Keynesianism: Origins, Principles, and Keynes's Debate with Hayek

33

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Contents

Abstract

The son of a Cambridge economist and a student of Alfred Marshall, Keynes was raised to believe in the benefits of market forces and competition. Yet, Keynes went on to become *the* great exponent of state intervention in the economy. In arguing in favor of state intervention, however, Keynes also contended that the profit-motive provided "social and psychological justification for significant inequalities of income and wealth." A paradoxical figure, Keynes lived a life of wealth and privilege while always showing concern for the social effects of capitalism. In exploring Keynes's ideas, we trace his intellectual development from his first public work *The Economic Consequences of the Peace* through to his seminal work *The General Theory of Employment Interest and Money*. In doing so, we also explore how Keynes's work stimulated a powerful anti-Keynesian tradition through the rebuttals penned by Friedrich August Hayek,

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an author who believed that government intervention always led to adverse long-term consequences by causing a misallocation of resources. As management historians, we suggest, a proper understanding of our craft can only be achieved if our ideas are grounded in an awareness of this debate.

Keywords

Keynes · Keynesian · Economics · Kahn · Hayek · Wealth creation · Investment · Employment

Introduction

Keynes changed the world. More specifically, his economic policies shaped the post-war global economy. By 1950, he was "the world's most celebrated economist" (Moss and Schumpeter 1996). Despite earning worldwide recognition and a place in history with the publication of his *The Economic Consequences of the Peace*, John Maynard Keynes achieved even greater fame with *The General Theory of Employment, Interest and Money* (Keynes 1919/2005, 1936/1964; Dimand 2019). With this book, Keynes believed that he would "largely revolutionise...the way the world thinks about economic problems" (Skousen 2007). Keynes was right. Having an acute understanding of the "economic theory of his time" Keynes was able to develop the "reasoned challenge to the reigning orthodoxy" of economics, a challenge embodied in *The General Theory* (Krugman 2018). Perhaps his exposure to sophisticated economics and the inner works of politics during his early years contributed to his "revolutionary" mind (Skousen 2007). An intellectual rebel, Keynes nevertheless grew up in privileged circles and was raised to "believe that free trade promoted peace" (Markwell and Oxford University Press 2006). His father was "an economics professor at Cambridge University" and a friend of Alfred Marshall – who would go on to be "described as a supreme" authority "among the economists of the English speaking world" (Davenport 1935/1965; Skousen 2007; ► Chap. 16, "Neo-classical Thought: Alfred Marshall and Utilitarianism" by K. Boccalatte). Keynes's mother bore an equally impressive figure as the "first woman mayor" of Cambridge (Skousen 2007). Despite receiving no "formal training" in economics (for his degree was in mathematics), Keynes, after only a "single course from Marshall," developed an acumen for the subject, "quickly" becoming proficient enough to begin teaching (Skousen 2007). Keynes's unique economic prowess would go on to flourish during some of the worst times in the history of the Western world. From the depths of destruction and devastation caused by World War I and its aftermath, Keynes became an economist – undeterred by the challenges of re-shaping an economy and purposed to better the lives of the people at their time of need. Keynes was not a socialist, for "he came to save capitalism, not to bury it" (Skousen 2007; Krugman 2018). He did, however, go on to become *the* great exponent of state intervention in the economy. This chapter examines Keynesianism and its social and political influence.

Keynes's early frustrations with economic management arose during the peace negotiations following World War I. During the war, Keynes was part of the "British Treasury" and later appointed as their "official representative" at the "Paris Peace Conference" where the *Treaty of Versailles* – the "Treaty of Peace with Germany" – would be negotiated (Keynes 1919/2005, 1936/2017; Treaty of Peace with Germany (Treaty of Versailles) 1919). Much to the disappointment of Keynes, the economic implications of negotiations were overlooked. The Paris Peace conference had centered its objectives on punishing those perceived by the war's victors as responsible for war rather than establishing a workable "peace" (Sharp 2010). Little attention was paid to economic stability. Rather, attention focused on detailing what Keynes deemed, a Carthaginian Peace. When it became clear that "hope could no longer be entertained of substantial modification" to the harsh terms of the treaty, Keynes "resigned" from his delegate position and made public his case against the treaty (Keynes 1919/2005). By this stage, Keynes was already an experienced economist. He saw that the development of the *Treaty of Versailles*, a "deliberately cruel settlement," as one constructed by the self-interest of a few that would have a steep cost to many (Sharp 2010). The strength of *The Economic Consequences of the Peace* is found in Keynes's ability to critically evaluate the conditions of Europe both before and after World War I in ways that highlight the interconnected nature of the European and global economy. Significantly, Keynes not only identified failings in the adopted terms of peace but also provided logical economic remedies to the issues being faced by Europe during this time. In order to understand Keynesianism and its social and political influence, therefore, it is necessary that we commence our analysis with the book that initially earned Keynes "a place in. . .history" (Dimand 2019). Accordingly, the first section of this chapter involves a discussion of Keynes's critique of the Versailles Treaty.

