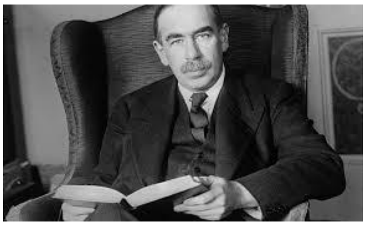
An Economist Looks at Europe | SEPTEMBER 7, 2015

Keynes as Lucifer

Pedro Schwartz*

| An Economist Looks at Europe

If thou beest he; but O how fallen! How changed
From him, who in the happy realm of light
Clothed with transcendent brightness didst outshine
Myriads though bright.
—John Milton: Paradise Lost



Few economists in history have attracted such a large following as **John Maynard Keynes**. Not only did he fascinate two generations in the 20th century, he still is an inspiration for today's large and distinguished 'New-Keynesian' school—or should I say, 'schools'. The conundrum is why so many swear by his name though so little has been kept of the original model of his *General Theory of Employment, Interest, and Money* (1936), except his insistence that aggregate demand is the main mover of the economy and that the price system does not function well.

A number of circumstances and coincidences explain this everlasting fascination with Keynes. First and foremost is the failure to foresee, account for, and remedy the Great Depression of the 1930s—and the same with the Great Recession of 2007-11. Secondly, his own seductive personality fits in supremely with the new morality of the progressive elites. Thirdly, people of progressive intent feel a crying need to find some excuse for continued government intervention in society, after Marxism, socialism, economic planning, imposed egalitarianism, public schooling, and state welfare have signally failed to fulfil their promises or are threatened with impending failure.

Keynes's rejection of the classical model opened a door to the many who were unhappy with the orthodox belief that supply created its own demand; that unemployment was self-righting; that the gold standard was the best monetary system; that investment could be left in private hands; that the stock market, despite temporary episodes, reflected the fundamental values and trends of the productive system; and in general, that laissez-faire was the best possible social arrangement.

Even after so many years it is difficult to resist Keynes's power of seduction. He was blessed with the gifts of greatness. His distinguished parents formed a home that suited that supremely intelligent and restless boy. He shone as a scholar at Eton. At King's College Cambridge he studied mathematics and probability theory but then was attracted to economics under the influence of his father and**Alfred Marshall**. He soon acquired the knowledge and abilities of a percipient monetary economist and applied them with good fortune to financial investment and public advice. He was a master of English prose, in explanation, metaphor and invective. In debate he was convincing and could be deadly. In friendship he was intense and attractive. His patronage of the arts, the theatre, and the ballet count among his greatest glories. And though during World War I he was a conscientious objector, he should be remembered as a patriot, of whom his friend and disciple **Lionel Robbins** said that, in his effort to obtain the American loan in the last year of his life, he died for his country as surely as if it had been in the trenches.

Keynes's early beliefs

Despite all his gifts and achievements, his influence on economics, in his time and now, was destructive of the fundamentals of a free society.

I am averse to using psychology (Freudian or not) to explain the path followed by great men and women in life. However, I think that the fundamental beliefs of the protagonists of history do shape their behavior throughout their lives. My *ideological* thesis is that Keynes's fall from the realm of light to the depths of deception would not have been so steep had he not looked at competitive capitalism and the free market in the decadent spirit of the 'Apostles' and the 'Bloomsbury' group of his younger years—as a necessary but rather vulgar social system, unworthy of the refined and the civilized.

The essay titled "My Early Beliefs" which Keynes wrote later in life makes unworldly reading for those who think that the Victorian virtues were not as laughable as Lytton Strachey portrayed the in *Eminent Victorians* (1918). The period of his life he portrays there is that of his membership in the secret Society of the Apostles at Cambridge University. It was an old Society, Christian in tone at its foundation in 1820, philosophical when Keynes joined it in 1903, Marxist in the 1930s when it became a breeding ground for future KGB spies, and at the turn of the 21st century full of welfare economists. As can be seen, the Society changed in character through the different generations. When the young Keynes belonged to it the inspiration was the philosophy of G.E. Moore.

