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A MONETARIST ON KEYNES—UNEMPLOYMENT WITHOUT THE UNEMPLOYED

Martin BRONFENBRENNER

Abstract. This is a review article on Prof. Allan Meltzer's *Kyenes' Monetary Theory*. This reviewer considers it the most original and thorough-going reinterpretation of Keynes' *General Theory* in 20 years.

Save for dislike of the rentier class and of high interest rates, Meltzer's Keynes retains "the presuppositions of Harvey Road" as regards the desires of labor and the potential efficacy of public investment. But this review suggests that, if Meltzer's "different interpretation" of Keynes should prove correct, the resulting system could not have maintained high employment in a regime of strong and militant trade unionism.

Professor Allan H. Meltzer's "different interpretation" of Keynesian economics[1] has developed into what is, in this reviewer's opinion, the most important study of Keynes and his work in the last 20 years, or since Robert Clower and Axel Leijonhufvud pointed out in 1968 the important distinction between "Keynesian economics" and "the economics of Keynes" himself.[2]

Professor Meltzer, of the Graduate School of Industrial Administration at Carnegie-Mellon University in Pittsburgh, is a recognized leader in American and indeed world-wide monetarist thinking. The outstanding disciple of the late Karl Brunner, Meltzer has been best known as a constant critic of the Federal Reserve System's exercise of discretionary powers monetarists do not believe it (or anyone else, for that matter) should possess in the first place. Meltzer is a founder and leading light of an unofficial "Shadow Open-Market Committee" of monetarist economists in banking, business, and academe, which plays gadfly to "the Fed" and is (in my opinion) more often right than wrong. He is also no stranger to Japan, having been a year-long Visiting Scholar at the Bank of Japan and continued his connection with the Bank ever since.

Meltzer's new book has seven chapters: the casual reader might do well to start with the first, fourth, and seventh, leaving the bramble-tangles of who-said-what

[1] Allan H. Meltzer, *Keynes's Monetary Theory: A Different Interpretion* (Cambridge and New York: Cambridge University Press, 1988). The study began life as an expansion of Meltzer's essay, "Keynes's General Theory, a Different Interpretation," *Journal of Economic Literature* (March, 1981).

[2] The title of Professor Leijonhufvud's doctoral dissertation (1968) is *On Keynesian Economics and the Economics of Keynes*. It was written under Professor Clower's direction at Northwestern University.

and of international complications to a later perusal. After an introductory Chapter 1, we have two chapters on the early-middle-aged Keynes of the 1920s, one on the *General Theory*, one on "Monetary Reform and International Economic Order," one on rival interpretations of the *General Theory*, and the final chapter on conclusions.

I opened this volume (by a former colleague[3]) expecting either what Americans call a "hatchet job" on Keynes and his professional reputation or, at the other extreme, the conversion of the author himself to one or another of the forms the Keynesian religion has taken since Lord Keynes's death in 1946. I was "favorably disappointed." The Meltzer book is neither a hatchet-job nor a conversion piece, but something substantially better than either of these extremes.

Let me summarize under seven heads what I take to be the principal points of Meltzer's "different" interpretation of Keynes. Some of them are necessarily less different than others:

1. Keynes's long-term social policy on the (British) domestic scene was clear and consistent as early as 1920, and as it related to "first best" solutions. Political exigencies and acceptance of "second best" solutions forced upon him from time to time the shifts, tergiversations, and improvisations for which he became famous in the popular mind as regards protectionism, inflation, etc.

2. One can summarize this social philosophy, which the late Sir Roy Harrod called "the presuppositions of Harvey Road"[4], as a political democracy with an electorate guided by benevolent experts of high technical competence—a 20th-century approach to the philosopher-kings of Plato's *Republic*. As Meltzer says here (p. 317) "Keynes does not ponder why society would delegate so much authority to a small non-elected group."

3. In macroeconomic policy, the major tasks of these disinterested experts should include the increase and direction of investment in physical capital, including its allocation over time and between branches of industry. (Keynes accused "laissez-faire" of over-saving and under-investment but not of under-consumption!)