While Keynes's reputation as a "famous" economist had his roots in war, his ideas developed during the ensuing peace (Janes 2014). Returning to Cambridge following the war, Keynes met Richard Kahn. Kahn would go on to play a significant role not only in the development of Keynes's economic thought but in his life. After meeting Keynes, Kahn wrote his fellowship dissertation titled, *The Economics of the Short Period* (Aslanbeigui and Oakes 2011). The contents of this dissertation made "a remarkable contribution to the then-emerging theory of imperfect competition" and went on to influence "Keynes in his development of the appropriate framework for the economics of underemployment equilibrium" (Harcourt 1992/2003). While Kahn's dissertation was not published at the time, his next piece of work, an article entitled *The Relation of Home Investment to Unemployment*, was published only 1 year later (Aslanbeigui and Oakes 2011). Within this article, Kahn conceptualized the principle of the "multiplier," a theory later adopted and propounded by Keynes, allowing investors to "shape investment behaviour. . .the economy. . .and impact the lives of everyone in society" (Wolff and Resnick 2012). Kahn's contribution to economic development was, therefore, highly significant. Geoffrey Harcourt stated that had Kahn's dissertation "been published closer to the time when it was first written, it and his 1931 multiplier article together would surely have meant the subsequent receipt of the Nobel Prize" (Kent 2007; Harcourt 1994). Despite not receiving a Nobel Prize, Kahn's contribution to economics did not go unnoticed. In 1946 Kahn was appointed as a Commander "of the Civil Division of the Most Excellent Order" of the British Empire (Supplement. 37598: Central Chancery of the Orders of Knighthood 1946). And in 1965, he was presented with the prestigious title of "Barony of the United Kingdom" for life, thereby causing him to be known as "Baron Kahn" (Issue. 43708: Crown Office Corrigendum 1965). While the degree of Kahn's influence on Keynes is much debated, it is "fair to say that, without the crucial influence of Kahn, Keynes would not have reached. . .the particular insights that he did" (Harcourt 1994).

If the extent of Keynes's debt to Kahn is unclear, what is nevertheless obvious is the profound revolution in economic thought that Keynes initiated (Dimand et al. 2010). He not only developed a new theory – *The General Theory* – but also successfully exposed the "fallacy of composition" of traditional economics (Krugman 2018). Within his book, *The General Theory of Employment Interest and Money*, Keynes explores the economic foundations upon which society is built. In doing so, Keynes not only sought to understand the relationships between key factors of the economy but ultimately to "discover what determines the volume of employment" (Keynes 1936/2017). By the early 1930s such concerns were more than academic interest as the global economic slipped into a deep recession amid closing businesses and soaring unemployment. While there existed proposals for "long-run" solutions, as Keynes famously observed, "*In the long run* we are all dead" (Keynes 1929). Keynes took a novel approach to remedy this situation. Rather than investigating how and why the economy was depressed, Keynes looked to answer a critical question: "given that overall demand is depressed – never mind why – how can we create more employment?" (Krugman 2018).

