Robert Skidelsky

KEYNES

A Very Short Introduction

OXFORD

Chapter 6
Keynes's legacy

Any assessment of the work of a past master is bound to reflect the state of mind of its time. At present (July 1995), Keynes's reputation is precariously poised. Ten years ago, one might have said that the Keynesian era was dead and buried. Nigel Lawson, then Britain's chancellor of the exchequer, did say so. 'The conquest of inflation', he declared in his Mais Lecture of 1984, 'should… be the objective of macroeconomic policy. And… the creation of conditions conducive to growth and employment… should be… the objective of microeconomic policy.' There was no commitment to full employment. Rather, the idea was to free up markets as much as possible and accept whatever level of activity they produced. Today, there is some reaction back to Keynes, partly because the deflationary policies pursued over the last fifteen years have left high and persisting unemployment in their wake – as, indeed, Keynes predicted such policies would. Unemployment in the European Union has been rising since the 1970s, stands at 10% of the work-force today and has not fallen by much during the recovery from the recession of 1991–2. It is as if the combined population of Denmark, Ireland, and Switzerland was producing nothing at all – hardly a triumph for market forces.

Although monetarism failed to deliver stable prices and tolerable employment, Keynesian policy as we knew it is not restored. Most governments believe that Keynesian remedies for unemployment will be either ineffective or mischievous, much as they did when Keynes first started advocating them. This partly reflects the view that most unemployment today is 'structural' not Keynesian; that is, it reflects not a shortage of demand but the wrong structure of capital and relative wages. Furthermore, it is widely believed that structural maladjustment came about (or was allowed to continue for as long as it did) as a consequence of the

'Keynesian' policy of creating or maintaining employment in unproductive or loss-making occupations. Even if some part, at least, of current unemployment is conceded to have its origins in a deficiency of aggregate demand, it is believed that expanding demand would cancel the gains on the inflation front, achieved at such cost, since 1979.

In short, Keynesian policies come to us today wrapped up in a history of rising inflation, unsound public finance, expanding statism, collapsing corporatism, and general ungovernability, all of which have seemed inseparable from the Keynesian cure for the afflictions of industrial society. We do not want to traverse that path again. By the 1980s, Keynes, who was praised for having saved the world from Marxism, had joined Marx as the God that failed.

The question of how the Keynesian age came to generate expectations which undermined the Keynesian revolution calls for both a theoretical and a historical explanation. Perhaps a historian is as well placed as anybody to offer one. Both sides of the explanation will be personal to the writer, since there is little agreement on 'what went wrong'. But anyone who wants to keep the spirit of Keynes alive has to face the failures of Keynesianism honestly, without always trying to shield the Master from the mistakes of the disciples. In essence, the Keynesian revolution was ruined by over-ambition – *hubris* might be a better word -driven by impatience and backed by unwarranted claims to both theoretical and practical knowledge. The monetarist counter-revolution was a plea for more modesty, and greater trust in the spontaneous forces of the market.

It is hard to fit Keynes himself into the Keynesian versus Monetarist debate, because his *General Theory* was built to understand the world of the 1930s, not the world of the 1960s or 1970s. It is perfectly possible to get (qualified) monetarist conclusions out of *The General Theory* on certain assumptions about expectations, but these were not the purposes for which the book was written. To understand much of what Keynes had to say about money and credit and exchange rates, the banking system and financial markets, the reader needs to turn to the *Tract on Monetary Reform* and the *Treatise on Money*. For those who seek contemporary inspiration in Keynes, three other facts are worth remembering. First, although he was intellectually over-confident -a trait inherited by his followers – he was notably modest about what policy could achieve in a free society – something which his followers tended to ignore. Secondly, his social aims were, as he put it, ‘moderately conservative’. There is nothing in Keynes’s social philosophy, or the Liberalism of his day, which would have supported the seemingly relentless expansion of the welfare activities of the state which contributed so heavily to the fiscal crises of the 1970s. Finally, he was an apostle of growth not for its own sake, but only as a means to leisure and civilized living. In fact, he argued in the late 1920s that ‘technological’ unemployment was a sign that the economic problem was being solved. ‘The full employment policy by means of investment is only one particular application of an intellectual theorem,’ he wrote to T. S. Eliot in 1945. ‘You can produce the result just as well by consuming more or working less… Less work is the ultimate solution [to the unemployment] problem.’

For twenty-five years after Keynes’s death, his revolution prospered. Most economists accepted ‘the new economics’ (even Milton Friedman said in 1966, ‘We are all Keynesians now,’ a phrase repeated by Richard Nixon in 1972); most governments committed themselves to maintain full employment. To be sure, not all who called themselves ‘Keynesians’ accepted *The General Theory* as gospel. Indeed, there was a retreat from Keynes’s own theory. As a result of Patinkin’s work (1956), classical theory was partly rehabilitated, in that the downward rigidity of money-wages was seen as the *essential* obstacle to full employment, as Arthur Pigou had always claimed. In Leijonhufvud’s reinterpretation (1968), Keynes’s ‘unemployment equilibrium’ was to be understood as a rhetorical device; his was a disequilibrium theory emphasizing co-ordination failures – an approach which stressed the continuity of *The General Theory* with the *Treatise on Money*, thus narrowing its distance from the monetary disequilibrium theorists of the 1930s. However, a world with downwardly rigid money-wages and the ever-present possibility of a collapse in private investment is still a world which leaves a necessary role for government *policy* to maintain continuous full employment.