Nothing mattered except states of mind, our own and other people's of course, but chiefly our own. These states of mind were not associated with action or achievement or with consequences. They consisted in timeless, passionate states of contemplation and communion, largely unattached to 'before' and 'after'. (Keynes, "My Early Beliefs," page 436)

It was Moore who had written:

By far the most valuable things, which we know or can imagine, are certain states of consciousness, which may be roughly described as the pleasures of human intercourse and the enjoyment of beautiful objects.

Soon this kind of quasi-religious mysticism extended to physical love. But the main doctrine was a rejection of Utilitarianism and of "the final*reductio ad absurdum* of Benthamism known as Marxism." (page 446). These Apostles saw human nature as fully rational.

[Bertrand Russell] in particular sustained a pair of opinions ludicrously incompatible. He held that in fact human affairs were carried on after a most irrational fashion, but that the remedy was quite simple and easy, since all we had to do was carry them on rationally. (page 449)

Keynes sums up the character the group with a most arresting metaphor:

I can see us as waters-spiders, gracefully skimming, as light and reasonable as air, the surface of the stream, without any contact at all with the eddies and currents underneath. (page 450)

Ten years later, the horrors of total war would destroy this dream like world.

"Despite his public spirit and his good work, Keynes was fundamentally unengaged with the philosophy of economic endeavor, social competition, productive innovation, personal ambition, and fair dealing that is the hallmark of the freedom-lover of today."

True, Keynes's student days as an Apostle were a passing phase in his life. Soon he was hard at work for the welfare of his country and for the progress of economics. Led by a burning passion for rationality, he soon engaged himself to the hilt in questions and activities of great practical import that he thought were badly managed. But those early beliefs marked him for the rest of his life in two ways: he was the philosopher-king to his last day and he did not abandon his dim view of capitalism. My thesis is that Keynes, despite his public spirit and his good work, was fundamentally unengaged with the philosophy of economic endeavor, social competition, productive innovation, personal ambition, and fair dealing that is the hallmark of the freedom-lover of today.

Change of direction

For more information, see **Gold Standard,** by Michael Bordo, in the *Concise Encyclopedia of Economics.*

This Apostolic philosophy soon resurfaced in Keynes's thought. Despite the underlying continuity in his economic thought, I see a fundamental change of direction around 1925. Before that time he was a monetary economist in the wake of Marshall. In his first work on economics, *Indian Currency and Finance* (1912), and in his 1923 *Tract on Monetary Reform* (to which I will return) he explained with great clarity how a nominal currency could be properly managed, both for the silver rupee in India before World War I and for a paper currency world in turmoil after the war. But around 1925, he started to move down a new theoretical path and left the strict monetarist fold of his earlier years, much to the shock of the other disciples of Marshall. He started to concern himself with what we today at his behest call 'macroeconomics', leaving behind the simple world of money and finance to enter a murkier one, where hidden psychological forces resulted in faltering aggregate demand and involuntary unemployment. This change was induced both by external events and by internal developments. As for events, he was reacting to decisions he deplored, such as Britain's return to the gold standard; also, there were unexplained situations from which he hoped to find an escape, such as the continuously high unemployment in Britain in the 1920s, and the unexpected depth of the Wall Street crash and the ensuing slump. As for internal developments, his radical change away from what I consider sound economics was impelled by his lifelong questioning of the morality of capitalism. His practical inclination led him to move away from the study of money to the real economy. In his *Treatise on Money* (1930-32) he started to question two of the central tenets of economic orthodoxy: the certainty that supply would always find a market; and the proposition that savings and investment would be in equilibrium. The experience of the Great Depression reinforced his growing doubts about the efficacy of cheap money and more generally of monetary policy, and it would confirm him in his search for systemic failures in the capitalist economy. So, after much soul-searching and technical discussion, he built and launched the*General Theory of Employment, Interest and Money* in 1936. **1**

The Keynes we remember today was thus born again in the mid-1930s. I prefer the Keynes of 1923 to the Keynes of 1936. The change away from the 'classical' doctrine of the *Tract* was deep and momentous. From simply explaining how to manage *fiat* money he moved to explaining how to manage society. Keynes's admirers say that he was on the side of the angels; that he was trying to save capitalism from itself; and that we poor misguided liberals should be thankful for small mercies. I find this disingenuous. Perhaps capitalism can save itself without us following the angel of light in his fall.

