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# John Maynard Keynes

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# John Maynard Keynes

## The Art of Choosing the Right Model

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# *Contents*

# *List of Tables*

# *List of Figures*

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# *Preface*

This book sets out in plain English the essence and implications of the economic thought of John Maynard Keynes. It is aimed at undergraduate students in the social sciences, including economics, but without the commitment to more advanced mathematics found in economics textbooks. It should be accessible to a bright A-level student and to any fairly determined intelligent reader.

This preface is mainly addressed to teachers, lecturers and professional economists who will ask why they should read or recommend this particular introduction to Keynes's thought. On the one hand, the present book is in the tradition of Robinson (1937), Dillard (1948), Hansen (1953), Stewart (1967) and, more recently, Davidson (2017). Each has its own perspective, style and approach. This book places emphasis on the elements of continuity in the development of Keynes's thinking over the course of his life and covers all his major economic writings, not only *The General Theory*. The final chapters place the Keynesian era in its long-term historical context and relate Keynes's thinking to the state of economic theory and policy today. The Further Reading contains references for the economics student who wishes to delve deeper. On the other hand, this book makes a good supplement to Collins (2017), which offers a highly structured modular text suitable for classroom teaching at an introductory level.

It is the richness and complexity of Keynes's thought that makes it possible to say something new about it several decades later. This book reflects a study of Keynes's works over a period of more than forty years, which is rather longer than what he took to write them. It embodies a distinctive understanding of Keynes's central ideas of expectation, liquidity and effective demand, one that does not fit any of the pigeonholes in Coddington (1976). It includes recognition that Keynes assumes flexible, not fixed, prices; recognition that, for Keynes, income, wages and interest are intrinsically monetary; and recognition of Keynes's paradoxical use of liquidity to mean that stock markets are illiquid, while land can be liquid. The detailed case for this interpretation can be found in my research papers and previous book (Hayes, 2006a to Hayes, 2018). This perspective reinforces Keynes's claim to have offered a general theory encompassing the classical theory – against the current convention to the contrary, that his theory is a special case of the classical theory.

Mark Gerard Hayes
Robinson College, Cambridge
18 March 2019

# *How to Read This Book*

Those who want just a basic introduction in order to decide for themselves whether Keynes is relevant today can read chapters 1 and 8 in isolation, referring back to chapter 7 for historical context.

Economics students will also want to read chapters 3 and 4 as a minimum. Beginner economists, students of other social sciences and lay readers will need to read chapter 2 in order to understand the elements of classical economics before tackling chapter 3. The Glossary allows quick reference to some of the technical terms.

Chapters 5 and 6 address more advanced questions within the context of the development of Keynes's economic thought throughout his life.

# *Glossary*

Words in **bold type** are cross-references: they refer to other entries in the glossary.

| | |
|---|---|
| aggregate | the total for the whole economy |
| aggregate demand | the **aggregate income** expected by employers as a whole to result from **expenditure** on **investment** and consumption |
| aggregate demand function or curve | the mathematical relation between **aggregate demand** and **aggregate** employment |
| aggregate supply | the minimum **aggregate income** expected by employers as a whole at which it is profitable to offer a particular level of **aggregate** employment |
| aggregate supply function or curve | the mathematical relation between **aggregate supply** and the **aggregate** employment offered |
| balance of payments | the overall balance on the **current** and **financial accounts** of one region with another |
| Bretton Woods | the 1944 international conference at Bretton Woods, New Hampshire, which established the International Monetary Fund and the World Bank |
| budget deficit | an excess of government **expenditure** over **income** |
| capital | durable goods used in production or as a store of value |
| capital budget | government **investment** and its funding |
| competitive equilibrium | the state in which competition in **supply** and **demand** leads to a market price at which **supply** and **demand** are equal |