Apart from this, three aspects of Keynes’s legacy seemed secure. First, practically all economists accepted Keynes’s macroeconomic framework. Keynes had invented a new branch of economics, macroeconomics, the study of the behaviour of the economic system as a whole, rather than the study of the behaviour of individuals, firms, or industries. ‘Students in the 1960s were taught that we could model the economy, diagnose the state of effective demand and devise appropriate fiscal interventions.’ Secondly, *The General Theory* had provided the conceptual breakthrough for constructing national accounts. The consequent mushrooming of economic statistics was hugely influential in the development of econometrics, which, in turn (it might then have been said), provided a secure forecasting basis for macroeconomic policy. Finally, Keynes had restored faith in the capitalist system. Keynesian economics had helped write Fascism, Communism, and some kinds of socialism out of the history of the developed world.

Keynesian theory had also contributed to the emergence of development economics – the study of economic growth in poor countries. Roy Harrod, in particular, extended the Keynesian explanation of short-run unemployment into a model of self-sustaining growth, emphasizing the central role of physical investment. The mid-1960s saw an upsurge of faith in the power of macroeconomic policy to deliver not just full employment, but high rates of growth, and many other desirable social objectives.

Ten years later the counter-revolution against Keynes was in full swing. Milton Friedman’s restatement of the quantity theory of money in 1956 was followed, in 1968, by the most influential macroeconomic paper of the post-war years. In this, Friedman claimed that attempts by governments to reduce unemployment below the ‘natural rate’ set by market institutions led only to accelerating inflation. In 1976, the Keynesian revolution in policy was officially declared dead in its birthplace, when Britain’s Labour prime minister, James Callaghan, announced that the option of ‘spending our way out of recession no longer existed’ and in the past had worked only by ‘injecting bigger and bigger doses of inflation into the economy’. Throughout the world, price stability rather than full employment became the stated goal of macroeconomic policy.

The monetarist counter-revolution called into question the most fundamental aspects of Keynes’s legacy. If nominal changes (changes in money) affect prices, not output, in the long run, as Friedman claimed, we do not need macroeconomics, only an updated quantity theory of money. If, as Friedman claimed, the economy is 'inherently more cyclically stable' than Keynes supposed, while macroeconomic interventions are subject to 'long and variable lags', not only do we not need counter-cyclical policy, it will be destabilizing. If we do not need counter-cyclical policy, we do not need large macroeconomic forecasting models. Finally, Keynesian macroeconomic policy did not preserve capitalism from socialism, but led towards it by the need for increasing political intervention in the microeconomy to make macroeconomic policy work. Instead of trying to stimulate the economy through mixtures of public spending and planning, governments should concentrate on controlling inflation and improving the working of the market system.

Rightly or wrongly, the fate of the Keynesian revolution has been determined by events. The depression of the 1930s gave rise to it; the 1950s and 1960s seemed to vindicate it; the 'slumpflation' of the 1970s (the combination of high unemployment and high inflation) ended it. The legacy of the 1980s is ambiguous, and should betoken a modest revival.

The 1950s and most of the 1960s were a capitalist golden age. By historical standards, unemployment was exceptionally low, growth in real incomes exceptionally fast, economies exceptionally stable; all achieved at a very modest cost in inflation. These successes were widely attributed to Keynesian policies, inspired by Keynesian theory.

Then prosperity started to unravel. From the late 1960s inflation *and* unemployment began to edge up, growth to slow down. In the OECD countries, consumer prices, which had risen by 3.1% a year on average in 1960–8, rose by 10.5% a year in 1973–9. Unemployment, 3.1% a year on average in the first period, was 5.1% in the second. The growth of real GDP per capita slowed down from 3.9% in 1960–8 to 1.9% in 1973–9. In 1971, growing macroeconomic (including external payments) imbalances brought down the system of fixed, but adjustable, exchange rates established at Bretton Woods in 1944, even before the first oil-price shock of 1973–4.

Having been credited with success, Keynesian policy was blamed for subsequent failure. Both conclusions are questionable. Did economic ideas, Keynesian or otherwise, have much influence on what governments did?

Did the policies of governments make much difference to what happened? The answer to both questions is almost certainly yes, but the interactions between the three realms of ideas, policies, and events are so complicated that no account of their relationship is likely to command general assent. We can at least try to distinguish between the rhetorical and technical uses of economic ideas, and avoid calling Keynesian the general expansion of state activity after the war, and attributing to Keynesian policy all the consequences, good and bad, which followed from this expansion. As Christopher Allsopp has written, 'The development of Welfare States, industrial intervention, and public expenditure programmes… has little to do with… the economics of Keynes… It is necessary… not to lose sight of the fundamental point that the original message was minimalist in spirit.' Beyond this, it is rhetorically useful to be reminded that Keynes was against inflation, nationalization, planning, equalization of incomes, etc., if only because many who have advocated these things have done so in his name.