The substance of Keynes's work was at a time embroiled in the "most famous" debate "in the history of contemporary economic thought" as Keynes exchanged intellectual blows with the Austro-English economist, Friedrich August Hayek (Bas 2011). Hayek's debate with Keynes confronts us with an alternate view on the consequences of interfering with the economy. An exponent for a measured external intervention in managing (i.e., stabilizing) the economy, Keynes's concepts presented within *The Treatise of Money* were challenged by Hayek in a series of published articles. Hayek was a supporter of "laissez-fair" economics (Facchini 2016), believing that interventionist tactics upset the natural state of the economy. Hayek argued, for example, that artificially improving the supply of money through lowering interest rates would have negative long-term economic consequences (Ebenstein 2003). Central to these adverse consequences, in Hayek's estimation, was an imbalance in the economy. For stimulating demand in the short term, Hayek believed that government intervention redirects capital away from long-term market needs and in consequence discourages "real investment" (Ebenstein 2003). Hayek published two lengthy articles, namely: *Reflections on the Pure Theory of Money of Mr. J. M. Keynes* and *Reflections on the Pure Theory of Money of Mr. J. M. Keynes (continued)* (along with one *Erratum* by the same name) criticizing elements of Keynes book (Hayek 1931a, b, 1932). Within his sole reply titled, *The Pure Theory of Money. A Reply to Dr. Hayek*, Keynes asserted that Hayek had misinterpreted his work, and even where Hayek's critique was correct, the matters he identified were inconsequential in terms of his overall conclusions (Keynes 1931). It can be thus surmised that the debate with Hayek contributed in part to the development and articulation of the ideas found within Keynes's later work in *The General Theory.*

Keynes's work revolutionized economic management. Living at a time that bore witness to some of the most volatile economic events experienced by the Western world (i.e., World War I, the Great Depression, and World War II), Keynes was determined to do what he could to make the world better for the people of this time, namely: improving the economy in the short term. Examining Keynes's contribution to management history is the core purpose of this chapter. In doing so, it is not possible to review all facets of his work. Instead, every effort will be made to do justice to those elements of his work which pertain to the central theme of this chapter. We will, therefore, commence this chapter with an examination of Keynes's first famed book *The Economic Consequences of the Peace* and trace the development of his models and concepts through to the publication of his seminal work *The General Theory of Employment, Interest and Money.*

The Economic Consequences of the Peace: Diplomat and Economic Critic

World War I shattered the global economy that had emerged during the nineteenth century (see ▶ Chap. 12, "Transformation: The First Global Economy, 1750–1914," for discussion of this economy). As Keynes expressed it, Germany "and her allies . . . imposed war" upon "the Allied and Associated Governments," and as a result "overturned the foundations on which" society "lived and built" (Keynes 1919/2005; Treaty of Peace with Germany (Treaty of Versailles) 1919). While an Armistice brought the war to an end in November 1918, the fight for peace was far from over (Henig 1995). Georges Clemenceau famously stated at the time, "we have won the war: now we need to win the peace, and it may be more difficult" (Henig 1995). In the wake of war, "the leaders of thirty-two countries" ("representing between them some three-quarters of the world's population") were responsible for negotiating the terms of peace, terms which would establish order, "make the world safe for democracy," and most importantly, "ensure that 1914–1918" was the "war to end all wars" (Sharp 2010). Five (original) Peace Treaties were signed for this purpose (Sharp 2010). Ending the war between Germany and the Allied and Associated Powers was the "Treaty of Peace with Germany" or the *Treaty of Versailles* (Keynes 1919/2005; Treaty of Peace with Germany (Treaty of Versailles) 1919).

Keynes predicted that the "terms of peace" contained within the *Treaty of Versailles* would have dire political and economic consequences for Europe (Keynes 1936/2017, 1919/2005; Sharp 2010). As the "British delegation's Treasury representative at the Paris Peace Conference," Keynes attended many conference sessions where the *Treaty of Versailles* was "negotiated" (Keynes 1936/2017; Janes 2014). He was displeased with their outcome. Germany was held responsible for imposing "war" and thus for the resultant "loss and damage" incurred by all those they subjected to war (Treaty of Peace with Germany (Treaty of Versailles) 1919). As such, it was believed that Germany should pay. Keynes was dissatisfied with the resulting "vindictive and unworkable settlement" (Sharp 2010). Aiming to overcome these issues diplomatically, Keynes expressed his concerns to "Foreign Secretary Sir Austen Chamberlain" writing, "We have presented a Draft treaty to the Germans which contains in it much that is unjust and much more that is inexpedient" (Graebner and Bennett 2011; Harrod 1982). Keynes was not alone in this belief. James Headlam-Morley, the British Political Intelligence Department's "effective leader," was quoted as saying on the eve of signing that, "I have not found one single person here who approves of" the treaty "as a whole." Headlam-Morley went on to say, the treaty is "quite indefensible and in fact is, I think, quite unworkable" (Sharp 2010; Graebner and Bennett 2011). Despite the growing "doubts and warnings" as to the long-term viability of the treaty permeating "the entire conference," no immediate revisions were made (Graebner and Bennett 2011).

