

Keynes's Monetary Theory: A Different Interpretation

Allan H. Meltzer

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In this controversial book, Meltzer contends that Keynes's central message has been misunderstood. According to Meltzer, that message as contained in the *General Theory* was most definitely *not* the notion of the spending multiplier or the theory of effective demand according to which output rather than prices adjusts to equilibrate aggregate demand and supply. Nor was it the notion of an economy caught in a liquidity trap, or of the interest inelasticity of investment, or of the downward rigidity of money wages, or of deficient aggregate demand as the cause of unemployment, or of fluctuating investment as the source of business cycles, or of irrational expectations, or of public works as a remedy for unemployment. Rather Keynes's central message was that excess uncertainty is the root cause of suboptimum levels of output and employment and that the eradication of such uncertainty is the first duty of the state.

Meltzer argues that Keynes supported this proposition by tracing a chain of causation running from volatile expectations to uncertainty to money demand to interest rates, and thence to investment, the capital stock, and real output. Volatile expectations of future prices and market conditions increase uncertainty and raise default risks. With default risks up, investors shift from holding claims to real capital to holding cash. The resulting increased demand for real cash balances bids up interest rates sufficiently to incorporate a risk premium that compensates lenders for bearing default risks. Augmented by risk premia, higher interest rates inhibit investment, thus causing the capital stock to be too low to produce the full employment level of output.

What is needed is something to reduce the excess uncertainty that holds output and employment below their maximum equilibrium levels. To Keynes, as Meltzer sees him, that something was the state. As director of investment, the state could stabilize investment spending, thereby eradicating a key source of variability and uncertainty. Moreover, the state, by effectively combining the investment-financing functions of lending and borrowing, could avoid default risks that arise when those functions are performed by separate individuals. In these ways the state would act to eliminate avoidable uncertainty and default risks. The result would be to remove the wedge between private and social costs of capital so that the capital stock could attain its optimum (saturation) level at which its marginal efficiency is zero.

Meltzer generally sympathizes with Keynes's message except for the proposition that the state direct investment. In this connection, he points out that state direction of investment in many countries has been disastrous, with projects bearing effective yields of zero or less often favored over projects with high potential yields. To be sure, Keynes advocated carrying investment to the saturation point of zero returns. But he wanted

the state to do it efficiently by systematically exhausting all higher-yielding projects before moving successively to lower-yielding ones. Believing as he did in a state run by an intellectual elite of dedicated, disinterested civil servants capable of making wise investment decisions, he did not foresee how partisan politics and bureaucratic rent seeking, favoritism, and corruption could produce the opposite result.

Meltzer's interpretation, despite its superficial plausibility, seems fundamentally wrong to me. For one thing, it attributes to Keynes the theory that equilibrium levels of output and employment are too low because the capital stock is too small, i.e., below its saturation level. In fact, however, Keynes himself believed that low levels of output and employment were caused by the capital stock being too large. Writing at a time when the economy was plagued by idle capacity, Keynes held that the capital stock exerted a negative influence on real activity via its depressing effect on rates of return and the inducement to invest. In ignoring this point and arguing that Keynes believed the existing capital stock was too small to absorb the labor force, Meltzer comes close to attributing to Keynes a Marxian theory of unemployment. Such a theory is more applicable to underdeveloped capital-poor economies than to the mature capitalistic economy described by Keynes. What Meltzer overlooks is that Keynes was less concerned with the long-run process of capital expansion than with the short-run determination of the equilibrium level of output by effective demand under the assumption of a fixed capital stock. Meltzer confounds Keynes's basic short-run analysis with longer-run growth considerations that were only of incidental interest to him.

Meltzer also probably overstates the role of uncertainty in Keynes's analysis. As Don Patinkin points out, Keynes never referred explicitly to such uncertainty in the crucial summary chapters 3 and 18 of the *General Theory*. Thus, although he was not primarily interested in the long-run growth process, he would have denied that uncertainty per se was the predominant factor inhibiting that process. Rather he would have seen deficient effective demand and its painful impact on real activity as the dominant influence. That is, he would have contended that the occasional appearance of mass unemployment interferes with the growth process, thereby retarding long-term capital formation.

One can also question whether state direction of investment was of major concern to Keynes. Patinkin, for one, argues that it was not. Another thing that seems wrong is the Meltzer-Keynes notion that default risks are somehow eliminated by combining the functions of borrowing and lending in the hands of the state. Investments can go bad for the state as well as for private individuals. And when they do, someone—taxpayer or private lender—has to suffer the loss. Combining the finance functions in the hands of the state does not reduce default risks. It merely shifts them from lenders to taxpayers.

