

Roger E. Backhouse and Bradley W. Bateman (eds). *The Cambridge Companion to Keynes*. Basingstoke: Palgrave Macmillan, 2006. 327 pp. pbk £15.99 ISBN 978-0-521-60060-6.

Michael S. Lawlor. *The Economics of Keynes in Historical Context: An Intellectual History of the General Theory*. Basingstoke: Palgrave Macmillan, 2006. 376 pp. £70. ISBN 978-0-33397-717-0.

Geoff Tily. *Keynes's General Theory, The Rate of Interest and 'Keynesian' Economics: Keynes Betrayed*. Basingstoke: Palgrave Macmillan, 2007. 346 pp. hbk £65. ISBN 978-1-4039-9628-2.

That the Keynes industry is alive and well is borne out by the publication in the last year of these three serious reassessments of his work (not to mention my own, of course). Michael Lawlor and Geoff Tily have each produced book-length expositions of major theses about Keynes's economics on which they have evidently worked for some years; Roger Backhouse and Bradley Bateman have edited a collection of papers from a variety of authorities as part of a series of guides to famous philosophers, ranging considerably beyond the field of economics alone.

I do not here attempt a comparison between the three books, beyond noting an important divide between Lawlor and Tily on the one hand, and Backhouse and Bateman on the other, along the lines of the hoary liquidity-preference vs. loanable funds debate. Another aspect of this impasse is their different attitudes towards the concept of long-period equilibrium. Lawlor and Tily both consider themselves faithful to Keynes in rejecting the full-employment long-period equilibrium implicit in loanable funds theory, although Tily goes beyond Keynes in putting forward his own concept of multiple equilibrium as part of a theory of the trade cycle. This debate, however wearisome to both sides, will not go away until it is properly resolved.

The Cambridge Companion to Keynes

My main bone of contention with this concise biographical study by Backhouse and Bateman is its title and appearance in a series which claims to offer a "reference work for students and non-specialists". This contrasts with the editors' own statement of purpose to offer neither "a comprehensive survey [of the major biographies] nor an alternative to them. Rather it takes up a number of themes from the literature, taking stock in certain areas, and it introduces some new ones" (p. 17). Although it does contain some excellent chapters (Peden, Hoover, Marcuzzo, Brittan, Gillies and Goodwin) which do meet the series criterion, others strike me as research essays making original but rather narrow points (eg Baldwin, Klaes, Leijonhufvud and Moggridge).

The book spans Keynes's wide range of interests, from the philosophy of ethics and probability to the arts, politics and of course, economics. I particularly enjoyed Goodwin's chapter on the Bloomsbury connection and the influence on Keynes of Roger Fry's distinction between the actual, emulative and imaginative life. Marcuzzo and Moggridge both provide fascinating vignettes of the details of Keynes's life at Cambridge and his relationship with, amongst others, his publishers. However, any attempt to provide a reference work to the economics of Keynes (which is necessarily the main focus of the book, at least for an economist) faces the serious problem that there is no overall consensus about its interpretation.

There is of course the mainstream ‘rigidity’ view; there is a more heterogeneous Post Keynesian view (of which Lawlor and Tily are examples); and there is the view presented here, associated with the names of Leijonhufvud and Laidler, which has been called Post Walrasian. The main hallmark of this approach is a rejection of Keynes’s liquidity-preference theory in favour of a loanable funds theory, in the tradition of Wicksell. Together with Bateman’s ‘discontinuity thesis’ (that Keynes radically changed his views on probability between 1921 and 1936 in the light of Ramsey’s critique), this perspective leads to a rather negative assessment of *The General Theory*. Both these propositions are hotly contested by the Post Keynesians, who receive short shrift, with a single reference to Davidson and a referral of those interested in ‘fundamentalist’ views (not usually a compliment) to King’s history (2002). Such views are characterised as denying the value of basing theory on rational choice (p. 27), rather than (more accurately) as requiring any theory of rational behaviour, i.e. behaviour based on reason, to take serious account of fundamental uncertainty. The most notable omissions in this context are of any reference to the work of Chick, particularly on effective demand, liquidity-preference and open systems thinking, or of Dequech (1999) on the link between liquidity-preference and confidence or ‘animal spirits’. My objection here is not to the exposition of a particular point of view, but to its presentation (to the student and the non-specialist, remember) as though it were the consensus, under the mantle of the Cambridge University Press, no less. A student reader will almost certainly form the impression that Keynes was not a terribly good economist, nor philosopher, but a gentleman amateur of a by-gone age.