4. Control over investment should have as its guiding principles the stabilization of price and wage levels and the reduction or socialization of risk to the (approved) private investor. With reduced risk and uncertainty could come

[3] We were colleagues at Carnegie-Mellon in 1962–71. Meltzer's intensive study of the corpus of Keynes's writings—29 volumes, including correspondence, letters to the editor, and "op-ed" articles in the public press along with major books and contributions to the scholarly journals, published by Macmillan (London) for the Royal Economic Society mainly under the editorship of D. E. Moggridge between 1971 and 1980—began in 1977–78, well after our colleagueship had been ended by my departure from Pittsburgh.

[4] Harvey Road was the comfortable upper-middle-class Cambridge street on which Keynes's parents lived during his childhood and youth. (His father, John Neville Keynes, was an eminent Cambridge economist and philosopher.) The American "limousine liberal" may share "the presuppositions of Harvey Road"—often in exaggerated form.

both increased investment rates in the short term and a higher eventual level of the private capital stock, steadily falling interest rates, and the eventual "euthanasia of the rentier." With the reduction or elimination of income without work (or uncertainty-bearing), discontent with capitalism on distributional grounds would die down. (Keynes was no socialist!)

5. The theoretical foundation of all Keynes's major macroeconomic efforts—the *Tract on Monetary Reform* (1923), the *Treatise on Money* (1930), and the *General Theory* (1936)—is to provide with maximum rigor a foundation for the policy views indicated above, in a form persuasive to Keynes's fellow-economists as well as to a wider public.

6. Such features of textbook Keynesianism as activist fine-tuning on the basis of econometric models, and the stress on fiscal as opposed to monetary policy,[5] represent additions by Keynes's eminent disciples, notably the late Sir John Hicks and the late Abba Lerner, and are no part of his own message. (As is well known, the graphic and algebraic garments of the textbooks are not to be found in the *General Theory*.) Nor does Keynes's argument require money-wage rigidity or other forms of money illusion, as many of his monetarist (and other) critics have had it, beginning perhaps with Franco Modigliani (1944).

7. In matters international, Keynes's crystal ball was often cloudy. His message varied over the years and never attained complete clarity. He wanted both fixed exchange rates and stable price-levels of internationally-traded goods—both within reasonable limits—with changes regulated by rules rather than by discretionary authorities—except in emergencies. He was less unclear when it came to the evils he wished to avoid: (1) deflationary and employment-decreasing pressure by countries with current-account surpluses on well-behaving countries with current-account deficits; and (2) the threat of private capital movements as "rentier vetoes" of domestic programs which might drive down interest rates by high domestic investment and capital accumulation.

The nub of the Meltzer reinterpretation of Keynes's *General Theory* is, I think, to be found in his Figure 4.1 (p. 172), based on p. 180f. of the *General Theory* and reproduced below as our Figure 1,[6] despite a minor error in draftsmanship.[7] The accompanying verbal argument can be paraphrased: Reduction of risk and

[5] Meltzer makes this point particularly strongly in the present volume (p. 205): "The association of Keynes with closed-economy macroeconomics, in which money 'does not matter' is one of the great anomalies in the history of economics. Throughout his life, Keynes gave great importance to monetary arrangements and the rules governing monetary policy."

[6] Meltzer's notation is not difficult. The price level is p; the real interest rate is r; IS and LM are as in the conventional textbooks. Deflation of the national income Y is by the real wage W, as in Keynes. The asterisk denotes a full-employment situation, and the subscript 0 a situation of less than full employment. SS is an aggregate supply curve, based on ch. 4.4 of the *General Theory*, where, however, supply is related to employment directly. The superscript e denotes an expected value, while r_s is a "neutral" value of r, "consistent with *full* employment... This rate might better be described, perhaps, as the *optimum* rate." (*General Theory*, p. 243).

[7] The neutral or full-employment interest rate r_s should have been determined by the intersection of (IS^*, LM^*) rather than by the intersection (IS_0, LM^*) as drawn.