Meltzer is hardly on safer grounds when he distinguishes his version of Keynes from the stereotypical caricature of the textbooks. For in some

respects, at least, the simplified textbook model fairly accurately captures many of the essentials of Keynes's own views. Indeed Keynes virtually admitted as much in a 1937 letter to J. R. Hicks, agreeing with the latter's IS-LM interpretation of the *General Theory*—the same interpretation enshrined in textbooks today. Be that as it may, Meltzer argues that Keynes, contrary to the impression conveyed by his celebrated remark that in the long run we are all dead, invariably took the long view over the short. Consequently, he emerges from the pages of Meltzer's book more a monetarist than a Keynesian.

Meltzer has it that the Keynes of the textbooks sought first and foremost to eliminate cyclical depressions. Accordingly the textbook Keynes adhered to such notions as activist countercyclical policy and discretionary fine-tuning. He also believed in the existence of inflation-unemployment tradeoffs, cost-push inflation, and downwardly rigid money wages. By contrast, in Meltzer's interpretation Keynes was less concerned with smoothing the business cycle than with raising permanently the long-run equilibrium level of output. To that end he opposed countercyclical policies to change interest rates in favor of policies designed to maintain low interest rates so as to promote capital saturation. Meltzer's Keynes wished above all to eliminate excess uncertainty and variability including that arising from policy shocks and surprises. Therefore, he sought to limit activist fine-tuning and discretionary intervention with well-defined policy rules. No believer in money illusion or the power of nominal economic variables permanently to influence real ones, he denied the existence of long-run inflation-unemployment tradeoffs and asserted the validity of the classical neutrality proposition. Likewise he denied that inflation stems from the exercise of monopoly market power by trade unions and business firms. Instead, he assumed that labor and product markets are perfectly competitive and that inflation is a monetary phenomenon. As for his alleged belief in the absolute downward rigidity of money wages, Meltzer's Keynes argued that money wages, in fact, possess some downward flexibility but that their reduction cannot be depended on to raise the level of employment.

One can be skeptical of Meltzer's characterization of Keynes. But one cannot deny that his book is a cornucopia of fascinating information about Keynes. Among the nuggets: The same Keynes whose name is attached to large-scale, multi-equation Keynesian macroeconomic models thought such models useless because their coefficient estimates were unreliable. The reader will also learn that the Keynes excoriated by modern rational expectationists for claiming that investment decisions were based on animal spirits adhered to something akin to the notion of rational expectations in short-run contexts if not in long-run ones. He will learn that the Keynes once depicted by right-wing extremists as being in league with Marxists scathingly dismissed Marxian socialism as an "illogical and dull" doctrine and strongly believed in private property and individual freedom. Finally, he will learn that the Keynes

accused of being an inflationist was so concerned with avoiding inflation that he urged a policy of price stability in his *Tract on Monetary Reform* (1923) and his *Treatise on Money* (1930) and even expressed concern with the possible inflationary consequences of Britain's rearmament program in early 1937 when unemployment was around 12 percent.

What the reader will not learn is why Keynes omitted open-economy considerations from his *General Theory*. Nor will he learn why Keynes, despite the sophisticated analysis presented in his *Tract on Monetary Reform* of inflation as a tax on real cash balances, failed in the *General Theory* to mention such inflation as a means of inducing wealth-holders to hold less cash and more real capital so that the capital stock could approach its optimum level. True, Meltzer advances some tentative answers to these questions. But he admits that they are mere conjectures unsupported by Keynes's own words. In the end they remain a mystery.

To summarize, Meltzer has written an important book that should revive interest in a great economist whose reputation has been in decline since the failure of Keynesian policies in the late 1960s and 1970s and the consequent rise of the anti-Keynesian monetarist and rational expectations (or new classical) schools. That Meltzer finds much of value in Keynes's writings while simultaneously being a leading monetarist critic of Keynesianism only adds to the book's appeal. Another plus is that Meltzer has found something new to say about Keynes. Still, it remains to be seen whether Meltzer's unconventional interpretation of Keynes's central message will withstand critical scrutiny. Certainly, it will generate discussion among scholars and policymakers for years to come.

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Unfair Competition: The Profits of Nonprofits

James T. Bennett and Thomas J. DiLorenzo
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Ideally government provides for the national defense and a few other public goods, establishes a legal setting conducive to specialization and exchange, and leaves the production of the vast majority of goods and services to the private sector. Things are far from ideal, however. Government routinely helps finance the production of a large number of goods and services that could be supplied privately and, in fact, would be more efficiently produced by the private sector. In doing so, government hampers the private sector's ability to create wealth by subjecting it to unfair (subsidized) competition and, to rub salt into the wound, these subsidies are paid for through higher tax burdens imposed on the private sector.

Bennett and DiLorenzo have written what can best be described as an analytical exposé on an important, but largely overlooked, aspect of government's pernicious usurpation of private sector activities. They