Taking these preconceptions as read, there are interesting points made in individual chapters. Backhouse and Laidler both provide concise accounts of the nature of the “Keynesian Revolution” and the development of macroeconomics to the point where, Laidler admits with irony, Keynes’s critique of ‘Classical’ economics is now true (even if, according to Laidler, it was not true in 1936).

Leijonhufvud is clear on the distinctions between Marshall and Walras, on the observability of equilibrium and the irrelevance of imperfect competition to the *G.T.*. However, he insists on seeing the establishment of equilibrium between aggregate supply and demand in *G.T.* chapter 3 as a dynamic process or ‘law of motion’ (p. 64), and heads off into the Swedish territory that Keynes explicitly rejected. He regards Keynes as “operating beyond the limits of what Marshall’s [static] method could accomplish” (p. 71), which implies that *The General Theory* is not rigorous theory in the modern sense but a verbal fudge. Nevertheless, he agrees that the liquidity-preference/loanable funds debate remains the crucial battle-ground. I can wholly support his final paragraph: “Keynes was a Marshallian in the deep sense, that when he broke with Marshall and went far beyond Marshall, their very differences presumed a shared system of thought. Keynes’s claim to greatness as a theorist is based on his departures from Marshall.”

Hoover’s chapter on Keynes’s understanding of theory in terms of causality rather than models is excellent, but omits any reference to the work on open systems by Chick and Dow (e.g. 2001), among others, on precisely this topic. This and the following two chapters by Peden and Marcuzzo are very accessible, as also (unsurprisingly) is Brittan’s chapter on Keynes’s political philosophy. Peden disposes efficiently of the myth that Keynes was an advocate of inflationary deficit finance by means of a factual account of Keynes’s engagement with policy-makers, although he

does not emphasise Keynes's commitment to cheap money and radical monetary reform.

Gillies provides an accessible introduction to Keynes's theory of probability, although he then proceeds to put forward his own resolution of the Keynes/Ramsey debate. Rafaelli's chapter is also good on this topic but is much more difficult and assumes quite a lot of philosophical training. Both authors, along with Bateman, take the 'discontinuity' line, Rafaelli arguing that "weight is the only concept [in *The General Theory*] rescued from the [*Treatise on Probability*]" (pp. 167–8).

The fact that the book is a collection of essays by different authors writing about the same individual leads to a fair amount of overlap and repetition, particularly in the area of probability. As already noted, there is a major inconsistency in the style between the two groups of chapters, with only some addressing the publishers' (as opposed to the editors') objective. The front cover sports a pleasant photograph of Keynes at his most affable. Production is to a high standard, with no more than a very few typographical errors. Perhaps, given the divided state of Keynes scholarship and the frantic lives of modern economists, this is as good an effort as one can reasonably expect, although it should carry a health warning.

The Economics of Keynes in Historical Context: An Intellectual History of the General Theory

It is unnerving to find a book published simultaneously and independently with a title almost identical to one's own. Yet it is encouraging that two independent lines of research, using quite different methodologies, reach conclusions that are mutually supportive: a good example of 'triangulation'.

Michael Lawlor explores the historical development and context of Keynes's views in *The General Theory* on three main themes: the labour 'market', the role of speculation in asset markets, and the nature of a monetary economy. His underlying thesis is that an awareness of the essential continuity between Marshall and Keynes within a wider Cambridge School permits a deeper understanding of Keynes's points of departure from Marshall. The book falls into three main parts corresponding to the chosen themes, together with introductory and concluding sections. These last are far more than top and tail: in the introduction, Lawlor sets out his methodological stance, while in the conclusion, he grounds a critique of 'Swedish' loanable funds doctrine on the understanding developed in the book.