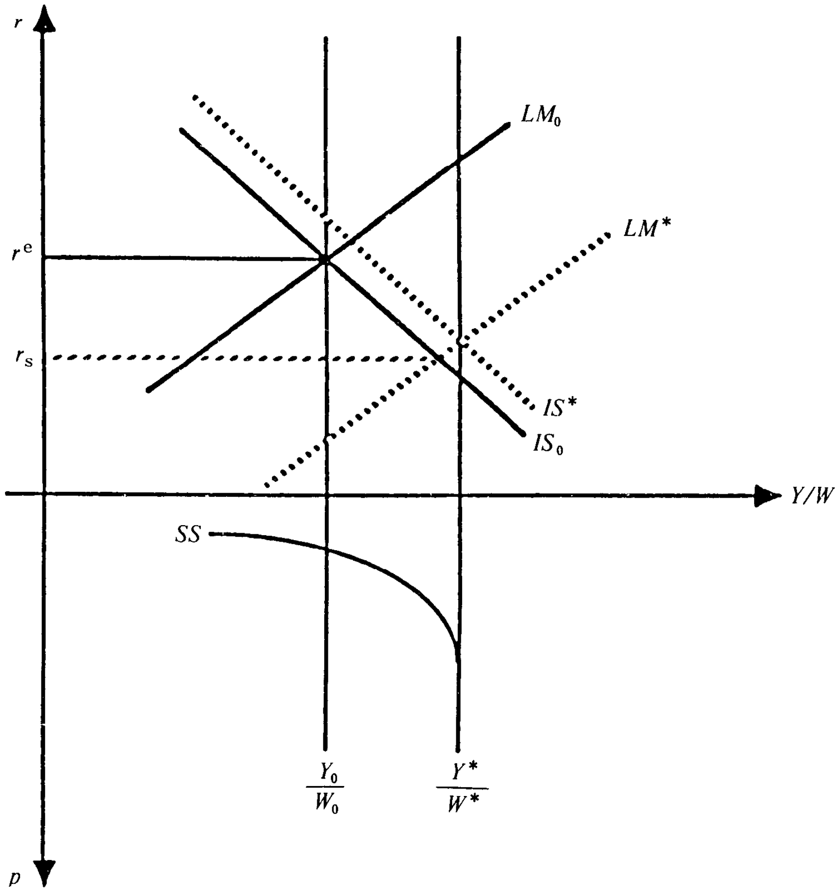

Figure 1

uncertainty, as by public control of investment, will lower the interest rate from r^e to r_s, reduce the demand for money (causing the shift of LM_0 to LM^*, and raise investment (causing the shift of IS_0 to IS^*). (Note that Meltzer draws the monetary effect as substantially larger than the fiscal one; one can wonder whether Lord Keynes would agree.) The real national product accordingly rises from (Y_0/W_0) to (Y^*/W^*) at some cost in inflation to creditor interests. Were *IS* and *LM* to shift further to the right, the result would be pure inflation, as the aggregate supply function *SS* becomes vertical at the full-employment income level (Y^*/W^*).[8]

But had we not known in advance (from Meltzer's text) that the income (Y^*/W^*) of Figure 1 required a higher employment rate and a lower unemployment rate than the income (Y_0/W_0), and also that the supply function *SS* turned vertical at (Y^*/W^*), could we have been certain which of the two real incomes gave us the higher employment and the lower unemployment rates? Quite

[8] One wonders what Lord Keynes (or his ghost) would think of the more conventional aggregate supply or *AS* functions, developed along neoclassical lines in several texts, including my own *Macroeconomic Alternatives* (1979), pp. 220–223.

conceivably not, since the labor-force participation rates of the population, the capital-labor ratios in production, the wage-rental ratios in income distribution, and also the availability of "made work" may differ between the two situations in inter-related ways.

To discuss the employment situation, and also its Keynesian interpretation, we apparently require in general some addition to the Meltzer analysis. This addition or appendix can be derived from a conventional labor supply–labor demand (N^s–N^d) starting point. Figures 2–3 (below) offer such an extension in a close parallel with the basic Meltzer diagram of Figure 1. Figure 2 confirms Meltzer's interpretation; where this figure applies, full employment is secured by Keynesian policies as Meltzer interprets them, with no need for anything more. Figure 3, however, confirms a more nearly traditional view, relating unemployment to (real or nounival) wage rigidity; where this figure applies, unemployment persists despite the Keynes-Meltzer program. We may also view Figure 2 as illustrating one important "presupposition of Harvey Road," and Figure 3 as illustrating its