Dissatisfied with the direction and likely "longevity" of the treaty, Keynes "resigned from the British delegation" in June of 1919 and took "his case against the Treaty from closed meeting rooms to the reading public" (Keynes 1936/2017; Sharp 2010; Keynes and Hutchison 1973). Keynes publicly objected to the "Allied leaders'" proposed "terms of peace" within his publication of *The Economic Consequences of the Peace* (Keynes 1936/2017, 1919/2005; Sharp 2010). It was with this book that Keynes found himself transformed from diplomat to economic critic. Publication of *The Economic Consequences of the Peace* also commenced Keynes's "public life," which saw him go on to become one of the "most important economic" thinkers of the "twentieth century" (Keynes 1936/2017). Contrasting post-war economic circumstances with the comparative prosperity that existed on the eve of hostilities, Keynes's study paints post-1918 Europe as a land of stark inequality. On the one hand, the people of England appeared "a great deal richer than" they were before the war. They were looking not only to replace what had been taken by the war but to "broaden and intensify" their lifestyle "comforts" (Keynes 1919/2005). Of England Keynes comments: "All classes alike. . .build their plans, the rich to spend more and save less, the poor to spend more and work less" (Keynes 1919/2005). On the other hand, the citizens of "continental Europe" were struggling to survive (Keynes 1919/2005). Central and Eastern Europe alike were destitute. Their citizens – "allied and enemy alike" – Keynes states, were engaged in a battle of "life and death, of starvation and existence"(Keynes 1919/2005, 1936/2017). Before the war, by contrast, the continent of Europe had prospered in apparent unity. Benefiting from advancing technologies in industry, transport, and communication, "the greater part of" European society was "reasonably contented" with its "standard of comfort" (Keynes 1919/2005). Of this pre-war European era, Keynes painted a picture of what was outwardly a veritable "economic Utopia" in which, for some, the world was their "oyster" (Keynes 1919/2005). Providing an example of this prosperity, Keynes states that an "inhabitant of London could order by telephone, sipping his morning tea in bed, the various products of the whole earth, in such quantity as he might see fit, and reasonably expect their early delivery upon his doorstep" (Keynes 1919/2005). Significantly, Keynes says, this same Londoner, considered "this state of affairs as normal, certain and permanent, except in the direction of further improvement" (Keynes 1919/2005). On the surface, Europe prospered. Under the surface of Europe's pre-war economy, however, was an unstable, untenable, and "unnatural reality" (Keynes 1936/2017). Four specific "economic peculiarities" contributed to this instability. According to Keynes, these included: "the instability of an excessive population dependent for its livelihood on a complicated and artificial organization, the psychological instability of the laboring and capitalist classes, and the instability of Europe's claim, coupled with the completeness of her dependence, on the food supplies of the New World" (Keynes 1919/2005). Running on an increasingly precarious foundation, the subsequent war shook the European economy to the core. With war, the "extraordinary" age of "economic progress" had come to an abrupt halt (Keynes 1919/2005). Life for the Europeans had changed, a "great part of the Continent" was now "sick and dying" (Keynes 1919/2005). After the war, hope for a better future, a future with "justice" satisfied and "life" re-established, hinged on the outcome of the Paris Peace Conference (Keynes 1919/2005).