| | |
|---|---|
| current account | exports including foreign **income,** minus imports and **income** earned by foreign residents |
| current budget | the balance of government **income** and consumption **expenditure** |
| demand | offers to buy new goods or services; not to be confused with **expenditure** |
| demand function or curve | the mathematical relation between **demand** and price, often drawn as a straight line for illustration |
| effective demand | the **aggregate income** expected by employers as a whole to result from the **aggregate** employment they find it most profitable to offer |
| expectation | the expected value of a future price, quantity or **income** |
| expenditure | purchase of goods or services |
| financial account | borrowing from foreign residents minus lending to them |
| forward market | a market for delivery of goods or services at a future date |
| gold standard | a monetary system in which the value of a currency is defined in terms of a quantity of gold |
| income | the money value of **net output** |
| investment | **expenditure** on the production of **capital** |
| liquidity | the property of an asset of maintaining its sale value when the state of **expectation** changes |
| long-term expectation | investors' **expectations** of **income** from the production of goods or services using the **capital** in which they invest |
| macroeconomics | the study of the economy as a whole |
| marginal product | the extra **net output** expected to result from the employment of an extra unit of labour or **capital** |
| medium-term expectation | dealers' **expectations** of **expenditure** by customers |
| microeconomics | the study of the economic decisions of individuals and firms |
| net output | **output** minus the quantity of product consumed in production, e.g. the harvest of corn minus the seed-corn planted |
| output | the quantity of a finished good produced during a period |
| SDR | special drawing right – the monetary unit of the International Monetary Fund |

| | |
|---|---|
| short-term expectation | employers' **expectations** of income from production and employment, best understood as their order books |
| spot market | a market for immediate delivery of goods or services |
| supply | offers to sell new goods or services; not to be confused with **output** |
| supply function or curve | the mathematical relation between **supply** and price; often drawn as a straight line for illustration. |
| trade deficit | an excess of imports over exports |
| Versailles | the 1919 Peace Conference after World War I at Versailles, near Paris |

# 1

# *Why Study Keynes?*

Few will deny that John Maynard Keynes (1883–1946) was the most outstanding economist of the twentieth century. Undoubtedly his reputation is based not only upon his scholarship, which remains controversial, but also on his roles as a prominent public figure, as a newspaper journalist and broadcaster, as an official representative of the UK government during the two world wars, and as Lord Keynes of Tilton. Nevertheless he was, first and foremost, a Cambridge economist. He wrote about economics and economists in the following terms:

> An easy subject, at which very few excel! The paradox finds its explanation, perhaps, in that the master-economist must possess a rare combination of gifts. He must reach a high standard in several different directions and must combine talents not often found together. He must be mathematician, historian, statesman, philosopher – in some degree. He must understand symbols and speak in words. He must contemplate the particular in terms of the general, and touch abstract and concrete in the same flight of thought. He must study the present in the light of the past for the purposes of the future. No part of human nature or institutions must lie entirely outside his regard. He must be purposeful and disinterested in a simultaneous mood; as aloof and incorruptible as an artist, yet sometimes as near the earth as a politician. (CW 10, 173–4; references to Keynes's *Collected Writings* are explained in the Bibliography)

Although Keynes was writing about his mentor Alfred Marshall (1842–1924), he was really describing himself. There are only a handful of other individuals – perhaps Adam Smith (1723–90), David Ricardo (1772–1823), John Stuart Mill (1806–73) or Karl Marx (1818–83) – who might fit the bill. Not many of today's economists are historians; only a tiny minority are philosophers, let alone statesmen. Most are content to be mathematicians.

## The Use of Models and Mathematics in Economics

Economics has come to be distinguished from the other social sciences mainly by its use of mathematics rather than by its subject matter. There is a difference between mathematics and numbers. It is true that economics studies quantifiable aspects of human behaviour; yet students of other social sciences, together with the intelligent lay reader who is quite capable of reading a chart, find themselves excluded by the mathematical language of economics.

Economists use mathematics to build models of the real world. Any model, whether physical or mathematical, is necessarily an abstraction from reality. For example, a map is a model of terrain; a map at a scale of 1:1 is not useful. Niels Bohr's model of the atom as a tiny solar system with electrons orbiting a nucleus is not a complete representation of reality, yet it allows us to understand the properties of atoms well enough to do advanced chemistry.

Undergraduate, let alone graduate, degree courses in economics involve learning a series of mathematical models of such complexity that most students have no time or energy left to question their limitations as an explanation of the world around us. Leading employers of economists such as the UK Government Economics Service and the Bank of England have complained that an economics degree no longer equips a student to be an economist outside a self-perpetuating academia. Many economics students are fed up and, remarkably for such short-lived creatures, have organised themselves into a permanent global association, Rethinking Economics, which demands what its name declares: a rethinking of economics.