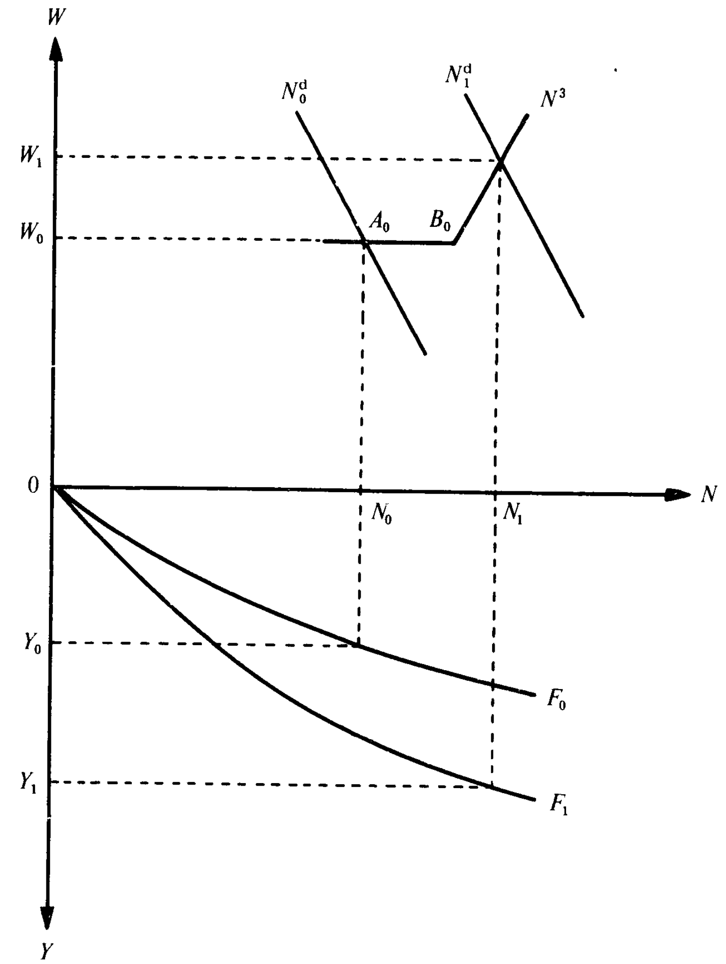

Figure 2

denial. The particular presupposition is, that workers are satisfied enough by full employment at constant money wage rates to secure industrial peace, if not precisely industrial harmony of interests.

Figure 2, the diagram fully supportive of Meltzer's reinterpretation of Keynes, needs little explanation. In situation 0, at less than full employment and an hourly wage of W_0, there is unemployment of A_0B_0 man-hours of labor. This unemployment disappears in situation 1, where capital accumulation has raised the marginal productivity of labor from the slope of F_0 to that of F_1, and consequently also the demand for labor from N_0^d to N_1^d. With the labor supply function N^s remaining unchanged, the real wage rate rises from W_0 to W_1 and the national income from Y_0 to Y_1, presumably with little or no change in the functional distribution of income between labor and property. We should also note an implicit element of technological optimism in this diagram, and later in Figure 3, of which both Keynes and Meltzer would surely approve. This is an assumption of complementarity between labor and capital equipment, so that a rise in the capital stock raises the demand for labor at all values of employment N.

