The Keynesians

(A letter from America to a friend)*

by PAOLO SYLOS LABINI

This time I am going to tell you something about the Keynesians. I have been in touch with many and diverse kinds of them, first in Chicago, and now here at Cambridge. By talking with them and listening to their lessons one gets a truer idea of their views than by reading their arguments summarised on the printed page.

Keynes's influence in America is great. An incredible number of Keynesian books and articles have been published here, some with titles perhaps hardly suited to the severity of scientific works. "The New Economics," "Economic Research and the Keynesian Revolution of Our Times," "The Keynesian Revolution"; and so forth.

In Chicago I became acquainted with the economists, among whom many are (or have been) Keynesians. For a long time Keynes's global quantities, the "liquidity preference" and the "propensities" have supplied the "data" or the "unknowable" for their mathematical exercises. They reached a point, as is known, when Keynes himself found them more than tiresome. The Keynesian zeal of some economists is still not as it was. One of them, and this struck me during a lecture on the blackboard, some little formulae to explain the relations, if I remember rightly, between money wages and employment. He had chalked a little dividing line between the blackboard in two: one side he had written "Pre-Keynes", on the other "Post-Keynes". Two eras, in short. In the first era, the professor explained, it was believed that there was an inverse relation between the two terms; in the second era it was realised that a change in wages cannot modify employment.

Utterly devastating, as you see, has been the Keynesian revolution, in which, as in the French Revolution, many worthy people have lost their heads.

* Translated from Italian by Olivia Rosetti Agresti.

The Keynesians have a right wing and a left wing; both alike insist on their orthodoxy and both alike make the Master say things of which he never even dreamt. Keynesianism is, in short, a full fledged philosophic school. Instead of theses and anti-theses there are the "propensities". "Liquidity preference" has replaced the idea.

The government departments at Washington are full of Keynesians of all tendencies. Their prescriptions vary with prevailing economic conditions (Keynes's system is wonderfully elastic); it is always easy to demonstrate that the conditions are those one wishes them to have.

Are the trade unions taking a threatening attitude and do wages rise? It is inevitable: Wage rises are advantageous. Keynes says so and so do the left wing Keynesians.

Does it seem possible to withstand the demands for wage rises? Other Keynesians (the right wing) pay up, writing other writings of the Master showing how such rises are an evil.

Is the budget deficit alarming and does the party in power need to fill its popularity? It is found that the marginal efficiency of capital is too low to attract savings to investments; it is necessary to tax the rich, whose propensity to save is dreadfully high. But may be the rich know their teeth: it is not advisable to attack them. It will then be discovered that the marginal efficiency of capital is high enough; there is no danger that money remains in the drawers; however taxation would be a serious mistake.

Then, there are the findings already accepted. The economic horizon darkens: is it a depression is sight? Well and good: the time has come for wilder finance (technically known as a "debt sinking")

"What should be financed? Public works, armaments, perhaps even social services. All of this course is garbed in dignified scientific terms and claims the respect of all, if it were not for the existence of disposable incomes and global savings, with calculations of the various "propensities" and multipliers".

A student of economics has even discussed in all seriousness how the multiplicity of armament expenditure and has written an impressive article bearing a title which might well intimate the incredulous.

One might say: but these are the usual aberrations of following, who traditionally, or by some law of nature, are always the worst enemies of the Masters. If we were Keynesians, we would say, could say: "We are on keyness, or par keyness?"

I am afraid he could not: there are of course the aberrations of his followers, but to a large extent they can be traced back directly to him.

Keynes takes no cognizance of the problem, on which good classical economists laid so much stress, of what is "productive" and what is "unproductive", i.e. what is "productive" and what is not. For him, the problem is as good as solved, since he means spreading the article on the multiplier of armament expenditure is an example of this aberration; and it is an aberration of a follower; it is one of the Masters.

All will be well, provided people spend; and should not keep their money in their drawers, then the government must do the spending. It does not much matter whether the money is spent on building a electric power station or on paying people to carry away from the Atlantic to the Pacific. A Keynesian (assistant professor of economics at Harvard), to whom I made this objection, answered me: "But, as we know, Keynes's theory only holds good for the short run; and in the short run investment expenditure has no effect on prices."

This famous "short run" is always brought forward by the followers of Keynes. "In the long run we are all dead". But before dying we shall be living a rather wretched life if we go on committing a series of "short run" follies.

Keynes ignores not only the problem of social productivity but also, and consistently, that of costs. The costs are high or low, that they be rising or falling, matters little to him. He thinks that, in the short run, technological changes can be quietly ignored; and he has no notion of the changes that these changes may account for many of those disequilibria that he tries to explain by "propensities" and "multipliers" and other economic gadgets.

We might well ask ourselves as a premise what we can make in the interpretation of economic reality, above all modern reality, of a "system" bound on such distortions.

But we are still outside the system. Let us enter it.

The point is to seize Keynes's line of thought, and then discuss it while respecting his premises. The line is not so easy one, for Keynes's ideas are so many.