In trying to assess the influence of Keynesian policy on post-war events, an initial problem is to understand what is meant by Keynesian policy. In France and Italy, for example, what would now be called active supply-side policies were routinely mislabelled 'Keynesian'. A more relevant test is the commitment to maintain full employment. But only in Britain and the United States was such a commitment given, and even then ambiguously. The British Employment White Paper of 1944 pledged the government to maintain a 'high and stable' level of employment. What was high? What was stable?

Jim Tomlinson has suggested a more stringent test. The Keynesian revolution, he says, 'should be defined in terms of an attempt to legitimize (budget) deficits as a device for use when the level of aggregate demand required stimulation'. Keynesian policy may then be said to be in operation when budget deficits are deliberately incurred to raise the level of output. On this test, there was no Keynesian policy during the height of the 'golden age' because, as R. C. O. Matthews pointed out in 1968, 'the [British] Government, so far from injecting demand into the system, has persistently had a large current account surplus'. The same was true for the United States until 1964. Similarly, there was no active demand management policy in the most successful 'golden age' economies, Germany and Japan.

The implication is that the post-war world did not need, and did not get, a Keynesian revolution in policy.

In *The General Theory*, Keynes had talked of a happy 19th-century 'conjuncture' which allowed employment to be reasonably full without government intervention. It may be that the 'golden age' should be seen as resulting from a similar conjuncture. As Crafts and Woodward point out, across the developed world there were 'widespread opportunities to imitate American technology, to contract low productivity agriculture, and to exploit cheap energy'. The opportunities for technological catch-up gave capital a high marginal productivity, leading to high private investment demand. A high rate of productivity growth allowed a sufficient rise in real incomes to satisfy workers' aspirations while keeping unit costs fairly stable. Governments also consumed a much higher proportion of the national income than they had before the war. As John Hicks put it in 1977: 'The combination of more rapid technical progress (surely a fact) with the socialist tendencies which increased demand for collective goods (surely also a fact) could have produced such a boom without the added stimulus of Keynesian policies.'

In this happy conjuncture a key role was played by the United States. In practice, only the United States enjoyed the luxury of an 'autonomous' macroeconomic policy. Under the gold-exchange-rate system established at Bretton Woods only the United States was on the gold standard; other countries held most of their reserves in dollars. Monetary conditions for the system as a whole were set by American financial policy, with other countries' macroeconomic policy being limited to maintaining their currencies' chosen exchange rate with the dollar. Under Truman and Eisenhower, American budgetary policy was conservative, interest rates were low, the balance of trade in surplus. Till the mid-1960s, the United States provided most countries with a reasonably secure anti-inflationary anchor, while supplying them with enough liquidity to prevent the deflationary contractions associated with a pure gold standard. The stability of the monetary regime allowed a progressive liberalization of the payments and trading system which, as Adam Smith would have predicted, was highly favourable to the growth of real incomes. Finally, there were *ad hoc* injections of demand from the United States – notably through Marshall

Aid and the Korean war – which had the same stimulating effects as the Californian gold discoveries and the 'small wars' of the mid-19th century. In short, it was the Pax Americana which secured a rough and ready macroeconomic balance across the 'free world' during the golden age, much as the Pax Britannica had done in the 19th century. The existence of a buoyant international economy (unlike in the 1930s) made national economic problems much more tractable.

However, if purposeful Keynesian policy cannot explain the golden age, the explicit or implicit commitment to avoid a collapse in demand – and just as important, the belief that Keynesian policy would work if required – may well have secured the expectations ('state of confidence') necessary to sustain the private investment boom for so long. In particular, in the 1950s Keynesianism seemed to have erected a decisive barrier to the advance of socialism, whether in the form of public ownership or national planning. The subsequent identification of Keynesianism with a disproportionate growth of the public sector accompanied by growing labour militancy was crucial in destroying the psychological or *expectational* function of the Keynesian revolution – the belief that it would make the world safe for capitalism and capitalists.

It is worth pursuing the 19th-century parallel a little further. The boom of the 1850s and 1860s was followed by the depression of the 1870s through to the 1890s, which, as has often been pointed out, was not a slump in the 1930s sense, but a mixed period of prosperity and depression, with enormous technological restructuring accompanied by a shift of competitive dynamism from Britain to Germany and the United States. This is not totally dissimilar to what happened from the 1970s onwards, with competitive advantage shifting this time to the Pacific rim. What was missing from the earlier period was the phenomenon of 'stagflation'. There was heavy unemployment for much of the 1880s, but prices fell. In contrast, was the boom of the 1950s and 1960s 'artificially' prolonged by Keynesian policy?

According to the standard Keynesian story, the long boom was ended by the oil-price shock of 1973–4, though it was acknowledged that the path to this débâcle was strewn with policy mistakes and unexplained 'sociological' happenings like the wages explosion in 1968. But the deterioration of macroeconomic performance had been evident from at least the mid-1960s. It coincided with the switch to active Keynesian policies.