A Tract on Monetary Reform

Monetary questions have a permanency that lends an intemporal quality to the best monographs on the subject. If I were asked what authors a budding monetary economist should read today, my list would begin at Henry Thornton and **David Ricardo**, proceed to the young **John Stuart Mill**, go on to Walter Bagehot, and then (you may be surprised to hear) turn to Keynes's *A Tract on Monetary Reform* of 1923. It is in my view one of the best exposés of the functioning of that strange institution we call "money", especially when it is money created by state *fiat*.

The aim of the *Tract* was to propose a new monetary policy for times of inconvertible paper currencies. As a start, Keynes somewhat irresponsibly mocked the belief of the investing classes in the stability of the value of money, in the same tone that Lytton Strachey had adopted in *Eminent Victorians* (1918).

To save and to invest became at once the duty and the delight of a large class. The savings were seldom drawn on, and, accumulating at compound interest, made possible the material triumphs which we now all take for granted. [...] God and Mammon were reconciled. Peace on earth to men of good means.

Still, he had to admit that the admirable story of economic growth in the 19th century in great part depended on the stability of money, and that for a hundred years the gold standard system worked, throughout Europe, with extraordinary success and facilitated the growth of wealth on an unprecedented scale. (Vol. IV, page 6)[2] The unstable currencies of the 20th century would prove to be a loss for the class of savers*cum* investors. Other classes in society would also suffer from the instability of the measure of value embedded in the currency. "Rising prices and falling prices each have their characteristic disadvantage." In sum, "inflation is unjust and deflation inexpedient". (*A Tract on Monetary Reform,* page 36)

The quantity theory of money

To explain the effect on domestic prices and foreign exchanges of the gyrations of paper currencies he used the quantity theory of money, after adapting it "to the existing regime of mutually inconvertible paper standards". The quantity theory! One could not be more classical than that! Of course, he later repudiated this quantity theory in his anti-classical *General Theory*.

The formulation of the quantity theory that Keynes used in the *Tract* is fundamentally the one monetarists still use today. It connects the price level p of the economy with the supply of money, n. Prices move in harmony or conjunction with the quantity of money, rising and falling with it *in the long run*. In one of his most famous phrases, Keynes said that "*in the long run* we are all dead". What he meant here is that he rather wanted to study the connection between money and prices in the short run. The phrase still resonates because, though he wrote this phrase in the context of monetary policy, it is not unfair to take it as an expression of his philosophy of life.

In the *Tract*, the relation between the quantity of money and the price level was disturbed by two variables: k, the cash balance that families and firms choose to keep as a proportion of their total assets; and r, the proportion that commercial banks keep of their liabilities k' to their depositors. Thus:

$n = p\ (k + rk')$

So, in a boom, the relation between the quantity of money n and the price level p also depended on the expectations of ordinary people, whose high hopes in a boom led them to keep a lower cash balance than usual, and on the corresponding optimism of deposit banks, little worried by the possibility of their clients running to withdraw their deposits in a panic—and vice versa in a slump. Monetary authorities had an instrument to counteract these reactions. The Bank of England, by increasing or reducing the bank rate, could cool the optimism or counteract the pessimism that reduced or increased the amount of money in circulation and its initial effect on prices.

Purchasing power parity

All this is in a closed economy. In a world of many paper currencies, the effect of monetary expansions and contractions was not reduced to the domestic price level. The policies of the different central banks affected the exchange rates. At this point Keynes introduced **Gustav Cassel's** theory of purchasing power parity into the quantity theory.

In equilibrium the rate at which two currencies are exchanged must be the ratio of the purchasing power of each within its own monetary zone, or the ratio of their inflation rates.