The conference and the *Treaty of Versailles* were central to Keynes's critique. Four political leaders – David Lloyd George (Prime Minister of the United Kingdom), Georges Clemenceau (President of France), Thomas Woodrow Wilson (President of the United States of America) and to a lesser extent, Vittorio Emanuele Orlando (Prime Minister of Italy) – dominated negotiations for the *Treaty of Versailles* (Dimand 2019; Janes 2014). Each member of this "Council of Four," Keynes says, brought to the negotiations different characteristics and different agendas (MacMillan 2001; Keynes 1919/2005). Clemenceau, described as by "far the most eminent member of the Council," sought "to weaken and destroy Germany in every possible way" (Keynes 1919/2005). Preoccupied with "French interests" and an associated intention of subjecting Germany to a "Carthaginian Peace," Clemenceau paid little attention to the ways in which the stifling Germany's "commercial activity" would have a negative effect on Europe's economy (Keynes 1919/2005). Lloyd George was more cautious and perceptive by nature (Keynes 1919/2005). Outlining his approach to treaty terms, he stated: "I do not want . . . to pursue any policy of vengeance, but we have got so to act that men in future who feel tempted to follow the example of the rulers who plunged the world into this war will know what is waiting for them at the end of it" (Sharp 2010). Lloyd George doubted Germany had the capacity to pay the "astronomical" cost of war. However, he succumbed to public demands for precisely this, winning the 1918 British election by effectively pledging to "extract the full cost of the war from Germany" (Dimand 2019; Keynes 1919/2005; Sharp 2010). Although Keynes considered Orlando a "minor player," Italian interests were often aligned with those of France. Thus, where treaty rights contrasted the interests of "French and Italian Industry" against "German industry," the united "French and Italian case" possessed "great force" in negotiations (Keynes 1919/2005, 1936/2017). Wilson, on the other hand, was a "major player" but lacked the political prowess necessary to influence the other members of the council (Keynes 1919/2005, 1936/2017). In describing Wilson, Keynes stated, he is someone who "would do nothing that was not honourable. . .nothing that was not just and right" (Keynes 1919/2005). In elaborating on this description, however, Keynes declared that the “President was not a hero or a prophet.” Instead, he was “but a generously intentioned man… lacking that dominating intellectual equipment … necessary to cope with the subtle and dangerous spellbinders … in the swift game of give and take, face to face in Council – a game of which he had no experience at all” (Keynes 1919/2005). It was with this combination of men and their ability to develop a suitable treaty with Germany that the hopes of Europe’s future rested.

The *Treaty of Versailles* would outline the reparations demanded of Germany for their role in initiating hostilities (Dimand 2019). Left seething by the terms of what they deemed “the Peace of shame,” the German’s did not have the capacity to pay the reparations demanded of them, reparations that were moreover outside the scope of the terms of the initial truce (Dimand 2019; Kershaw 2009; MacMillan 2001). For in requesting an armistice, Germany did so on the basis of “the Fourteen Points” outlined by United States President, Thomas Woodrow Wilson, during his “speech before Congress” in February 1918 (MacMillan 2001; Keynes 1936/2017, 1919/2005). Significantly, however, the major European victors (i.e., France, Britain, and Italy) were never prepared to accept Wilson’s fourteen terms “without modification” (MacMillan 2001). For, Wilson’s fourteen points provided reparation only for “invaded territory” and failed to account for the lives lost and damage done at sea and by air (Keynes 1919/2005). The cost of war had certainly been high. Soldiers’ blood was spilled in battle, civilian lives were lost, and economies deteriorated. Accordingly, for the “victorious” Europeans, it was felt that Germany must pay for “*all...* damage” (Keynes 1919/2005). In summing up the conflicting agendas, Keynes stated that “Two rival schemes for the future polity of the world took the field – the Fourteen Points of the President, and the Carthaginian Peace of M. Clemenceau.” Mutually opposed, Keynes went on to note that in the final analysis, “only one of these [plans] was entitled to take the field” (Keynes 1919/2005).

Keynes likened the *Treaty of Versailles* to the Carthaginian Peace: a peace which saw the “harsh…terms” imposed by Rome with the intent of disabling its ancient enemy, Carthage, to such a degree that there was no “possibility” of the city “recovering power” (Dimand 2019). Within the *Treaty of Versailles*, the Allies were seeking “compensation” from Germany for “all damage done to the civilian population of the Allies and to their property by the aggression of Germany by land, by sea, and from the air” (Keynes 1919/2005). Using a “strict interpretation” of these terms, Keynes calculated what damages could “be claimed from the enemy” (Keynes 1919/2005). France, according to Keynes, would have “the greatest claim” (Keynes 1919/2005). For losses incurred, to “*physical and material* damage” ($2.5b) and for losses at sea ($1.5b), Keynes calculated France was owed a figure amounting to approximately four billion dollars ($4b) (Keynes 1919/2005). Adding this figure to the cost of damages incurred by Great Britain, Belgium, and “Other Allies,” Keynes surmised that the amount owing by Germany to her enemies, for damages incurred in war, totaled $10.6b. He believed that had the Allies requested the sum of $10b from the “German Government at the Peace Negotiations … an immediate and certain solution” would have been achieved – a fair and *realistic* solution (Keynes 1919/2005). However, practicability was not a cornerstone of