In his introductory section, Lawlor identifies the need to approach *The General Theory* from a Marshallian rather than Walrasian perspective on time and equilibrium. *G.T.* Chapter 5 on 'expectation as determining output and employment' overturns Marshall's use of the short and long periods and elevates the state of long-term expectation to the same independent status as technology and preferences. Keynes "replaces, rather than just mucks up with frictions, the Marshallian theory of the long period" (p. 19). Today's equilibrium shifts with the state of long-term expectation, and the long-period normal values of Marshall (or their Walrasian equivalents) are not the fundamental attractors of the system. Short-period equilibrium is best understood, not as long-period disequilibrium, but as the only scientifically relevant form of equilibrium. Keynes's long-period equilibrium (*G.T.* 48) depends on a given state of expectation that is unlikely to persist beyond the short term, if at all. These points are absolutely fundamental and need to be proclaimed from the roof-tops.

What is undeveloped here is the supply side of *The General Theory* and the principle of effective demand, as Lawlor acknowledges. He underestimates *G.T.* Chapter 3 as a sketch, “a sort of prop, a demonstration of where the argument is headed” (p. 24), perhaps because he believes that Keynes offers, not a model, but “suggestions for various models” (p. 5). Lawlor does not clarify analytically Keynes’s explanation why a short-period competitive equilibrium with flexible wages and prices need not be a full-employment equilibrium. However, his historical treatment of this question in Part I on the labour ‘market’ does provide some valuable insights.

Part I (‘Keynes, Cambridge and the economics of employment’) identifies two approaches to (un)employment emerging at Cambridge after Marshall, represented by Dobb (1928) and Pigou (1933). Dobb’s approach maintained Marshall’s concern always to qualify any attempt to explain complex phenomena by the use of an abstract model, with numerous reservations and practical exceptions. Pigou, by contrast, pursued the logic of Marshall’s theory of Normal Value to its limit and, according to Keynes, *ad absurdum*. Lawlor identifies the indeterminacy of labour supply and demand as a key element of Marshall’s thought on employment and attributes the concept that unemployment is a matter of non-clearing to Pigou (noting that neither Marshall nor Dobb had a theory of unemployment *per se*). By a strange irony of history, the modern New Keynesians are really New Pigovians.

Thus Lawlor grounds Keynes’s *G.T.* Chapter 2–3 arguments (that employment determines the real wage, rather than vice versa, and that in aggregate the money-wage does not determine the real wage) in the Marshall-Dobb tradition. This is not entirely convincing. The indeterminacy addressed by Marshall and Dobb may be understood as the existence of multiple long-period equilibria in the labour market, rather than as the lack of short-period equilibrium addressed, in different ways, by Pigou and Keynes. It does seem likely that the greater Marshallian realism of Keynes’s approach to economics (pp. 75, 88) provided the impulse to jump the impasse between Pigou’s theory and the inter-war experience of unemployment. Yet, as Lawlor recognises (and Ambrosi 2003), *The General Theory* addresses Pigou’s ‘mechanical’ version of the labour market (pp. 26–7).

In Part II (‘A philosopher and a speculator’), Lawlor sets out to identify the roots of the ‘meta-theory’ of portfolio equilibrium (pp. 105–7) employed in *G.T.* Ch. 17 (which Keynes shared with Marshall and with the other members of the 1920s Cambridge neo-classical school) and of the theory of interest (over which they ultimately parted company). Lawlor skilfully traces the extent of the continuity between Marshall and Keynes on speculation, and the influence of Emery (1896) on both. He draws upon two essays by Marshall of 1871 and 1899, only recently published, and on the Keynes archive at King’s College. He shows how Keynes began by distinguishing speculation from gambling in terms of superior knowledge of the ‘fundamentals’ and seeing speculation as stabilising, as did Friedman later. He links the emergence of the idea of speculation as risk-bearing to the development of large-scale industry and global commodities markets and argues cogently that Marshall well understood the serious implications for the tranquil model of the *Principles* but could not make the intellectual leap to bring his theory closer to the new facts. He shows how Keynes’s experience as a speculator and his understanding of probability gradually changed his views and, notably, how these views largely coincide in *A Treatise on Money* and *The General Theory*. What changes between these books is Keynes’s abandonment of Marshall’s concept of long-period equilibrium and Normal value.