This would be so because if one could buy more with one's currency in a foreign market than in one's own, one would find it advantageous to import the cheaper goods—and vice versa. This theory, says Keynes, is subject to a number of complications that make it ill advised to rely wholly on comparing relative purchasing powers to predict exchange rates: the existence of transport charges, of import and export taxes, of goods and services not entering international trade; seasonal influences, changes in interest rates due to sudden capital movements, and especially the anticipation of all those movements by firms and speculators reflected in spot and forward markets—all these circumstances made the reliance on equilibrium exchange rates dangerous in the short run. Keynes, who speculated in currencies for the government during WWI and later on his own account, had in one instance to be rescued by his moneyed friends.

Two kinds of monetary policy

On the strength of the quantity theory and the purchasing power parity theory, Keynes debated three practical questions concerning a system of inconvertible paper currency: (1) Deflation *versus* devaluation; (2) Stability of prices *versus* stability of the exchange; (3) The restoration of a gold standard.

When he spoke of the need to choose between deflation and devaluation, Keynes was referring to either depressing the domestic price level by a return to gold at the high pre-war parity or accepting the devalued parity set by the inflation level during WWI. A return to the pre-war parity would be destabilizing and painful.

He then generalized this dilemma deciding in favor of monetary policy: what today we would call domestic inflation targeting and what comes under the name of currency board arrangements. Under the first dispensation, domestic prices are kept stable and the exchange rate fluctuates; under the second, the exchange between the pound and the dollar, say, is fixed and domestic prices in Britain must vary to adapt to that exchange rate. Keynes preferred the policy of stabilizing the domestic price level and the domestic economy as much as possible and letting the exchange rate fluctuate.

The barbarous relic

A revealing phrase can be found at the beginning of Keynes's text: "money is simply that which the State declares from time to time to be a good legal discharge of money contracts". Since money is what the state *says* is the legal tender, then the state has a new instrument of taxation: to wit, inflation or "taxation by currency depreciation". Two driving forces favored this hidden tax: "the impecuniosity of governments and the superior political influence of the debtor class". Public profligacy and democratic imposition would tend to continuous depreciation of the currency legally defined as the measure of value. This for me leads one to conclude that the monetary authorities or the state should on no account be trusted with the management of money. Keynes's surprising conclusion was different: (a) that the standard of value should be governed by deliberate decision; (b) that it was possible to maintain a middle course between deflation and inflation; and reading between the lines (c) that a knowledgeable public servant could always be found who would manage money in the best national interest—possibly Keynes himself.

Keynes's preference for a stable domestic price level in contrast with a fixed exchange rate is a clear signal that he would not favor Britain's return to the gold standard in 1925—and at the pre-war parity to boot! For him, the only possible reason to worship that "the barbarous relic" was that monetary authorities were currently showing dreadful irresponsibility in the management of their inconvertible moneys.

It is natural, after what we have experienced that prudent people should desiderate a standard of value which is independent of finance ministers and state banks [...]; in fact, a chief object of stabilising the exchanges is to strap down ministers of finance. (pages 135-136)**3**

For more on these topics, see the EconTalk podcast episodes**Wapshott on Keynes and Hayek**, **Larry White on the Clash of Economic Ideas**, and**Rustici on Smoot-Hawley and the Great Depression**. See also**"Gold Is Money, in Spite of Mr. Keynes,"** by Pedro Schwartz, May 6, 2013 and **"The Economy: Metaphors We (Shouldn't) Live By,"** by Max Borders, August 1, 2011, Library of Economics and Liberty.

The argument for linking the measure of value to some fixed standard has not lost its attraction even today. Despite this, however, Keynes thought that we should prefer a managed inconvertible national currency. Not that today's central banks are doing a very good job... **4**

The General Theory

We now can compare Keynes's mainstream ideas in the *Tract* with the path-breaking concepts of the *General Theory.* In the *Tract,*monetary authorities were exclusively charged with the task of steadying the value of money, either domestically or internationally. In the *General Theory*, by contrast, the task of the authorities was different and much wider. The economic market was portrayed as full of blemishes and defects, which could not be cured or alleviated by mere monetary measures. In fact in this book he showed little faith in monetary policy. The only hope for preserving the free market in acceptable order was to have the government intervene continuously to maintain effective demand and compensate the shortcomings of private investment.**5**

The leading ideas of this book are: the first, that he presents aggregate demand as the engine of growth instead of productive investment as the classical economists would. The second is that he introduces expectations as a fundamental modifying element in the functioning of the economy. The third is that he suggests that money has very little to do with inflation.

