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## Article

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## Contextualising Keynes's Revolution. Review of Michael S. Lawlor's ›The Economics of Keynes in Historical Context‹

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As befits the Post-Keynesian perspective of this forum, the books being reviewed here are related to time: Lawlor (2006) deals with antecedents of Keynes's *General Theory*; Tily (2007) mainly with what happened to it afterwards.<sup>1</sup> Michael Lawlor has done us an important service, in bringing together in one place the fruit of many years' work on the origin and evolution of Keynes's ideas. These ideas are organised into three areas: (1) the economics of employment, (2) speculation (including new work on institutional features: Marshall on the representative firm and joint stock ownership), and (3) ›the shifting equilibrium of a monetary economy‹. The latter category encompasses (a) the theory of money and interest, (b) Sraffa and Hayek on own rates of interest and (c) the essential properties of money. Marshall plays a key role in the story, as is right. Other key figures include Pigou, Hawtrey, and Robertson.

In contrast to Laidler (1999), which gives the impression of seeking to undermine the originality of Keynes by finding antecedents for the key ideas, Lawlor takes an evolutionary approach, showing what ideas were around and how they impinged on Keynes's thinking, which was always developing and changing. A good example of this approach is Lawlor's 1997 account of Keynes's views on speculation and financial investment, reprised in this volume. Keynes at first sees speculation as a benign influence, part of the smooth operation of markets, as Marshall and his precursor Emery thought. He then learned from his own experience as a speculator and bursar and from the events of 1929: in the *General Theory* he stressed the disruptive influence speculation could have.

Each of the areas covered is full of insights, but there is far too much to cover in a short review. I have chosen therefore to concentrate on the major subject which Lawlor is tackling afresh here: the theory of employment (Chs. 2–5). In choosing to do this I am in no way downgrading the importance of bringing so much of his earlier, important work together under the same covers, for Lawlor has cast the work to show its coherence, and the synergy works beautifully. The book is a great pleasure to read.

But I cannot forgo a comment on the introductory Ch. 1, which is also new. This chapter situates this book in the context of several other interpretations of Keynes. It outlines precisely where and why Lawlor agrees with or differs from each. This is a masterly treat-

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1 Michael S. Lawlor (2006): *The Economics of Keynes in Historical Context: An Intellectual History of the General Theory*, Basingstoke: Palgrave Macmillan, 357 pages, ISBN 0-333-97717-3. For Tily see the contribution by Jan Toporowski in this issue.

ment of a number of very complex debates, conducted in simple language, with a courtesy and even-handedness rare in this area. It is both exhilarating and insightful, worth reading as a survey, independently of its purpose in situating this book.

### *Employment and Wages*

Now to Chs. 2–5, which deal with the question of employment, unemployment and wages. Lawlor paints a picture of the transition from an outlook where unemployment plays almost no role in economics to its central role in the *General Theory*. In the days of Adam Smith the question instead was the appropriate management of the poor, and to a great extent that remained the outlook in the Victorian era. The Victorians thought of unemployment essentially as an individual moral problem (unemployment owing to laziness, the contrast between the deserving and undeserving poor, and so on).

Theoretical emphasis was on employment, not unemployment (and these are not complements unless the labour force is well defined). For Marshall, adverse labour-market conditions led to low wages, not unemployment. While Marshall contributed mightily to the development of a micro supply-and-demand approach to the employment question, Lawlor stresses his emphasis on social, institutional and legal factors. He saw poverty and poor education as root causes and social reforms as the solution. Sidgwick was his great influence here. At the level of theory, however, his approach followed the traditional focus on the individual. Marx is an exception both to the individualism and the moralising tone of this period: the reserve army is a collective ›need‹ of the ruling elite. Another was Hobson (1896), who blamed orthodox economics (Say's law) for ignoring unemployment and emphasised social causes rather than individual morality.

The theory of the just wage fits well with these Victorian conceptions. Keynes wrote of the tension between the just wage and the supply-and-demand approaches in this period:

»The truth is that we stand mid-way between two theories of economic society. The one theory maintains that wages should be fixed by reference to what is ›fair‹ and ›reasonable‹ as between classes. The other theory – the theory of the economic Juggernaut – is that wages should be settled by economic pressure, otherwise called ›hard facts‹ [...]. The gold standard, with its dependence on pure chance, its faith in ›automatic adjustments‹, and its general regardlessness of social detail, is an essential emblem and idol of those who sit in the top tier of the machine.« (CW IX: 223–4, quoted by Lawlor: 82–3. Punctuation as in CW.)

Marshall's investigations of actual manufacturing conditions led to his belief that high wages would improve efficiency (a precursor of efficiency wage theory). He campaigned for voluntary payments of higher wages. He recognised that if the marginal productivity of labour is raised by higher efficiency and that in turn is raised by higher wages, the labour market is indeterminate. Lawlor's tone leads us to infer that he welcomes Marshall's relaxed acknowledgement of this difficulty. We shall see that this inference is well founded.