Yet Keynes himself was a modeller. He wrote to Roy Harrod (1900–78):

> It seems to me that economics is a branch of logic, a way of thinking; and that you do not repel sufficiently firmly attempts … to turn it into a pseudo-natural science … Progress in economics consists almost entirely in a progressive improvement in the choice of models. The grave fault of the later classical school, exemplified by Pigou, has been to overwork a too simple or out-of-date model, and in not seeing that progress lay in improving the model …

> Economics is a science of thinking in terms of models joined to the art of choosing models which are relevant to the contemporary world. It is compelled to be this, because, unlike the typical natural science, the material to which it is applied is, in too many respects, not homogeneous through time. The object of a model is to segregate the semi-permanent or relatively constant factors from those which are transitory or fluctuating so as to develop a logical way of thinking about the latter, and of understanding the time sequences to which they give rise in particular cases. Good economists are scarce because the gift for using vigilant observation to choose good models, although it does not require a highly specialised intellectual technique, appears to be a very rare one. (CW 14, 296–7)

However, even if economics is a branch of logic, a science of thinking in terms of models, it does not follow that models can be expressed only in mathematics. Keynes writes:

> The object of our analysis is, not to provide a machine, or method of blind manipulation, which will furnish an infallible answer, but to provide ourselves with an organised and orderly method of thinking out particular problems … Too large a proportion of recent 'mathematical' economics are mere concoctions, as imprecise as the initial assumptions they rest on, which allow the author to lose sight of the complexities and interdependencies of the real world in a maze of pretentious and unhelpful symbols. (CW 7, 297–8)

Furthermore Keynes understood that economics is also an essay in persuasion:

> When we write economic theory, we write in a quasi-formal style; and there can be no doubt, in spite of the disadvantages, that this is our best available means of conveying our thoughts to one another. … [Yet in] economics you cannot *convict* your opponent of error; you can only *convince* him of it. And, even if you are right, you cannot convince him, if there is a defect in your own powers of persuasion and exposition or if his head is already so filled with contrary notions that he cannot catch the clues to your thought which you are trying to throw to him … Time rather than controversy … will sort out the true from the false. (CW 13, 469–471)

## The Models in This Book

As I have noted, modern economics is full of models, most of which are written in mathematical squiggles incomprehensible to the untrained reader. The models in this book are simple. There are a few tables, charts and the odd equation but rather less than is demanded of today's 16-year-old. Economics has to use models to say anything coherent, because everything connects and changes together. Without a model, however simple, we lose our way in a shifting maze.

The use of a *simple* model leads to the accusation of setting up a straw man in order to demolish it. This is not the intention. The corn model used to explain classical theory in chapter 2 is a simplification of more advanced mathematical models, but not a distortion. The purpose is to show the essence of classical analysis and to demonstrate the power of its central ideas, notably the concepts of competitive equilibrium and marginal productivity.

If those terms make you groan, please ask yourself whether you really want to understand Keynes. His thought cannot be understood, especially in the light of the classical restoration, without understanding the essence of the classical model. You cannot understand his revolution without a grasp of what he was revolting against, let alone of what he actually wrote. Many criticisms of both classical economics and Keynes's are misinformed. As he himself wrote,

> The worst of economics is that it really is a technical and complicated subject. One can make approximate statements in a common-sense sort of way which may appear superficially satisfactory. But if someone begins to ask one intelligent and penetrating questions it is only possible to deal with them by means of something much more complicated. (CW 20, 469)

Nevertheless this book tries to make the learning process as painless as possible. Readers who already know what is meant by competitive equilibrium and marginal productivity will find chapter 2 an easy read. The intention is that students beginning economics, students of other social sciences, and interested lay readers should find that chapter 2 equips them with the basic knowledge required to understand the real issues at stake.

## The Nature of This Book

This book is a biography of sorts, but not of Keynes the man. There are several hundred books about Keynes. Many better qualified authors have written about his life and his loves, the extraordinary,