In Part III, Lawlor turns to the development of Keynes's theory of interest from his strictly Marshallian pre-1914 lectures through to Ch. 17 of *The General Theory*. As in Part II, Lawlor identifies the influence of the changing world on Keynes's views, beginning with his full recognition in the *Tract* of rentier capitalism and speculative forward markets and of the importance of a stable price-level for confidence and employment. He describes the *Treatise* as a first attempt, loosely based on Wicksell and still wedded to the idea of long-period equilibrium, to provide an explicit account of the transmission mechanism implicit in the quantity theory of money and a theory of the business cycle. He then places, most illuminatingly, Keynes's use in *The General Theory* of own-rates of interest (together with the asides on forced savings, the period of production, a composite commodity and a non-monetary economy) in the context of Sraffa's (1932) highly technical exchange with Hayek, citing Adarkar (1935) as further evidence of this linkage. The key insight is that, outside the long-period stationary state, there is not a single real natural rate but a different own-rate for each commodity, as recognised by modern general equilibrium analysis. Yet in a monetary economy, the relation between spot and forward prices must be such as to provide a uniform rate of return, measured in any given standard.

The comprehensive exposition of *G.T.* Ch. 17 to which Part III builds up is not as lucid as the historical work that precedes it. There is some confusion over futures market price relationships and between working and liquid capital—e.g. speculators do not hold working capital on Keynes's definitions (p. 253). Lawlor states that the "qualities of wage stickiness and low carrying costs are Keynes's explanation for money's liquidity" (p. 270), but Keynes states that "It is because of money's other characteristics—those, especially, which make it *liquid*—that wages, when fixed in terms of it, tend to be sticky" (*G.T.* 233). Lawlor does not offer an entirely consistent explanation of what Keynes meant by liquidity, although he has identified most, if not all, the clues.

The concluding chapter addresses what remains perhaps the most crucial unresolved issue in economic theory, the loanable funds and associated natural rate doctrines (or fallacies, depending on your perspective). Lawlor sees the root of the trouble as hinging on the difference between stock and flow equilibrium. Keynes's Marshallian theory of portfolio equilibrium at a point in time, as unfolded in the book, leaves no room for flows to influence the interest rate directly: "the time integral of any flow goes to zero as the period goes to zero" (p. 294). Flows can only affect the interest rate through changes in expectation *today*. Underlying the dispute are conflicting views of the appropriate treatment of time and equilibrium: not only the natural interest rate, but the whole Swedish *ex ante*, *ex post* method rejected by Keynes (although not by most of his followers), are at the bottom of the matter.

The fascination of *The General Theory* is that its meaning remains elusive and controversial after 70 years: some see this as evidence that it is a bad book, badly written, others that it is a work of genius which the profession is still only beginning fully to understand (Samuelson alone appears to have regarded it as both). Lawlor's excellent book records a solid piece of historical research that contributes significantly to our understanding of *The General Theory* through a better understanding of the context in which it was written, including some now largely forgotten sources and debates. Of the greatest importance, he identifies clearly why Keynes rejected the concept of long-term, long-period equilibrium and the loanable funds theory of interest. He provides a thoroughly compelling account of the coherence of Keynes's thought as it developed out of Marshall's over time in the light

of changing circumstances. Perhaps Michael Lawlor might next help us understand the historical reasons for the failure of Keynes's immediate followers at Cambridge to maintain and further develop the Marshallian tradition?