Finally Lawlor comments that Marshall's emphasis on long-period normal positions has led to dead ends. He could have made much more of this point, as we shall see.

In the transition from Marshall to Keynes, Lawlor contrasts the methods of two other followers of Marshall, Pigou and Dobb. Dobb maintained the qualifications and complications that Marshall used to flesh out the dry bones of supply and demand. Pigou did not, and he comes to represent 'mechanical Marshallianism'. Pigou in 1913 has the idea of involuntary unemployment and 'an inkling' of demand-deficient unemployment. But in Pigou 1933, unemployment is identified with disequilibrium caused by rigid wages, the only possibility of 'dry bones', supply-and-demand, partial equilibrium analysis. The interesting question of whether it is the 'dry bones' or partial equilibrium that is responsible for this misleading conclusion is not raised explicitly, though the following suggests Lawlor would place the blame on the dry bones.

Keynes is portrayed as embracing supply and demand, qualified as by Marshall, but in the 1920s the 'facts'<sup>2</sup> led him to doubt the rigid wage explanation of Pigou. Keynes rejects the idea of a self-adjusting mechanism preserving full employment. According to Lawlor (89; his emphasis), Keynes moved away from individualistic analysis and also away from a deterministic relation (Lawlor says *any* relation) between employment and the real wage as early as 1930:

»[Keynes's] earlier position is a much stronger rejection of classical reasoning than was finally presented in the *General Theory*. For instance, recall his 1931 [*sic*] pronouncement (CW 13, p. 180)<sup>3</sup>: 'Real wages seem to me to come in as a by-product of the remedies which we adopt to restore equilibrium [...] Employment is not a function of real wages in the sense that [a] given degree of employment requires a determinate level of real wages, irrespective of how the employment is brought about.' Compare this to the following from Chapter 3 of the *General Theory* (GT, p. 30, emphasis added): 'The propensity to consume and the rate of new investment determine between them the volume of employment, and the volume of employment is *uniquely related* to a given level of real wages – not the other way around [*sic*].' «

Lawlor maintains that by comparison with this first quotation, the statement in the *General Theory* is retrograde (Lawlor: 89). Although he distinguishes between a causal relationship between employment and real wages and a correlation (90), he then seems to forget this distinction, arguing that any determinate relation, even a correlation, made Keynes's argument unnecessarily difficult<sup>4</sup> and is empirically doubtful. In the latter connection he cites Dunlop and Tarshis (see CWVII, Appendix 2, and references therein), failing, as so many

2 These are Lawlor's single quotation marks. Why does he use them here? Are these facts particularly contentious? I should have thought not.

3 Memorandum to the Committee of Economists of the Economic Advisory Council, September 1930.

4 This conclusion may be related to Lawlor's finding the definition of involuntary unemployment, and Ch. 2 in general, is difficult. I do not share his difficulty. See Chick (1983: Ch. 7; and 2006).

do, to recognise that they dealt with the relation between money wages and real wages, not real wages and employment, and in the case of Dunlop covered a period (1860–1937) which cannot possibly be construed as conforming to the assumption on which the relationship is based, namely, the short period.

While Lawlor would be happiest with indeterminacy, my own view is that, although the Marshallian qualifications are important, economic theory needs definite results. To get them, simplifying assumptions are made which are not always met in the real world. Qualifications are bound to arise from the relaxation of assumptions needed to move from theoretical results to real-world application. On that I am in perfect agreement. But Lawlor's evaluation of Keynes's 1930 statement seems to imply that he favours indeterminacy at the *theoretical* level. Here we disagree. For this reason I find his discussion of Keynes's antecedents more valuable than his interpretation of Ch. 2 itself.

But there is something else in Marshall, at the level of pure theory, that no-one ever seems to mention (I have just done so in Chick 2006): the concept of the derived demand for labour. Surely, what Keynes did with the principle of effective demand was to generalise this idea to the macroeconomic level. To me the influence of Marshall on Keynes's theory of employment is as simple – and as profound – as that.

### *Keynes and Pigou*

The other aspect of Lawlor's approach to the *General Theory* Ch. 2 (and Ch. 19) concerns Keynes's adverse evaluation of Pigou (1933). Lawlor accepts the traditional story, that Keynes was 'irked' by Pigou and set out to 'crucify' and 'excoriate'<sup>5</sup> his theory, and that the *General Theory* was distorted thereby.

Michael Ambrosi, in his *Keynes, Pigou and the Cambridge Keynesians* (2003), explains the 'irritation' as based in a massive provocation by Pigou (see pp. 30–1 for an extraordinary story). One could argue that it would have been better for Keynes to have answered Pigou in articles or a short book and leave him alone in the *General Theory*, but the need to answer him is obvious, once you know the context of Pigou's remarks.