See **Jean Baptiste Say** in the*Concise Encyclopedia of Economics.*

Say's Law, which holds that supply always find its demand, was the bugbear of Keynes. The classicists founded on it their belief that full employment was the natural state of a free economy and there could be no involuntary unemployment in a competitive labor market, barring the frictional unemployment of people changing jobs. On the contrary, for Keynes, the engine of growth was aggregate demand (the sum of consumption and new investment): and the normal situation of a free economy was one where that aggregate demand was insufficient to guarantee the full employment of resources. This shortcoming was due to the tendency of consumption always to lag behind income, leading to excessive saving; and investment depending capriciously on the animal spirits of entrepreneurs. It was necessary for the state to use those excessive savings to top up flagging investment. *Laissez-faire*was not the best policy.6

One of Keynes's best contributions to economics was the importance he lent to expectations. He conceived them as the principal cause of the unreliability of private investment decisions. But he thus reduced them to playing the role of a wild card that increases uncertainty, it was an idea on which much later theory was built.

As regards the connection of money with inflation, Keynes hopelessly watered down the quantity theory he had explained in 1925. In the*Tract*, velocity being constant, an increase in the money supply would result in a proportional increase in prices. In chapter 21 of the *General Theory*, however, the quantity theory only held in a situation of full employment: if there were unemployed resources, there could be no inflation. An increase in the money supply did not cause an increase in prices when there was unemployment.7

The model

For Keynes,

... the outstanding feature of our experience [...] is that we oscillate, avoiding the gravest extremes of fluctuation in employment and in prices in both directions, round an intermediate position appreciably below full employment and appreciably above the minimum employment a decline below which would endanger life. (*General Theory on Employment, Interest and Money,* Volume VII, page 254)

It will surprise my readers that to analyze the travails of capitalism, Keynes uses a model where the economy oscillates around a secular trend of underemployment. The profession may not have a fully convincing explanation of the economic cycle and the possible causes of depression and recession. But surely a model announced with such fanfare should have attempted something better than representing the evolution of the capitalist economy as an anemic lurch from deep unemployment to mild underemployment and back again—this when the world was going through the Great Depression of the 1930s. A damp squib?

The two objective variables the model tries to explain are the volume of employment and the growth of national income. Left to its own devices, the economy will lead a bloodless life due to four*psychological* laws: (a) the law relating consumption to income, whereby individuals will expand their current consumption when their employment and their income increase, but in a lesser proportion; (b) the inclination of employees to bargain to keep their relative wages stable; (c) the faltering inducement to invest as capital grows because it makes the expected return to capital diminish; and the unsteady path investment follows as partly guided by uneven obsolescence; 8and (d) the inflexibility downwards of the rate of interest when bond holders feel the bank rate cannot be lowered any more.

These psychological laws save the model from exploding or imploding and keep it on its listless sleepwalking path. When people refrain from consuming the whole of their income and save an excessive part of it, they dampen the rate of growth of the economy.9 When employees only struggle to maintain their current wage relative to that of their mates, rather than asking for higher real wages, they help keep costs within reasonable limits. The marginal cost of capital sets a limit upwards and downwards to private investment. And the liquidity trap reduces the effectiveness of injections of money to fight a slump.

This all means that the economy, if faithfully described by this model, will show a perpetual tendency to underemployment equilibrium, a sad state that the market cannot correct of its own. There is a need for a*deus ex machina* in the form of public investment, especially since private industry cannot be relied upon to pursue long term projects because entrepreneurs are subject to the vagaries of their "animal spirits".