Keynes's General Theory, The Rate of Interest and 'Keynesian' Economics: Keynes Betrayed

Geoff Tily argues that Keynes's magnum opus has *never* been taken seriously on its own terms by most economists or policy-makers, at great loss to society. So-called 'Keynesian' economic theory stemmed from the absorption of some of Keynes's ideas into a neo-classical school of thought that was already well developed, notably by Robertson, Hawtrey and the earlier Keynes himself, before Hicks, Hansen, Samuelson, et al. At the root of the synthesis was an instinctive rejection of the implicit methodological conclusion of *The General Theory* that economic theory had to take a historical and sociological turn, if it was to be applicable to long-term questions such as business cycles and growth. Similarly, the 'Keynesian' policy of deficit financing was essentially deeply conservative in political terms, reflecting a wide consensus, and rejected Keynes's primary calls for the radical use of monetary policy ('cheap money') and redistributive taxation.

The book is divided into three parts, addressing in turn History, Theory and Macroeconomics After Keynes (a clear tribute to Tily's mentor, Victoria Chick). Part I sets out a brief history of monetary economics, of Keynes's own contribution to both theory and policy, and of the development of the rival 'Keynesian' theory. Of particular interest are the emphasis on the historical association between prosperity, the development of banking, and low interest rates, together with the reproduction of the Treasury's 1945 National Debt Enquiry (NDE) internal report, which Tily regards as "the handbook of practical policy measures that *The General Theory* deliberately was not" (p. 77).

Part II is an exposition of the *G.T.* with an emphasis on policy rather than Keynes's own emphasis on the points of departure from 'Classical' theory (in Keynes's sense). Thus it re-orders Keynes's argument and begins in chapter 6 with the saving-investment identity and its importance as a refutation of the Classical theory of interest; sets out in chapter 7 the liquidity-preference theory of interest as a necessary alternative to fill the resulting vacuum; and turns only in chapter 8 to the money-real nexus, the monetary theory of employment and the business cycle.

Tily regards it as a major tactical error on Keynes's part to have switched his argument: from the indeterminacy of the 'Grand Tautology' (so named by D H Robertson in his implacable rejection of its causal significance), by which (aggregate) saving and investment are but different names for the same thing; to the under-determinacy attributed to the Classical theory in *G.T.* Chapter 14, in which the equilibrium of saving and investment is not independent of income. In his view, Keynes failed to deal adequately with the counter-claim that the identity was a matter of semantics and quite compatible with loanable funds theory, rather than a key plank of *The General Theory*.

Tily's exposition of the liquidity-preference theory of interest is pure Keynes, one might say 'ultra-Keynesian': Kaldor, Kalecki, Goodhart and Davidson are all judged to have fallen short. Tily sees Robertson's 'boot-strap' jibe as no more than the truth: the long rate of interest is based either on the 'norm' of past experience or on 'deliberate policy', the management of expectations. He sees no obstacle of principle

to the setting by government of the entire spectrum of interest rates, especially the long rates, provided the maturity structure of debt accommodates the liquidity-preference of the private sector, and domestic interest rates are decoupled from international rates by capital controls.

Chapter 8 turns to the monetary theory of employment, with an emphasis on the cycle. Tily's main innovation, based on Keynes's analysis of the trade cycle in *G.T.* Ch. 22, is the concept of a long-period equilibrium corresponding to a 'correct' state of expectation. There are multiple positions of long-period equilibrium corresponding to different long-term rates of interest. Following Keynes, the boom is caused by excessive optimism, and following Minsky (broadly), the crisis is caused by the combination of disappointed expectations and increasing indebtedness in the financial structure of the economy. Echoing Keynes's paradoxical prescription of cheap money for the boom, Tily spells this out as shifting the long-period equilibrium to a higher level. As he recognises (p. 245), there is no theoretical reason why this should reduce instability, although employment might on average be higher.

