first half of the 1930s] its theoretical underpinning. The policy of low

[3] Meltzer offered: "He [Keynes] favoured policies to reduce interest rates to the level at which investment would absorb saving at full employment. That rate, he believed, would bring interest rates to zero in a generation. This is the correct interpretation, I believe, of Keynes's statements favouring lower interest rates" (Meltzer, 1988, p. 280).

> interest rates was maintained throughout the war – the Government borrowed enormous sums, at very low interest rates, not only on short-term but also in medium and long-term paper, without the slightest difficulty. (Kaldor, 1986, p. xxi)

The policy was held as the reverse of monetarism and as greatly successful. Kaldor – rightly, surely – regarded the six years of Clement Attlee's Government as "undoubtedly the most successful of this century in terms of economic and social achievement" (*ibid.*). He also observed that this achievement was not universally celebrated: "during all these years, the banks and the financial institutions of the City were increasingly unhappy" (*ibid.*). However, Kaldor's theoretical work did not greatly aid understanding of Keynes, and he was not – in general – an advocate of cheap money.

Richard Kahn was Keynes's greatest champion. During the 1950s, he kept up a steady and voluminous commentary on monetary policy developments. For example, he rejected the re-activation of the discount rate in 1951 (Kahn, 1952), arguing that the action would inevitably damage the markets' expectations of low long-term rates. In 1954 he re-stated Keynes's theory of liquidity preference in the *Manchester Review of Social Science*, and published two articles, 'The case for cheap money', in the *Financial Times* (3 and 4 June 1954):

> Do not present problems call for lower long-term rates of interest and for an expansionist rather than a restrictionist application of the machinery of bank credit? … The trouble, it appears to me, is that the seat of power has been moved back to the Bank of England. … It would be a terrible thing if we were to drift back to the situation of some of the interwar period with the Bank of England subjecting the economy to a monetary stranglehold in order to avoid an excessive capital outflow.

He put similar arguments to the Radcliffe Committee in October 1958 (Cmnd. 837, 1960, para. 10993). But his efforts generated no wider interest or momentum. At the end of the 1970s and early 1980s he championed again Keynes's message to a profession that remained (and remains) – in great majority – not interested (e.g. Kahn 1975, 1977 & 1984).

Joan Robinson was the most outspoken Cambridge critic of mainstream developments. Her 'Rate of Interest' (1951) preceded Kahn and more baldly asserted Keynes's position:

> The most important influences upon interest rates – which account for, say, the difference between 30% in a Chinese village and 3% in London – are social, legal, and institutional. Side by side with the industrial revolution went great technical progress in the provision of credit and the reduction of lender's risk and great changes in social habits favourable to lending; and in the broad sweep of history these considerations are more significant than any others. (Robinson, 1951, p. 92)

She dismissed the term-structure theory attributed to Dennis Robertson, Kaldor, Michel Kalecki and J. R. Hicks: "The view that the long rate can be determined solely from expectations about the short rate is untenable" (*ibid.*, p. 102). In the 1950s she attacked the 'bastard-Keynesian model' and neo-classical growth theory. But Robinson never pursued the interest rate critique with vigour and was seemingly content to align herself with Kalecki's basically 'Keynesian' position in terms of policy. Her 1972 Ely Lecture to the American Economic Association contained the following somewhat disheartening statement: "The

supply of finance has an influence on these plans – cheap money makes investment easier. In my opinion, Keynes rather exaggerated the influence of the rate of interest …" (Robinson, 1972, p. 4).

Roy Harrod appears to have been the only Oxford scholar reasonably faithful to Keynes's policy line, if not his theoretical approach. His 1951 biography of Keynes has the monetary dimension prominent and straightforward:

> Most important of his contributions during this year [1930] was his article in the September issue of the *Svenska Handelsbanken Index* on the future of the rate of interest. He had become convinced that the time was ripe for a large and permanent reduction throughout the world. This was to be the basis of *all* his future thinking on economic policy; … (Harrod, 1951, p. 399, my emphasis)

Equally, Harrod gave front place to cheap money in his own fairly frequent policy interventions. In 1963, in a retrospective article and in his book, *The British Economy*, he deplored the widespread disregard of the theory of liquidity preference and advocated a return to a 3 per cent long-term rate of interest (Harrod, 1963a and 1963b). In a January 1964 essay published in *Encounter* magazine, he forcefully re-asserted the policy dimension (cited by Leijonhufvud, 1968, pp. 14–15):

> Keynes always attached the utmost importance to low interest rates; he never ceased to preach them. … They [members of the Establishment] are being completely anti-Keynesian in regard to the matter that he held to be of the *greatest importance of all*. [Leijonhufvud's insertion and emphasis]

(Sidney Weintraub, Leon Keyserling and Hyman Minsky offered to various extents a similar commentary on US policy, but I am setting this aside for reasons of space.)

Leijonhufvud's *On Keynesian Economics and the Economics of Keynes* (1968) gave prominence to the notion that 'Keynesian' and Keynes's economics were different. The book captured and held the attention of the profession in a manner denied to the longer-standing Cambridge opposition. Yet, while he cited Harrod, he did not develop his position. Instead he motivated two changes in perspective: one theoretical and one historical.