I expect to see the State, which is in a position to calculate the marginal efficiency of capital-goods on long views and on the basis of the general social advantage, taking an ever greater responsibility for directly organising investment. (VII, chapter 12, page 164)

Critical remarks

Keynes's own macroeconomics have stood confuted now for a long time. **Milton Friedman** admired Keynes's way of doing economics because the simplicity of the assumptions and predictions made testing easier. And he tested! He was the first to show theoretically and statistically that consumption was a fixed proportion of permanent income.10 Friedman argued convincingly for the importance of money in macroeconomic theory, and for the explanation of inflation in practice.11 In *A Monetary History of the United States, 1867-1960*, written with Anna J. Schwartz, he gave weighty reasons for a monetary explanation of the *depth* of the Great Contraction of 1929-32 as he called it.12 The concurrence of unemployment and inflation after the oil crisis of the 1970s just killed Keynes's re-interpretation of the quantity theory in the *General Theory* to show that an increase in the money supply could not bring inflation while there was unemployment. There is no liquidity trap of the kind Keynes posited, and the changes in the velocity of money can be modelled in a more useful way by including financial wealth in the model.13

Modern growth theory has moved well beyond the marginal efficiency of capital, starting with **Roy Harrod** in 1939. We now know that unemployment is the consequence of expectations shaped by badly designed institutions, not the effect of a psychologically insufficient aggregate demand. More generally, one should criticize Keynes's excessive attention to purely nominal or monetary data—as if individuals did not after a pretty short time focus on deflated data to act as rationally as possible. Rational expectations are the basis of the 'Lucas critique,' 14 the most deadly of the arguments against Keynes's recommendations as to the conduct of economic policy: **Robert Lucas**showed that discretionary decisions by the authorities destabilize the policy framework, as other agents guess and discount changes of direction by those in charge. Governing by rules is best because it will stop us trying to outguess and force the hand of the crew in the cockpit.

This is not the moment to look at the modern 'new Keynesian' schools of macroeconomics that are so in fashion now. One of these schools we associate with the names of Clarida, Galí and Gertler.15 Their idea is that the monetary system does not work well in the short run, because of sticky prices and other external effects delay adjustments, but that this sluggishness can be used under the radar, so to speak, to slip by short term interventions in monetary markets. The other neo-Keynesian school is that represented by Paul Krugman and **Joseph Stiglitz**.**16** What they pick of Keynes's *General Theory* is the importance of maintaining aggregate demand in the economy, if necessary by an expansion of public expense financed by debt. At bottom, what unites all these neo-Keynesians is the belief that the free market will fail unless political authorities mend it and prop it up continuously.

Visions of capitalism

In a letter to **Friedrich Hayek** on reading *The Road to Serfdom*(1945), Keynes wrote the following revealing words:

I should say that what we want is not no planning, or even less planning. Indeed I should say that we almost certainly want more. But the planning should take place in a community in which as many people as possible, both leaders and followers, wholly share your own liberal moral position. Moderate planning will be safe if those carrying it out are rightly orientated in their own minds and hearts to the moral issue. (XXVII, page 387)

In a liberal society, the management of an economy could be placed in the hands of superior specialists. Keynes thought that the restraint and honorability of the servants of the state (of which he was a signal example) would endure when the limited powers of government of Victorian and Edwardian times would be hugely increased. He thus showed scant knowledge of human nature and politics.

His rejection of free markets went deeper than showing a soft spot for planning. He who had written about "the euthanasia of the rentier" paradoxically thought that a free society was one given to the enjoyment of accumulated wealth. In 1930 Keynes had written a revealing essay under the title "Economic Possibilities for Our Grandchildren". The central idea of this essay was that the advancement of science and the accumulation of capital promised a future of abundance when most of us would be free from the chore of long hours of work. The abundance of leisure would change our work ethic. "Of course there will still be many people with intense, unsatisfied purposiveness who will blindly pursue wealth." But the time will have come when we honor not them but those who live like "the lilies of the field who toil not, neither do they spin." Come that time and we shall

... dare to assess the money-motive at its true value. The love of money as a possession—as distinguished from the love of money as a means to the enjoyments and realities of life—will be recognised for what it is, a somewhat disgusting morbidity, one of those semi-criminal, semi-pathological propensities which one hands over with a shudder to the specialist in mental disease. (Vol. IX, page 239)

I cannot but conclude that the passage of Keynes through the firmament of political economy was baneful even to our own day.