In the 1960s, Keynesianism was universalized, ‘came into its own’, in a double sense: the use of fiscal policy to balance economies was extended to France, Italy, Germany, and to a lesser extent Japan; and fiscal policy became more active and ambitious as fears of recession revived. Broadly speaking, while early Keynesian interest concentrated on securing the full use of existing resources, the Keynesianism of the 1960s tried to secure the full use of potential resources – i.e. growth in the productive capacity of the economy with the object of restraining cost-push inflation and meet the increasing ‘social demands’ being placed on the economy. What David Marquand (1988) has called the social democratic phase of Keynesianism is associated with a move to the Left in politics, and the serious use, for the first time, of budgetary policy to shift demand from the private to the public sector. The budget simultaneously became the agent of demand management, growth, and welfare. From the 1960s the share of public spending in GDP everywhere started to rise. The most significant macroeconomic episode, from the global point of view, was the Kennedy-Johnson tax cut and ‘great society’ spending programmes of 1964–6. In retrospect, though it was not evident at the time, this, together with the inflationary financing of the Vietnam War, ended the United States’ role as the world’s anti-inflationary anchor.

We can identify several plausible reasons for the shift from full employment to growth. In the United States, the observed tendency for unemployment to be a little higher at the peak of each cycle in the 1950s (though the average for the 1950s, at just over 5%, was close enough to the target rate of 4%) revived the old Keynesian fear of the ‘secular stagnation’ of mature economies. It suggested a growing output gap – the gap between the actual annual rate growth of output and its potential growth rate. Rejecting the idea that higher unemployment might be caused by technological factors like automation, the president’s Council of Economic Advisers suggested that demand expansion could lower unemployment to 4% without ‘unacceptable’ price inflation, James Tobin arguing that the evils of ‘small increases in prices’ had been ‘greatly exaggerated’. The Keynesian promise that demand expansion could achieve faster growth fed the politicians' desire to boost the American growth rate to avoid losing the ideological war (as well as the arms race) against the Soviet Union, which in the 1950s was trumpeting prodigious growth rates and dramatic technological achievements like Sputnik.

In Europe, resort to deficit finance stemmed from a fear that labour shortages would slow down growth (the erection of the Berlin Wall in 1961 stemmed the flow of cheap labour from East to West Germany); from the fear that the opening-up of domestic economies to free trade and capital flows, both globally and as a result of the formation of the European Economic Community in 1958, would make them more vulnerable to external shocks; and from the re-equipment of left-wing parties, long out of power, with up-to-date (that is, non-Marxist) ideologies. Keynesian growth policy seemed to be what was left when plentiful supply, protectionism, and obsolete ideologies were removed from the picture. In slow-growing Britain, growth policy was adopted to enable it to 'catch up' with industrial rivals like Germany and France. Japan resorted to deficit financing in 1965 when it started to lose key post-war instruments like tariffs and control over capital movements. Common to all countries was the belief that fast or faster growth was needed to raise the feasible real wage, and win trade-union support for wage restraint by making possible the expansion of welfare programmes.

In the 1960s, developing countries, some recently decolonized, embarked on state-led industrialization designed to enable them to catch up with rich ones. Growth would be accelerated by redirecting underemployed rural labour to heavy industry. The Keynesian-trained Argentinian economist Raoul Prebisch developed a 'terms of trade' argument for public investment in import-substituting manufactures. The result was a series of public investment booms within a framework of state ownership and indicative planning, largely financed by foreign borrowing.

Expectation that the rate of capital accumulation would fall was not unreasonable after post-war reconstruction and 'catch-up' had run their course. Much more questionable was the extension of Keynesian thinking from the short-run problem of securing full employment of existing resources to the problem of increasing the growth of these resources. For 'growth' Keynesians, active demand management (including fiscal deficits) was required not just to prevent or offset recessions but to realize the economy's long-run growth *potential*, an altogether more elusive idea. Keynes himself would have said – in fact he did say – that at full employment any exogenous injection of demand leads to inflation. This is the 'special case' to which classical economics applied, when faster growth of output can come about only through increased productivity and improved technique – matters on which Keynes had nothing distinctive to say. The growth Keynesians argued, *au contraire*, that productivity growth was endogenous to the growth process. The rate of output growth depended on the rate of growth of investment; the faster investment could be induced to grow, the larger would be the productivity gains, owing to the effect of dynamic economies of scale, leading to a 'virtuous circle' of rising productivity, greater competitiveness, and higher growth. Given sufficient total demand, output could always be induced to rise more than proportionately to the input of labour. Thus high employment was no barrier to demand-led expansion: growth, in the jargon, was demand, not supply constrained.

Demand expansion went hand in hand with indicative planning. In the British National Plan of 1965, indicated growth rates were worked out for each sector over a five-year period to raise the expectations of businessmen. But the key indicator was the projected growth of public spending. This would tell industrial sectors how much they needed to expand capacity, and at the same time guarantee that the increased output would be bought. Thus public spending emerged as the real engine of growth – a fateful conjuncture in Keynesian political economy. Governments also encouraged company mergers to realize minimum efficient scale. Devaluation was added as an instrument to help lift economies onto higher growth paths, rather than simply to overcome disequilibria in the balance of payments as envisaged at Bretton Woods.

In retrospect, all the presuppositions underpinning the dash for growth, in developed and developing countries alike, turned out to be intellectually and politically insecure. No one in fact knew how to make an economy grow faster over time than it was actually growing. Did the causation run from productivity growth to output growth or from output growth to productivity growth? Economists disagreed. Again, the Keynesians were remarkably sanguine about the effects of the growth of the public sector on productivity growth, wage behaviour, and business expectations. They thought that a little inflation (how much?) was stimulating, and had no inkling of inflationary expectations. Finally, they greatly exaggerated the extent of 'disguised' rural unemployment in developing countries, and hence the benefits to growth to be obtained by transferring these supposedly costless resources into industrial production. If there is a common theme linking these presuppositions, it was that the state is wise and the market is stupid.