From the point of view of theory, Davidson's *Money and the Real World* (1972) has, for many, constituted a manifesto for post-Keynesian economics. Again the work was not set in the context of the opposition to the 'Keynesian' construct detailed above, but took Leijonhuvfud as its point of departure from the mainstream. Davidson (and Kaldor of course) offered an alternative theoretical approach, as the major flaws in the mainstream 'Keynesian' construct were exposed by the onslaught of Freidman's monetarism. However, in spite of Kaldor's later observations (p. 14 above), Keynes's views of interest rates were not central to the revised 'post-' 'Keynesian' approach. Indeed, Hicks's much publicized endorsement of Davidson's criticisms of IS–LM warned:

> It is well known that in later developments of Keynesian theory, the long-term rate of interest (which does figure, excessively, in Keynes' own presentation and is presumably represented by the *r* of the diagram) has been taken down a peg from the position it appeared to occupy in Keynes. (Hicks, 1980–81, p. 153)

The new lines of thought also led to a revised historical interpretation of Keynes's policy interest. Howson and Moggridge (1974), explicitly motivated by Leijonhufvud's and Davidson's books, introduced the world to yet another Keynes. This Keynes regarded monetary policy as a powerful instrument to be used when the situation required. However, this Keynes does not obviously emerge from Moggridge's (1992) biography. While Howson has gone on to a number of detailed studies of monetary policy over the 1920s to the 1950s, Keynes is often portrayed as somewhat distanced from events (see especially the entry for 'cheap money' in the *New Palgrave*, Howson, 1987). Moreover Howson is sceptical about the desirability of cheap money, and is hardly a champion for Keynes's position.

Robert Skidelsky's biography to some extent tells the story of a 'Keynesian' Keynes, with emphasis on fiscal policy and the discovery of the multiplier. Yet there is something more beneath the surface. He cites notes of Keynes's 1933 lectures taken by Martin Fallgatter:

> We might play with the idea that the inability of the interest rate to fall has brought down empires. …
>
> Thus, it is of overwhelming importance that the optimum interest rate be determined by institutions and banking practice. And the bad effect of saving must be recognised. All past teaching has (if my view here given is correct) been either irrelevant, or else positively injurious. We have not only failed to understand the economic order under which we live, but we have misunderstood it to the extent of adopting practices which operate most harshly to our detriment, so that we are tempted to cure ills arising out of our misunderstanding by resort to further destruction in the form of revolution. (Skidelsky, 1992, p. 502)

and adds: "… For today, in truth, there is little left of Keynes's vision, only some crumbling bones of scholasticism, disinterred for first-year macroeconomics students" (*ibid.*). In Harcourt's and Riach's *A 'Second Edition' of The General Theory*, writing as if he were Keynes, Skidelsky offers this – spot on – evaluation:

> Nothing I wrote has been subject to more misinterpretation than the sentence: 'I conceive … that a somewhat comprehensive socialisation of investment will prove the only means of securing an approximation to full employment.' This was widely understood as a call for the State to take over the accumulation function from the private sector by methods which included the nationalization of industry. It was supported by the alleged interest-inelasticity of investment – a doctrine I was also supposed to uphold, despite the fact that *all* my theoretical writings, including *The General Theory*, were directed to the problem of securing a *reduction in the rate of interest*. (Skidelsky, 1997, pp. 432–3, *my emphasis*)

Yet the policy angle has not been a subject of controversy among post-Keynesians. The liquidity preference / loanable funds debate may be regarded as of theoretical significance, but not, commonly, of policy significance. John King's (2002) celebrated history offers an account of a wide range of theoretical approaches, yet differences in policy perspective scarcely feature. King characterises post-Keynesians as either concerned with *interpreting* or *developing* Keynes's perspective. He does not observe that from a policy perspective many post-Keynesians are in fact *disputing* Keynes's conclusions.

The subsequent debate motivated by the book has centered on trivialities about who should be classified as a post-Keynesian. This continues even into 2009, with Davidson's

ongoing and unpleasant attack on Minsky (e.g. Davidson, 2009). But no light has been shed on what Keynes really said, and whether it matters. It matters in a very big way, because ultimately it concerns policy.

Conclusion

As the crisis is confronted, most policymakers are proving willing to adopt quite bold monetary and fiscal measures. However, much fuss is made about the eventual unwinding of these actions. In evaluating cause, there is no sense at all of any great retreat from the orthodoxy of the past 30 years. The world appears to be offered a more regulated but still liberal financial environment, that relies on free trade and must at some point reign in public expenditure.

As with the Keynesians, interest in Keynes is fixated only on his views of fiscal policy. There is deep ignorance about what Keynes really stood for. Contributors to the *Real-World Economics Review* have rightly dismissed the 'Keynesian' depiction of Keynes's theory. I want to point out that those who developed and promoted this interpretation – not least Hicks and Samuelson – opposed the interest rate policies upon which – for Keynes – "the whole management of the domestic economy depend[ed]"(p. 1 above). Their work has led to grave policy misunderstandings, even in post-Keynesian economics. I ask the readers of this journal to look again and to look hard at Keynes's work.

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