Peace negotiations. Providing an example of the exorbitant amounts demanded of Germany, Keynes says the "French Minister for Finance" (M. Klotz) estimated his country's total "claims for damage to property" to be $26.8b. Klotz's figure, "more than six times" of Keynes's "estimate" could "never have been justified" (Keynes 1919/2005). In total, Keynes estimated that the *Treaty of Versailles* demanded of Germany approximately $40b in reparations (Keynes 1919/2005). This figure was more than 80 times greater than her annual "trade balance" adjusted for "the rise in pre-war prices" ($500,000,000) (Keynes 1919/2005). As such, the figure indebted Germany to reparation payments in excess of 30 years (the initial timeframe examined for reparation payments at the conference) (Dimand 2019). Keynes concludes his discussion on reparations by stating:

> The policy of reducing Germany to servitude for a generation, of degrading the lives of millions of human beings, and of depriving a whole nation of happiness should be abhorrent and detestable, – abhorrent and detestable, even if it were possible, even if it enriched ourselves, even if it did not sow the decay of the whole civilized life of Europe. Some preach it in the name of Justice. In the great events of man's history, in the unwinding of the complex fates of nations Justice is not so simple. And if it were, nations are not authorized, by religion or by natural morals, to visit on the children of their enemies the misdoings of parents or of rulers. (Keynes 1919/2005)

Keynes's main "purpose" in his book *The Economic Consequences of the Peace* was to "show that the Carthaginian Peace is not *practically* right or possible," nor was it a means to securing enduring peace (Keynes 1919/2005). The consequences of this treaty were nevertheless felt throughout Europe.

Europe immediately after the Treaty was in large part a place of misery. Economically stunted by the loss of domestic and international trade, a depression so severe as to mean "actual starvation for some" was feared to be on the horizon (Keynes 1919/2005). The "Council of Four" had paid "no attention" to the "economic rehabilitation of Europe" (Keynes 1919/2005). Three key facets of the European economy were perceived by Keynes as failing: "internal productivity," the ability to "transport and exchange" what was produced, and an "inability" to import the resources necessary for domestic production (Keynes 1919/2005). Moreover, domestic production was unable to feed and maintain the population. According to Mr. Hoover, "the population of Europe" was "at least [100 million] greater than" could "be supported without imports" (Keynes 1919/2005). Governments needed to intervene. However, in an unfortunate effort to "secure the resources. . .required" for domestic use, the European governments – "unable, or too timid or too short-sighted" to increase taxes or acquire loans – "printed notes for the balance" (Keynes 1919/2005). That is, they printed money in order to purchase necessary goods. Keynes aptly demonstrates that "this process" causes inflation and reduces the value of that country's currency. In severe cases (as had occurred in "Russia and Austria-Hungary"), the value of currency is rendered, "for the purposes of foreign trade. . .practically valueless" (Keynes 1919/2005). In these situations, without some form of "regulation," "essential commodities soon attain a level of price out of reach of all but the rich" (Keynes 1919/2005). For, as Keynes stated, "The price of imported commodities, when converted at the current rate of exchange" is far higher than the "local price" (Keynes 1919/2005). This means that "many essential goods will not be imported at all by private agency, and must be purchased by the government" and sold to citizens "below cost price" (Keynes 1919/2005). While this practice fends off society's starvation, it pushes a government towards "insolvency" (Keynes 1919/2005). Despite the country's currency retaining "a measure of purchasing power over some commodities" in domestic markets, inflation detrimentally affects the currencies ability to accurately represent the real value of any given commodity (Keynes 1919/2005). Keynes provides an example of the impact:

> If a man is compelled to exchange the fruits of his labors for paper which, as experience soon teaches him, he cannot use to purchase what he requires at a price comparable to that which he has received for his own products, he will keep his produce for himself, dispose of it to his friends and neighbors as a favor, or relax his efforts in producing it. A system of compelling the exchange of commodities at what is not their real relative value not only relaxes production, but leads finally to the waste and inefficiency of barter. (Keynes 1919/2005)

Inflation, Keynes says, is "not merely a product of the war, of which peace begins the cure. It is a continuing phenomenon" (Keynes 1919/2005).