Even Keynesians would now concede that the economic and social goals of the 1960s were over-ambitious. The record is clear: by the decade's end the OECD inflation rate had doubled from 3% to 6%, without any improvement in real variables. The rising inflation which was the real legacy of the growth Keynesianism of the 1960s set Keynesian macroeconomic policy an impossible task in the 1970s. Once inflation had been let loose, government interventions were bound to be seriously destabilizing, involving either acceptance of higher unemployment to check the rise in prices, or acceptance of higher inflation to check the rise in unemployment. The oscillation of policy between these choices produced a rising 'misery index' (inflation plus unemployment) for most of the 1970s. Monetarism gained respectability by being able to explain worsening stagflation in terms of the interaction between 'stop-go' Keynesian macroeconomic policy, and wage behaviour which adapted ever more quickly to inflationary expectations.

In the most general sense, excessive pressure of demand led to what a classical economist would have predicted: a worldwide explosion in costs due to supply shortages. The wages explosion in the West, starting in 1968, had its counterpart in the rise in raw material and energy prices, starting in 1972 and culminating in the fourfold increase in oil prices in 1973–4, which reduced the real wage warranted at full employment for industrial countries. Direct controls over wages ('incomes policies') broke down as the decade progressed, producing a squeeze on profits, which could be offset only by pumping more money into the public sector. Western countries became, in the phrase of the day, 'ungovernable'.

Eventually governments had had enough. In face of the second oil price rise of 1979–80, Western governments tightened fiscal and monetary policy, bringing about the most severe slump since the 1930s. Developing countries, which had maintained their public investment booms throughout the 1970s by borrowing recycled petrodollars at negative real interest rates, found themselves faced with crippling foreign debt burdens as export earnings collapsed, real interest rates rose to punitive levels, and foreign investment dried up. In return for rescheduling and new loans, the IMF imposed tough stabilization packages. World-wide, state-led growth policies had precisely the opposite effect to those intended: they had raised, not lowered, the cost of producing goods and services, and they had lowered, not raised, the capacity of economies to produce marketable output. The Keynesian age was over.

Even at this distance, it is hard to disentangle the specific Keynesian responsibility for these disasters from the more general climate of opinion and economic and social pressures causing governments and economies to behave in the way they did. The overestimate of the power of macroeconomic instruments was certainly important; but just as significant was a fatalistic acceptance, by both Left and Right, of a collectivist and corporatist future, made inevitable, so it seemed, by the increasing scale of business organization, the growth of encompassing pressure groups, and the demand for an increasing range of social and economic entitlements. After 1974–5, when governments had truly lost power to 'manage' their economies, the worst that can be said about Keynesianism was that it presented a barrier to new ideas and the development of alternative political strategies. For by this point in time the Keynesian revolution could not renew itself. It had spawned pathologies inhospitable to its remedies, and it had no intellectual or political resources left to understand them, or deal with them. Keynes cannot be blamed for this exhaustion. Nevertheless, certain aspects of his legacy proved troubling, in so far as they appeared to paralyse criticism from within the Keynesian camp of extensions and applications of his theory to problems and situations for which it was not intended.

First, two incautious phrases in *The General Theory* gave a rhetorical warrant for the belief that public spending is better than private spending.

Keynes conceived that the maintenance of full employment might require a ‘somewhat comprehensive socialisation of investment’; he also said that if the Treasury paid people to dig holes and fill them up unemployment would fall ‘and the real income of the community, and its capital wealth also, would probably become a good deal greater than it actually is’. However, Keynes was always alert to the effect of policy on business psychology. He understood that excessive state spending would undermine confidence in the direction of policy and raise funding problems for the government, which would jeopardize the aim of maintaining a low long-term real rate of interest. No one has more eloquently or succinctly summarized the mechanism of the ‘inflation tax’ than Keynes in 1923: ‘A government can live by this means when it can live by no other. It is the form of taxation which the public finds hardest to evade and even the weakest government can enforce, when it can enforce nothing else.’ He understood that if public finance is judged unsound it will not be able to fulfil its genuine Keynesian purpose, as forward-looking agents take steps to protect themselves from the risk of repudiation or monetization of government debt. Yet he never explicitly discussed how much of the community’s spending could be safely or efficiently left to the state in a free society.

Secondly, there was no clear guidance in *The General Theory* as to what Keynes meant by full employment, either conceptually or statistically. A ‘general theory’ of employment which nourishes the belief that the level of employment is entirely determined in the goods market, and not at all in the labour market, is seriously misnamed. To be sure, in one passage Keynes distinguished between voluntary and involuntary unemployment, or as it was later put between ‘classical’ and ‘Keynesian’ unemployment, but his rhetorical purpose was to deny classical explanations of unemployment, and these were also ignored by his followers. Richard Kahn has testified to the fact that ‘the concept of “voluntary unemployment” left me very cold’ and that the distinction between the two types of unemployment ‘has not proved to have any practical significance’. The reason is that *The General Theory* can be read as saying that if the state controls the wages fund and allocates labour, voluntary unemployment can always be converted into involuntary employment, and the rate of unemployment reduced to zero – as indeed it was in the Soviet Union. Keynes did not think like this, but his more collectivist followers, influenced by wartime planning, did, and there is nothing in *The General Theory* which explicitly says that voluntary unemployment is a choice which, in a free society, can or should be dealt with only by changing labour market incentives.