I musted to the help of one of the most brilliant of the Keynesians here, Franco Modigliani, and I had with him several talks. I have been led to modify somewhat the picture I had in mind, but I have seen that it was substantially correct. When Modigliani had finished skitching the outline of the Keynesian edifice I raised my objections. To my opponent's honor I must say that he agreed that what seems to me to be the fundamental objection to the Keynesian system gave him pause for thought and made it necessary for him to re-examine his convictions.

The fundamental objection is this: Keynes has failed to understand the part played by the banks in modern life, and this failure undermines the whole construction of his logic.

Let me sum up the substance of my conversations with my Keynesian friend, for I should like to have your opinion on the matter.

Each person, says Keynes, may spend his money on consumption goods, or he may save it; if he saves it, he may invest or he may hoard it.

Men are disposed, as a rule and on the average, to increase their consumption as their income increases, not by as much as the increase in their income. The ratio between the increase in the consumption of a community and the increase of its income — the marginal propensity to consume — is less than unity. If the aggregate income grows, savings grow in actual figures and perhaps also proportionally. The richer, moreover, have a lower propensity to consume than the poorer. The more unequal the distribution of income, the lower the rate of savings, although perhaps one may or may not be invested.

A new expenditure on consumption goods increases aggregate income and employment; new individual savings increase both the one and the other only in so far as they are invested. Those who save are induced to lend only if they obtain an adequately high rate of interest. Interest is the price paid to induce savers to remit their liquid money. Now, who pays this interest? It is paid by the firms, whose demand for loans and whose investments vary according to the more or less high marginal efficiency of capital (or, as Lerner corrects, of investments, be it according to another or the only in the fund should not be confused with a flow).

And here I come to the core of the argument.

If the marginal efficiency of capital falls, the total investment declines. Effective demand (whether in terms of outlays for consumption or of those for investments) falls below the level ensuring full employment, and therefore the social income shrinks. Under these conditions Keynes says, the automatic mechanism assures the return of full employment and raises again the income. The decline in the rate of interest, which according to the "classics" might establish the balance, does not do so. The fact that interest depends on "liquidity preference", which, for various reasons, increases, or does not decrease; and as money cannot be produced by the individuals, the price of money, i.e. the rate of interest, increases, or
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This reasoning is based on the assumption that the volume of money is constant. This assumption, Keynes says, is legitimate because, in the case of a gold-standard currency, metallic money can be produced by private enterprise in gold-mining countries in a manner which, for the world as a whole, is negligible; in the case of an inconvertible managed currency, paper money can be produced only by the monetary authority, that is to say by the central bank, and the ability of the private enterprise. Should the liquidity preference grow, and with it the rate of interest, the production of money cannot increase, as, for instance, the output of motor cars can increase.

Here is the fallacy. The "production" of means of payment, in the modern economic process, did not and does not depend, substantially, on the miners or, respectively, on the monetary authority; it did and does depend on the banks (and among them there is the central bank) and on the private enterprise, that is to say from the firms. It is not true that the firms cannot "produce" money: they can and do produce it; not directly, but through the banks, which in turn are themselves firms. This means that the banks, continuing, create means of payment by non-banking firms (we do not say that they "create credit," as expression which has given rise to so many misunderstandings), and these means of payment have been used by others. But how do the banks continue, and how do they do it? They do it by the means of payment they themselves create: the banks create the means of payment, and it is not true that the firms cannot "produce" money.

My Keynesian friend replies, and then says that my objection might be valid in the case of circulating capital, which is financed by bank loans; but not in that of fixed capital, which is financed by shares and debentures. These are purchased by individual investors; and here we are forced to take into account their preferences and propensities.

This line of defense cannot hold. A set distinction between the two types of capital, in a purely theoretical way, is well known. Firms often finance long-term investments with short-term bank loans, which they renew several times. The short-term share and debenture are worth more than those of a first stage, summarized, at least in the form of a bank, by the banks, directly or indirectly, by loans made to brokers.

And here the discussion widens. Why did Keynes's ideas become so popular? In the 1950s, during the the Agnelli, the Agnelli, the Agnelli used to be rich, but in our century they are applauded. Frank Knight says jokingly, and this explains the success achieved by Keynes. Undoubtedly, in his General Theory, Keynes endeavours by all means to be taken for a heretic and expresses his lively sympathy for heroes of all kinds.

Joseph Schumpeter attributes the popularity of Keynes to his "ideology," which he considers substantially as a political ideology of radical type. For my part I am inclined to accept this point of view: for one reason or another it is the political conclusions of Keynes, rather than his line of argument, that please.

So many people, all with us, in Italy, desire to be Keynesians, not because they really approve (or know) the questions of "theoretical" economics, like, but because they see in Keynes's ideas the justification of an "investment policy." The more expression exercises today a strong attraction; it alone confers on those who use it a "rally up-to-date" tone.