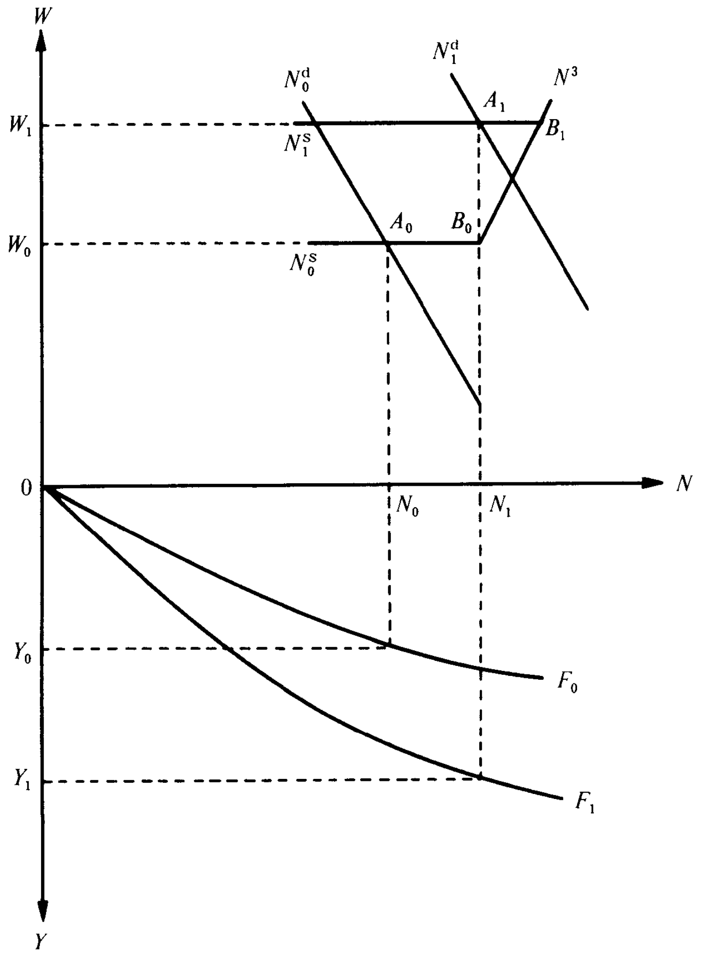

Figure 3

(Doomsdayers of technological unemployment anticipate the opposite.)

Where Figure 2 has left the entire labor supply function N^s in place, Figure 3 introduces an upward shift of the infinitely elastic portion. Such shifts are sometimes called by labor economists "raising the sights" of workers, following the realization that something better is within reach in situation 1 than the compensation acceptable in situation 0. Firms in imperfectly competitive industries also "raise their sights" in prosperous periods regarding profit margins per unit of output or of invested capital. (Such behavior of firms, which accelerates and increases the pass-through of wage increases to output prices, is not indicated explicitly on our diagrams.) The supply curve of labor is drawn shifting vertically from N_0^s to N_1^s at the wage rate W_1.

As labor's sights are raised by the tight labor markets of long-term prosperity, not to say affluence, unemployment persists in the higher and more desired reaches of the labor market. This unemployment may offset or more than offset, statistically speaking, the labor shortages which coexist with it in the lower ranges.[9] It is indicated by A_1B_1 in Figure 3, which may equal or exceed in size the A_0B_0 unemployment of recession years,[10] although I know no instance where it has done so.

Residual unemployment like A_1B_1 cannot be explained by the Meltzer analysis alone, helpful nd meaningful as that analysis certainly is. To whatever extent such unemployment remains with us in the current "affluent society" or "post-industrial age," a more simplistic and simpler-minded interpretation of Keynes also remains valid. This simpler-minded appendix to Meltzer is, naturally enough, the rigidity of money or real wages—or, if you prefer, the elasticity and shiftability of the labor supply function.

To my satisfaction at least, Meltzer makes his case that, as he says (on p. 204), "the *General Theory* put into the language of economics [but into a novel *dialect* of that language—M.B.] beliefs that Keynes held in the 1920s. The beliefs concerned progress, the role of the state in achieving progress, the importance of investment for progress, and the harmful effect of uncertainty in investment and progress [and employment—M.B.]."[11]

[9] As of the second half of 1989, young Japanese workers are reported to shun jobs affected with any of "three *ki*'s" (*kiken, kitanai, kitsui*), meaning respectively dangerous, dirty, and difficult. Hence a demand by smaller firms in unglamorous places for freer immigration of unskilled workers from other Asian countries. Similar phenomena were apparently occurring in North America, with labor recruitment legal and otherwise from Latin America and the West Indies, and in Western Europe, recruitment from Southern Europe, the Near East, and North Africa.

[10] In Figure 3 as drawn, the demand for labor in situation 1 is equal to the labor supply in situation 0, since A_1 lies directly above B_0. This is of course a special case; A_1 may lie either to the left or to the right of B_0.

[11] A footnote at p. 320 mentions that Meltzer had not previously (or, I think, subsequently) cited two well-known essays of Keynes, "Economic Possibilities for Our Grandchildren" and "Some Economic Consequences of a Declining Population Growth." Meltzer's case might be even stronger had he explained why he had not cited them—particularly the second, which is darker and gloomier in its implications than is Meltzer's reading of the Keynesian message.