One has to go outside *The General Theory* to discover what Keynes habitually thought about the nature of unemployment. In *The General Theory*, he adapted, and clothed in new terms, a much older distinction between 'normal' unemployment, related to slowly changing labour market institutions, and 'abnormal' unemployment resulting from a cyclical downturn. He thought that the order of magnitude of 'normal' unemployment in Britain was about 5% – the pre-1914 average, leaving 5% in the 1920s, and nearer 10% in the 1930s, 'abnormal'. Thus as late as 16 December 1944, he wrote to Beveridge, 'No harm in aiming at 3 per cent unemployment, but I shall be surprised if we succeed.' Keynes also seems to have thought of 'normal' unemployment as that level of unemployment at which money-wages (and prices) are stable. When unemployment is above normal, money-wages fall, when it is below normal, they rise. This is close to the neo-Keynesian idea of the Non-Accelerating Inflation Rate of Unemployment (NAIRU) – the level of unemployment required to contain inflation. But it was left to non-Keynesians to draw the conclusion that the only feasible way of lowering the level of 'normal' unemployment (or the NAIRU) in a free society was through labour-market reforms. The Keynesian obsession with incomes policies left the defence of contractual freedom to the monetarists.

Thirdly, Keynes bequeathed no adequate theory of prices. Keynes himself cannot be accused of being soft on inflation. Not only had he graphically analysed the rotting effect of inflation on the social system of capitalism, but in 1920, with British consumer prices rising by 20% a year (the same as in 1975), he had urged a severe dose of 'dear money' and savage public expenditure cuts as the only alternative to state socialism: 'I would do this because I put very high the danger of going on with our present diseases without a drastic and unpleasant cure. And I would do it though I knew I risked a depression and possibly a crisis.' And he wrote in 1940: 'With all unorthodox [i.e. socialist] methods of control… excluded, I feel myself that I should give today exactly the same advice that I gave then.' Delay in imposing and sticking to a ‘dear money’ policy in the mid-1970s made the subsequent situation much worse than it need have been.

This point can be generalized. In the pre-Keynesian era, the price level fell in a depression, rose in a boom, and on average stayed the same. It was thus easy for Keynes to be both an expansionist *and* a price stabilizer: in fact it could be shown that stability of the price level *required* that spending be increased when prices were falling. In the Keynesian era, prices went on rising during both upturn and downturn, though at different rates. The achievement of Keynesian policy in the 1970s was to change the popular perception that unemployment was an unacceptable cost of *laissez-faire* into the perception that it was an acceptable price for reducing inflation. Nor was this just ideological prejudice. Keynesian policy to expand employment is *unusable* until inflationary expectations have disappeared from the system, since if inflation is expected to rise workers will simply demand higher wages.

How did this perverse situation come about? Despite Keynes’s own anti-inflationary credentials, the models derived from *The General Theory* were constant price models: they focused, that is, on inadequate, not excess demand. But a ‘general theory’ of money must include both possibilities and intermediate positions, and it is quite true that *The General Theory* accepted the quantity theory of money as valid at full employment: ‘So long as there is unemployment, *employment* will change in the same proportion as the quantity of money; and when there is full employment, *prices* will change in the same proportion as the quantity of money.’ More realistically, Keynes acknowledged that inflation could start before full employment was reached – he referred to ‘positions of semi-inflation’ when output still rises but prices rise more – owing to structural rigidities (skills and geographical mismatches) and trade unions’ ability, as the labour market tightened, to push up wages ahead of productivity. In such a situation, is aggregate demand still to be considered deficient? Keynes did not say. Should demand management aim to maintain what Abba Lerner called ‘low full employment’ and price stability, or ‘high full employment’ with controls on wages and prices? Keynes did not say. He confined himself to the observation that the task of restraining wage push was ‘a political rather than an economic problem'; he was 'inclined to turn a blind eye to the wages problem in a full employment economy'.

In place of a theory of inflation, there was an empirical observation dating from 1958, the Phillips Curve, showing a stable relationship over time between the level of unemployment and the rate of change of money-wages and, by later inference, prices. Keynes's grey area of 'semi-inflation' became the 'safe zone' of the Phillips Curve, within which governments were said to have a 'menu of choice' between degrees of inflation and of unemployment. Conservative-minded Keynesians wanted to run the economy at a slightly higher 'margin of unused capacity' in order to lower inflation. This was a possible policy deduction from *The General Theory* model. But it was condemned as immoral by the growth Keynesians, who wanted to expand demand till the last person seeking work at any single moment was employed, using incomes policy to control costs, either with the agreement of the trade unions, or by legislation. But, as Alan Coddington observed, the Keynesian habit of treating the centralization of power as a residual from the solution to problems of economic management ignored the question of how much power the government actually had, or should have in a free society. The failure of Keynesians to take supply constraints seriously, the product of the depression perspective of *The General Theory*, destroyed not only the intellectual balance which Keynes himself tried to hold, but also the political balance of the Keynesian revolution. By the late 1970s, lovers of liberty and those who valued efficiency started to desert the Keynesian camp in droves.