We may ask: do we really need Keynes in order to justify such a policy? Would it not be better for those who advocate it, to study closely the specific investments it might be advisable to encourage, rather than to descend on disputable "propensities" and problematic "multipliers"?

But, one may object, if we give up Keynes we fall into the trap of "laissez faire," which we believe in "laissez faire." This is a distortion. An analysis that claims to be scientific is neither for "laissez faire" nor for any other type of economic policy. If many economists, after making their analysis, go out the experience of hypothetical economic policies, that is something additional that has nothing to do with the analysis. The distortion consists in believing that the accept or rejection of the additional conclusions implies the accept or rejection of the whole; while the experience of real economic policies is one and the same thing. If there is any hope that measures may be or may become a corpus of scientific doctrines, then the only test of reasoning intended to interpret economic life and to make it comprehensible, then we must have the courage to free ourselves of political sophistry. It is not a question of renouncing our political or ideal preferences—this is impossible—but of being honest with ourselves and always faithful to see if we accept a given line of argument because the political conclusions please us, or because we must really consider it to be logically correct. If we accept or present a certain argument for political reasons, we should say so clearly, and not play the ignoble comedy of science.

They say: to Keynes belongs the credit of having stimulated the study of "macroeconomics," the study of the relations existing between global quantities, the study of the national income, investments, savings; and of having suggested new conceptual instruments, foremost among which the "propensity to consume." But, when we want to see deeply into things, the movements of these global quantities, of these "big boxes," can tell us very little; they often muddle things up instead of clarifying them. This mode of considering economic problems (here it is called the "aggregative approach") is found again in those studies of "dynamic macroeconomics," of which the so-called "dynamic schema" or "models" are conspicuous examples. It is claimed that through these "models," describing as a system of equations and reactions of a certain number of big boxes (actions and reactions duly separated by "lags") the business cycle can be explained. At the economic meeting held in Dublin, the "new-Keynesian" view has been applied to the now-a-days, with these "models," every economist is able to produce any kind of cycle. "Give him a couple of lags and initial conditions and he will conjure up phenomena which apparently regular, damped, or explosive oscillations, or exponential movements up or down, as desired. However, the more models we have, the less we seem to know of the real business cycle.

As to the "propensity to consume," substantially it is connected with a notion already known: the income elasticity of demand. The novelty consists in applying this notion (which, like the price elasticity of demand, is difficult to get a hold of individual goods) to a huge box: the total expenditure of the community on consumption goods. Should we be pleased with such a novelty? I fear not. The new notion is one which apparently simplifies the reasoning but in reality it reduces them to empty exercises. To convince oneself of this, one need only examine the results of the statistical studies dealing with the analysis of the price of goods and the changes of the "propensity to consume": the "theoretical" uniformity or uniformities appear to be mere illusions.

Theories enter into cyclical movements based on the propensity to consume, or, as is now commonly said, on "consumption function," which was fashionable during and immediately after the last war, are now discarded even in this country, especially after the failure of the forecasts—which several Keynesians expressed by extrapolating "disposable incomes,"
The growing power of the labour organisations makes it more and more difficult for private enterprise to compete with them. This transformation of the economic system into one of different kind (which may be described as a socialistic economy) would seem to be inevitable. It would be technically and commercially possible, but the reaction of mental sluggishness is not generally understood or recognised. The explanation may perhaps be, that the Marxians, captivated by the theory of the progressive improvement of the working classes, could not at least could not attribute due importance to the growing power (both economic and political) of the workers organisations. And it was difficult for the orthodox economists to admit it; in any case they preferred to lecture the working classes on the need of allowing the system to work. Then came Keynes, who gave de jure recognition to the power of the labour organisations. It is not expedient to reduce wages during depressions, he said; and even if we reduced the wage, he added with inviolate irony, it should not be possible. Full employment is not assured by the automatic working of the economic system; it must be assured by the government; and if, to do so, it should be necessary to tax the higher bracket incomes, so much the better: it is there where the danger of hoarded savings is greatest. Such is the substance, is Keynes's message. But we may well ask if this is indeed so or if it is not rather the formulation, in more or less rational terms, of a reality that is imposing itself and would be any case have forced itself on the attention of all. We may ask whether Keynes's message has helped to clarify people's ideas, or has not rather helped to muddle them. (But, let us say it to our credit, at least with us, in Italy, the vie confusionali of Keynes has been denounced in time by scholars who know something about economics.)

... ...

The left wing Keynesians try to make the impossibly match between Marx and Keynes.

Those of the right wing see the message in Keynes a means for saving the tottering capitalist system. Some do not admit this others like the incomparable Seymour Harris, openly say: Yet others with naive Machiavelism, go so far as to say: 'Well, maybe the Keynesian policy is the right policy; but better Keynes than Marx; better government intervention, in the long run.' These are the right wing: perhaps they are still not many among them: but without realising it and without meaning anything, by the transformation of the economic system founded on private enterprise into a different system, a different society, at whose character we can only make very uncertain guesses.

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