So why has not Meltzer abjured his false Gods and joined the Church? To this reader, the most informative summaries of his reasons why come in two widely-separated passages, be first from p. 204 and the second from p. 311, reproduced below in running-quotation form:

> Time has not dealt kindly with Keynes's conjectures about government management of investment. Where goverments have controlled the rate of investment, they have often directed resources toward declining industries, where the expected return is low or negative—to space shorts, supersonic aircraft, road building in the Amazon, state-owned airlines, and other prestige projects. That was not the way Keynes expected to bring the marginal efficiency of capital to zero in a generation. Keynes favored wasteful projects only if other alternatives did not exist or had failed. Often, governments have favored consumption and transfers, and reduced investment when the growth of spending was reduced. This, too, is contrary to Keynes's program. The precepts of Harvey Road, and his confidence that he and others like him would influence policy, misled him.
>
> There are four major flaws, I believe, [in Keynes's view of the world to which he and his analytic work and his policies led.]. First is the omission of open-economy aspects in the *General Theory*. Second is the failure to treat the inflationary consequences of the policies he espoused and of the Bretton Woods system to which he contributed so much. Third is his judgment that state direction of investment would lower the social return-to-capital to zero, or to some minimum rate, by increasing the stock of capital until capital is no longer scarce. Fourth is his neglect of, or willingness to sacrifice, freedom.

From a generally sympathetic viewpoint, I propose to comment further on the first, second, and fourth parts of this judgmental quadriad.

Ad 1, the *General Theory* in an open economy. I wonder if Professor Meltzer would agree with my conjecture that the present (1989) system of "dirty floating" or "quasi-stabilization" of the foreign exchanges under G-3, G-5, or G-7 auspices would meet with Keynes's grudging and qualified acceptance as "second best," if the Central Banks or Finance Ministries of the G-n countries were represented more largely by technical specialists and experts rather than political appointees and spokespersons, and also if their powers were expanded to include the direction of international capital movements, especially capital flights.

Ad 2, the inflationary consequences of Keynesian policies. These appear to me as consequences of the Harvey Road syndrome rather than of anything specifically Keynesian. At any rate, Keynes seems not to have reckoned adequately with the insatiability of economic pressure groups in organized labor, agriculture, and industry in pressing inflationary demands and resisting disinflationary policies, whether these be tax increases on the fiscal side or slower monetary growth. (He would clearly not have applied the axe to public expenditures, even "pyramid-building.")

Ad 4, economic freedom. This may be the greatest puzzle of the discussion. When Friedrich von Hayek's *Road to Serfdom* appeared (1944), Keynes wrote its author (his long-time adversary), a congratulatory note expressing himself as "morally and philosophically in agreement with virtually the whole of it, and not only in agreement, but in deeply moved agreement."[12] "It" was certainly the Hayekian political philosophy enunciated in that book and many other writings before and since: the importance of economic freedom in its civil-rights sense, and the danger to freedom from socialism and from economic planning, either singly or in combination. The question is, how "deeply moved agreement" with *The Road to Serfdom* is to be reconciled with the importance Keynes ascribes—not exclusively in the Meltzer interpretation— to the direction of investment, both domestic and international.

Hayek continues: "He [Keynes] qualified this approval by the curious belief that 'dangerous acts can be done safely in a country which thinks rightly, which could be the way to hell if they were executed by those who feel wrongly." Or, as per the Latin motto, *quod licet Jovi non licet bovi.* This romantic notion is in my view more than the "curiosity" which Hayek calls it. Keynes apparently believed quite seriously in the separability of freedoms. Economic laissez-faire was to him not only a horse of a different color from the Bill of Rights, but any correlation between the two was of neither statistical nor philosophical significance. How anyone differing so far from Hayek at this point could describe himself as in moral and philosophical agreement with him I do not know. Neither do I know how Hayek could brush aside Keynes's reservation as a *curiosum.* Rather the point, or perhaps rather the separability of freedoms, is the key explanation of Keynes's "willingness to sacrifice [economic] freedom" to which Meltzer takes exception, and regarding which I follow Meltzer. Both of us, however, are quite aware, as is Hayek, that Keynes was neither a Hitler, a Stalin, nor an Ayatollah.

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[12] Friendrich von Hayek, "The Keynes Centenary," *The Economist* (June 11, 1983), reprinted in Chiaki Nishiyama and Kurt Leube (editors), *The Essence of Hayek* (1984), p. 50. Meltzer too takes cognizance of this correspondence at p. 37.