Keynes was less guilty of political naivety than some of his detractors believe – he once remarked memorably that politicians have only ears not eyes – but he paid little attention to the political process by which policy is made, and therefore often gave the impression that, provided the state apparatus was equipped with the right theories and run by benevolent Old Etonians, it could be safely entrusted with much more discretionary power over economic policy than the Victorians would have considered prudent or desirable. It is easy to believe that he himself would have been more sensible and cautious in policy advice or conduct than later Keynesian economists and politicians; but it is difficult to find, either in *The General Theory*, or in other of his writings, any explicit discussion of the necessary limits which should be placed on discretionary economic action, either because the prince was inherently corrupt as the Victorians believed, or for the sake of the credibility of the policies being pursued or commitments entered into. Keynesians like Christopher Dow noticed that the 'fine tuning' interventions of British governments in the 1950s tended to be destabilizing, but attributed this to incompetence, even though it was apparent to more independent-minded observers like Terence Hutchison that governments were trying (with some success) to manipulate the economy to win elections.

More importantly, Keynesians did not suspect that inflation might be endogenous to the political process, characteristically attributing the increasingly malign outcomes of the 1970s to random shocks, avoidable errors, or the stupidity or selfishness of trade-union leaders, etc. It was left to the anti-Keynesian public choice school of economists to argue rigorously that politicians were in the business of maximizing a political utility function rather than a social welfare function, and to erect on this insight proposals for subjecting economic decision-making to constitutional or other rules. Whether the public choice theorists are right or wrong in the motives they ascribe to politicians and bureaucrats, the credibility issue has to be faced in an era of global capital markets. Unfortunately experience of Keynesian management in the 1970s has led the markets to mistrust any government which does not bind itself with hoops of steel to maintain a low rate of inflation.

The fundamental criticism of Keynes is not that his theory of output as a whole was so 'general' that it could be applied in any type of society ranging from democratic to totalitarian – something he explicitly acknowledged in the German preface to *The General Theory* – but that he never specified what types of application were appropriate to a free society and what were not. It is difficult to know from his writings, economic and political, where he would have drawn the line. He probably did not think it was necessary to do so, relying, in a very English way, on the automatic restraints of a community which 'thinks and feels rightly' to stop rulers doing dreadful things in his name.

In the light of this background, all too briefly sketched in, one can see why Keynesian policy has been in abeyance since the end of the 1970s, despite the heavy and persisting unemployment. There has been a general loss of confidence in the managerial, administrative, and spending activities of the state. The Keynesian revolution has been engulfed in a 'rhetoric of reaction', promiscuously directed at all forms of collectivism. The main political project over the more recent period has been to disinflate economies, restore public finances, de-corporatize and deregulate industrial relations, roll back (if possible) public spending, and privatize state industries. Unemployment has been viewed by the governments in power either as the necessary cost of accomplishing these reforms, or as something to be tackled after they have been accomplished. Such policies reflect the expectations formed by the Keynesian experience.

There remain fascinating questions. Could a more modest version of Keynesian policy in the 1960s have prevented the formation of expectations which made it unusable? Would Keynes himself have tried the incomes-policy route? There is no way of knowing. But it is worth remembering that Keynes was never someone to go down with a sinking ship, even one sailing under his flag. He would have tried to preserve the baby – his baby – while throwing out the bathwater.

Today, Keynesian policy cannot be openly avowed, though political pressure can still cause it to be pursued by stealth. Macroeconomic policy is increasingly pragmatic and a-theoretical. How it will evolve is uncertain. But two observations seem reasonably secure. With the globalization of markets, especially capital markets, the era of national economic management, which opened in 1914, is over. Keynesian policies, if pursued at all, will need to be on a global, or at the very least, regional basis. The era of discretionary demand management is also over. Whatever the eventual form of the policy framework it will be much more rule-bound than it was in the 1960s or 1970s. The Keynesian view of governments as benign social welfare maximizers is discredited beyond present repair. However, money supply or balanced budget rules will not be credible if the markets expect that political pressure will force them to be broken.

The question of how much Keynesianism will be needed to keep the world economy stable and prosperous in the years ahead is much harder to answer. It will partly depend on the outcome of the transition from Communism to capitalism in the former Soviet Empire and China. Will the transition usher in an era of very turbulent politics or will it reopen frontiers long closed to trade and commerce, and restore that confidence in progress and prosperity shattered by the 1914–18 war? The nature of the conjuncture will determine the governing ideas which capitalist economies will need; but the ideas will also determine the nature of the conjuncture. One cannot get away from this mutual dependence in social life. It should come as no surprise to learn that the ever-fertile mind of Keynes is a rich source of ideas directly relevant to the problems of the transition economies.

How much is left of Keynes? Keynes always insisted that economic models must be 'relevant to the contemporary world', and said of his remedies that they are 'on a different plane from my diagnosis… not meant to be definitive, [but] subject to all sorts of special assumptions and are necessarily related to the particular conditions of the time'.