I find some difficulty in this use of equilibrium. Keynes's own concept of long-period equilibrium was relative to a given, not necessarily a correct, state of expectation (*G.T.* 48). Furthermore, there are multiple positions of equilibrium for the same long-term rate of interest at different times, since the 'correct' assessment of prospective yields changes as capital accumulates. A state of tranquillity (in which expectations were 'correct') would involve falling investment (on the assumption of diminishing returns and in the absence of technical change, etc) and tend towards a stationary state in which the rate of net investment is zero. Tily's concept of equilibrium is something of a will o' the wisp, suffering no less than the Classical equilibrium from the problem that we can never be sure where it is. Tily is correct to place emphasis on the role of over-optimism in Keynes's analysis of the cycle, but he has tried to formalise precisely where Keynes refused to. In support of this contention I would cite Chick and Caserta (1997), to the effect that 'only provisional equilibria are suitable for use in economic models'. Here Tily is not ultra-Keynesian enough!

Furthermore, in placing so much emphasis on debt as the key to the cycle, he elides (as does Minsky) the distinction between debt and equity, and the fact that large corporations can, and do, refinance their balance sheets with rights issues when debt levels prove unsustainable in the light of disappointed expectations. It is certainly not correct to characterise what he calls 'distress borrowing' as bad debt (p. 242). I should have thought, as Keynes did, that a sudden loss of confidence is enough to create the crisis without invoking a somewhat deterministic and mechanical linkage to the level of debt. This is not to deny that fragile financial structures exacerbate any crisis.

Part III brings the story up to date from the *G.T.* to the present day. Chapter 9 considers Keynes's own response to the emerging neo-classical synthesis, quite muted apart from the well-known 1937 *QJE* summary article and the loanable funds dispute. Chapter 10 charts the emergence of modern macroeconomics as something quite different from the economics of Keynes, and of the Post Keynesian response. Chapter 11 draws an important distinction between the short and long interest rates, arguing that employment and growth are determined by the latter, which was Keynes's concern in the *G.T.*, in contrast to his concern with the short rate in his neo-classical *Treatise*. This distinction corresponds to that between easy credit (low short rates) and dear money (high long rates), the combination which Tily argues causes the cycle.

In the final chapter, Tily argues that nothing short of the radical reform of the international financial structure will restore the Golden Age. In the end, he sees recent history as a battle between industry and labour on the one side, and finance on the other. The touchstone of this conflict is control over the international movement of capital, anathema to the party of finance (presumably here including transnational corporations), as the price of domestic prosperity. His final, rather grim, conclusion is that it will take a global financial crisis and the failure of neo-liberalism (in his view, rather probable) for the necessary political choices to be made.

As a statement of Keynes's own policy stance this book is convincing, but less so as a prescription for today: indeed it may strike an orthodox reader as evidence of Keynes's datedness, quite the opposite of Tily's intent. Such a reader will be struck by Tily's lack of concern about the implications of a cheap money policy for inflation, reflecting the perceived absence of a causal link from money to the price-level in a state of aggregate excess supply. Tily does not challenge the mainstream view that inflation is mainly the result of excess demand, only its belief in the uniqueness at any given time of the natural rate of output, as opposed to Tily's multiple equilibria (p. 245).

The main contribution of this well-written and stimulating book is to demonstrate, not so much that Keynesian economics is not the economics of Keynes (which is already quite well recognised), but that Keynes's principal policy thrust was towards monetary reform and redistributive taxation rather than the fiscal policy associated with 'Keynesian' economics. The re-discovery that money matters would not have been greeted as a challenge to Keynesian economics, if the economics and policy of Keynes had been taken seriously.

Above all, this book is a good read, which may achieve that rare combination of a high level of scholarship with relevance to the non-academic policy advisor. Tily makes his main points incisively at the beginning of each chapter, and weaves together pure theory, history of economic thought, and empirical evidence impressively. He is deeply concerned about the policy implications of bad theory (to an extent that may not be to every reader's taste), and equally emphatic as to the radical nature of Keynes's analysis (*a fortiori*). As with other current offerings by Palgrave Macmillan, the hardback presentation is attractive, and the cover features a striking portrait of Keynes by Duncan Grant.

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