Footnotes

1.

Robert Skidelsky discusses these points perceptively page 439 ff. of volume 2 of his biography of Keynes: *The Economist as Saviour*. MacMillan, 1992.

2.

I will be using the different volumes of *The Collected Writings of John Maynard Keynes* published by Macmillan St. Martin's Press for the Royal Economic Society. The dates in the text are those of the original publication of the works mentioned.

3.

This would lead him to write *The Economic Consequences of Mr. Churchill* (1925), after Churchill as Chancellor or Secretary of the Treasury led the return of the UK to gold.

4.

See for example George Selgin, William D. Lastrapes, and Lawrence H. White (2010): *Has the Fed Been a Failure?* CATO Working Paper. December 2014.

5.

Keynes's *General Theory* is an especially difficult book to follow. If you are tempted to read it, do not start at the beginning, with the confusing postulates of classical economics or the obscure measuring rod of 'wage units'. Start with chapter 3 on "Effective Demand", read the first three pages of chapter 5 on "Expectation as Determining Output and Employment," and then proceed straight to chapter 18, "The General Theory of Employment Restated." Finally, end with chapter 21, "The Theory of Prices" with its curious notation, where he restated and debunked the quantity theory that he had so confidently applied in the 1923 *Tract.*. If you think that Keynes was writing about the Great Depression be disabused by you see that he gave it a mere appendix titled "Notes on the Trade Cycle".

6.

In 1926 Keynes had published his controversial "The End of Laissez Faire". And in 1933 he reacted to the unemployment caused by the Great Depression in an article defending national self-sufficiency, where he wrote: "Let goods be home spun whenever it is reasonably and conveniently possible."

7.

The way Keynes explained this in chapter 21 was by making *effective demand* the transmission link between money supply and prices. If effective demand increased in the same proportion as money, then the quantity theory behaved as in the traditional equation: an increase in effective demand proportionate to the monetary injection would lead to the same increase in prices. However, there could be leaks in the pipes leading from money to prices. When the money supply expanded, if (a) people increased their demand for cash balances; if (b) the reward of labor rose due to when more money led to increased employment; and if (c) the marginal productivity of physical capital fell when production grew, then the effect of money on prices was larger or smaller than proportional.

8.

See VII.16.iv, page 253, on what was later called the 'accelerator' principle.

9.

The effect of consumption by and individual on the income of those from which he purchases is known as the "multiplier" (see chapter 7) and *passim*. When private individuals save too much, says Keynes, national income and employment suffer. Fiscal expenditure can come to the rescue by filling the gap between income and private consumption. This is where the government can step in, says the Keynesian parable, by burying old bottles filled with bank notes in disused mines, to be retrieved by private initiative.

10.

Milton Friedman (1957): *Theory of the Consumption Function*. Princeton University Press.

11.

Milton Friedman (1956): *Studies in the Quantity Theory of Money.* Chicago University Press.

12.

Milton Friedman and Anna J. Schwartz (1963): *A Monetary History of the United States, 1867-1960*. Princeton University Press.

13.

Tim Congdon (2009): *Central Banking in a Free Society*. Edward Elgar.

14.

Robert E. Lucas: "Econometric Policy Evaluation: A Critique". Carnegie Rochester Conference Series on Public Policy, vol. 1, pages 19-46, 1976.

15.

Richard Clarida, Jordi Galí, and Mark Gertler (1999): "The Science of Monetary Policy: a New Keynesian Perspective". *Journal of Economic Literature*, volume 37, pages 1661-1707.

16.

Paul Krugman (2012): *End This Depression Now*. Norton. Joseph Stiglitz with Bruce Greenwald (2003): *Towards a New Paradigm in Monetary Economics*. Columbia University Press.

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