Today there is no generally accepted model either of the macroeconomy or of the microeconomy, or of the relationship between the two. On the one side, we have the anti-Keynesian monetarism of Milton Friedman, and the 'new classical' macroeconomics, associated with Robert Lucas and Thomas Sargent – the 'radical wing of monetarism' – which deny validity to Keynesian models and power (except possibly a perverse power) to Keynesian policies. The 'new classical' macroeconomists agree with the monetarists that macroeconomic policies affect nominal, but not real, variables, and that unemployment will always gravitate to its 'natural rate'. With the monetarists they believe that the 'natural rate' of unemployment can be lowered by supply-side policies designed to improve business incentives, deregulate goods and labour markets, and privatize state-owned industries. The main analytic contribution of the new classical macroeconomists is the rational expectations hypothesis. Rational agents utilize all available relevant information in making their decisions. They make correct forecasts of the effects of announced government macroeconomic policies, the forecasts (in most rational expectations models) being based on the quantity theory of money. Expansionary (or contractionary) macroeconomic policy has no real effects even in the short run (the Phillips Curve is always vertical), since prices are immediately adjusted to the anticipated monetary conditions. The paradoxical conclusion is that Keynesian measures to lower unemployment below its 'natural rate' can achieve their promised results only by surprise, hardly a basis for usable policy. This reinforces the monetarist contention that macroeconomic policy should follow fixed rules to minimize expectational errors.

On the other side, Keynesians believe that demand matters, and that there remains a significant role for purposeful government policy in reducing unemployment. European experience of the 1980s and early 1990s bears out Keynes's contention that shocks to demand, whether coming from the private sector or the government, can lead to persisting unemployment. Why this should be so is not clearly understood. If individuals are rational optimizers, how is it that unwanted unemployment can persist when opportunities exist for mutually beneficial trade? The puzzle has belatedly given rise to a lively Keynesian research programme. The 'new Keynesians' have tried to understand the causes of rigid wages and prices, simply assumed as facts of life by the Keynesians of the 1950s. They have developed models to explain imperfect adjustment to shocks based on information costs, coordination failures, menu costs, efficiency wage hypotheses, sunspot equilibria, hysteresis, and so on. These models are designed to show that, even with rational expectation, labour markets may not clear. The Post-Keynesian school has continued to emphasize Keynes's stress on the importance of time and uncertainty, the use of money as a store of value, and the 'animal spirits' theory of investment. Conventional behaviour by capitalists or workers which produces perverse results for the economy as a whole is seen as a sensible response to uncertainty, or in the Sraffian and Kaleckian versions of Post-Keynesianism, to the class struggle.

Despite their disagreements on the role of macroeconomic policy, there is a growing agreement between all the schools, Keynesian and anti-Keynesian, that supply-side measures can lower present unemployment, either by sweeping away obstacles to market transactions or by rebuilding damaged capacity, or by a mixture of both.

The question of what, and how much, governments should *continually* do to stabilize economic activity at a high level will not disappear. The answer one gives will depend partly on what one thinks the economy is like, partly on what one thinks governments are like. If an unmanaged economy is 'inherently more cyclically stable' than Keynes thought, the answer is: not very much. The very least government should do is not make things worse. Friedman believes that most traumatic shocks are political. Governments are irretrievably tempted to manipulate the monetary parameters in order to secure helpful short-run results. Therefore their discretionary activity should be strictly circumscribed by rules. Keynes believed that unmanaged economies are inherently volatile, with a tendency to subnormal activity, so that policy can play a large part in both stabilizing and raising their performance. He thought governments could be sufficiently trusted to carry out contra-cyclical policy with competence and probity.

It is difficult to resolve this question empirically. It can certainly be argued that Keynesian policy (with all its impure political admixtures) made matters worse than they would have been from the mid-1960s onwards. But history shows that private-sector activity can be very volatile. Moreover, monetarism failed to predict the high persisting levels of European unemployment which followed the disinflationary policies of the early 1980s, and it has failed to produce a viable financial rule.

This leads to the conclusion that economics has consistently oversold itself as a 'guide to action', as opposed to an organized method of thinking about states of affairs and about the design of institutions capable of sustaining well-being beyond the actions of a particular government in a particular place at a particular time. Economists have not, in Keynes's phrase, become as useful as dentists. One cannot help reflecting that it was in the 1960s, when theoretically based macroeconomic policy was most actively used, that it started to go seriously wrong, and that it was those very prejudices and institutions which constrained the discretionary use of Keynesian tools in the 1950s which kept economic policy relatively circumspect. Eisenhower Keynesianism did more good than Kennedy Keynesianism.

If we are to draw a lesson from post-war historical experience it is that Keynesianism works best as a discretionary resource in a rule-based framework which places strong constraints on the actions of governments and which promotes the well-being of peoples through the widest possible measures of free trade. Those who look for inspiration to Keynes today are more likely to be impressed by the care and thought which he gave to the design of the Bretton Woods system than with Keynesian prescriptions for the parochial diseases of individual economies. Consciously or unconsciously we are trying to recreate the happy conjuncture which produced the 'golden age', much chastened by the experience of the intervening years. Whether we succeed will depend, in part, on the quality of statesmanship.