Ambrosi puts the main burden of the dispute between Keynes and Pigou in a different place from Lawlor's, and his answer lies at a different level. There is every chance that they may be complementary. It was characteristic of Keynes that he took some things from others and left other aspects of their analysis aside; Fitzgibbons's book *Keynes's Vision* (1988) illustrates this many times over. Ambrosi deals with the part of Marshall that Keynes rejects. He starts by challenging the widespread view of Marshall as the champion of partial equilibrium analysis. He cites the importance Marshall attached to 'Note XXI' at the back of the *Principles* (Ambrosi 2003: 73–8). Note XXI outlines the rules of what Ambrosi calls general equilibrium analysis; I would prefer to call it systemic analysis, to avoid the obvious confusion. In a systemic framework, the real wage is endogenous. It is impossible to analyse employment within the confines of the labour market alone. The real wage cannot be set

5 The words in inverted commas are Lawlor's.

by wage policy, and employment cannot be determined without reference to effective or aggregate demand.<sup>6</sup> The *General Theory* is systemic analysis.

Pigou analyses short-period employment against the background of a stationary state. For capital to be fixed means, to Pigou, that there can be no net investment or saving. In Keynes's short period, by contrast, investment is positive but does not yet affect supply conditions, e.g. it is not yet installed or ›run in‹. In his draft comment on Pigou (CW XIV: 238)

»There also seems to be a confusion between a ›short period‹ during which finished capital equipment is assumed to be constant, and a ›short period‹ during which no new capital goods are allowed to be in course of production. The former ›short period‹ merges into the long period and the changes of the real world; but the latter relates to a frozen land remote in all its characteristics from all experience.« (CW XIV: 238)

This paragraph, with its rhetorically useful phrase ›frozen land‹, was suppressed (at the urging of Kahn!, see CW XIV: 260) in Keynes's published note (1937, CW XIV: 262–5), and so the debate between Keynes and Pigou about the methodological framework of economics was never joined. This important methodological issue is not dealt with in Lawlor's book, yet Keynes rejected Marshall's use of the stationary state as a reference point just as he rejected it in Pigou. The demand for labour is not derived from ›long-period normal‹ output but in the short period, in the here and now, with the capital on hand, even while new capital is being produced.

### *In Conclusion*

I have a few bones to pick in conclusion. One concerns Lawlor's interpretation of a most fascinating early piece (Keynes 1913, CW XIII: 2–14), in which the role of bank lending in allowing investment to exceed saving is explicit. There is a certain ambiguity of expression which could give the impression that Keynes sees banks as ›lending on‹ funds deposited with them, and in a footnote (231, n. 11) Lawlor wonders whether Keynes understood the credit multiplier at this time. To my knowledge there is no compelling evidence against this supposition in Keynes's own words, but the following evidence should allay Lawlor's fears.

We know that Marshall devised an elementary credit multiplier by 1877 (Humphrey 1987) and that he used a version in his evidence to the Gold and Silver Commission (1887–8) (Marshall 1926). Keynes attended Marshall's lectures in 1906 (Keynes's obituary of Marshall, Keynes 1924 and CW X). In the reading lists attached to Keynes's lectures for 1910/11–1912/13 (CW XII: 725–6) we find Marshall's contribution to the Gold and Silver Commission (1887–88), Fisher (1911) and Withers (1907). All these authors understood the ability of banks to

6 The fact that price is endogenous, but determined in the market for goods not labour, is important in understanding why Keynes gave such a convoluted definition of involuntary employment: a rise in price signals a rise in the demand for goods. And the money wage is set by bargaining, an activity that is ›off stage‹.

create money multiplicatively. If Keynes had disagreed, it is unlikely that these works would have been recommended reading (see also Tily 2007: 41–4.)

Although in Keynes's assessment of Marshall's key achievements he does not mention the credit multiplier, and he does not mention it in his review of Fisher (1911) either (CW XI: 375–81), my interpretation of these omissions is that the credit multiplier was widely understood in academic circles at the time and was taken for granted (see Chick 2005). Given Keynes's lifelong concern with how to manage a credit-money economy, it seems wildly unlikely that he did not understand the credit multiplier.

Secondly, Lawlor (87) refers to »drastic deflationary policy, like that enacted in 1925 by Churchill's Exchequer«. Such policies had been in place from 1921, in preparation for the return to gold. The actual return to gold forced their continuation, but deflationary monetary policy did not wait for the return to gold – or for Churchill.

Finally, the book has not been as well proofread as one would hope. In particular, quotations have not been faithfully reproduced. American spelling, punctuation and even a turn of phrase (»the other way around« instead of »round«) have been imposed on English authors and words and in at least one case an ellipsis have been omitted. Quotations in this book should not be taken as accurate and re-quoted without checking with the original source or a more reliable secondary source such as the *Collected Writings*.

But these are small bones, even though the last one is very inconvenient. The book is an exciting read, a great achievement and a goldmine for Keynes scholars to dig in. Pity the poor »mainstream« economists who think it has nothing to offer them – what riches they are missing!

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