Peace had failed to restore what war had destroyed. Keynes had remedies; proposals that he believed would create economic policies for the promotion and "re-establishment of prosperity and order" in Europe (Keynes 1919/2005). Past decisions such as those made by the Council of Four at the Paris Peace Conference could not be changed. The direction Europe took into the future, however, could be. Keynes outlined a plan for remedying Europe through four divisible yet interconnected areas, namely: "The revision of the treaty," "The settlement of inter-Ally indebtedness," "An international loan and the reform of the currency," and finally, reviewing the "the relations of Central Europe to Russia" (Keynes 1919/2005). Central to Keynes's proposed revision of the treaty was the modification of the reparations demanded of Germany, a revision that would see the cost of claims limited to a much reduced $10 billion and a feasible means – one proposed by Keynes – of extracting this payment over a 30-year period (Keynes 1919/2005). Inter-ally loans also required revision. War left many Allies (e.g., United Kingdom, France, Italy, Russia) with "a network of heavy" debts; debts that imposed significant economic strain upon countries financially struggling in the wake of war (Keynes 1919/2005). In proposing widespread changes to free these countries from the chains of this liability, Keynes stated:

> The war has ended with every one owing every one else immense sums of money. Germany owes a large sum to the Allies; the Allies owe a large sum to Great Britain; and Great Britain owes a large sum to the United States. The holders of war loans in every country are owed a large sum by the State; and the State in its turn is owed a large sum by these and other taxpayers. The whole position is in the highest degree artificial, misleading, and vexatious. We shall never be able to move again, unless we can free our limbs from these paper shackles. (Keynes 1919/2005)

Fiscal changes, however, formed only part of Keynes' plan. Many factors of European life required inter-country connectedness (i.e., transport, trade), and

Keynes believed that supporting Germany to "take up again her place in Europe as a creator and organizer of wealth for her Eastern and Southern neighbours" would benefit the European economy (Keynes 1919/2005). Recognizing that "many persons" would oppose these proposals, Keynes reminded his readers that when opposing a "German or Russian economic recovery" because of a "national. . .hatred for the populations or their Governments," society must be "prepared to face the consequences" of such actions. For, "Even if there is no moral solidarity between the races. . .of Europe, there is an economic solidarity which we cannot disregard" (Keynes 1919/2005). Accordingly, Keynes believed that the European public could build a stronger economic future for their country "by setting in motion those forces of instruction and imagination which change *opinion*" (Keynes 1919/2005). It was "to the formation of the general opinion of the future" that his book *The Economic Consequences of the Peace* was dedicated (Keynes 1919/2005).

Richard Kahn and the Origins of Keynesianism

After the war, Keynes returned to lecture at Cambridge. It was during this time that Keynes acumen for "making money" and "managing it" developed into an interest in monetary theory (Keynes 1936/2017). It was also during this time that he met Richard Kahn. Under the tutelage of Keynes, Kahn (influenced by "Marshall's *Principles*") began writing his Fellowship Dissertation on *The Economics of the Short Period* (Harcourt 1994; Kahn 1984). It was this topic choice that inadvertently stimulated the "radical restructuring of the shape of Keynes" work (Kahn 1984). Conceiving links between various factors of the economy (e.g., wages rates and prices or interest and employment), Kahn's dissertation not only displayed "considerable originality" but also developed concepts that would be utilized by others (including Keynes) in the study of economics (Aslanbeigui and Oakes 2011). Many of the concepts identified by Kahn were also "central concerns in the development of Keynesian theory" as evident in Keynes "short-period theory," *The General Theory* (O'Shaughnessy 1994; Kahn 1989).

If Kahn's fellowship dissertation had an enduring impact on Keynes's thinking, it was however not until the publication of Kahn's "multiplier" article in 1931 that a marked shift became evident in Keynes's public work (Kahn 1984). Published in the *Economic Journal* in June 1931, Kahn's article, entitled *The Relation of Home Investment to Unemployment*, not only introduced "the multiplier" into economic theory, it also "opened up" a realm of "possibilities" for which the "new technique" could be used (Wright 1956; Kahn 1984).

Kahn's "multiplier theory" is founded on the "fact that a net increase in the demand for any commodity, provided it is not offset by a decline in the demand for any other commodity, sets in motion a process of expansion which is eventually transmitted throughout the entire economic system" (Wright 1956). Taken independently, this definition is similar to Malthus or Lauderdale's "formulations of this type of theory of effective demand" which, according to Professor Paglin, "were on the right track, but. . .lacked precision" (Wright 1956; Spiegel 1971/1991).

Distinguishing Kahn's "multiplier theory" was its ability to demonstrate "*quantitatively* the related changes in income and (investment) demand" (Wright 1956). Despite Kahn never using the term "multiplier" within the article – instead employing the name "ratio" – by 1933 the term "multiplier" as a means to describe Kahn's theory had been "adopted in professional circles" (Wright 1956). Keynes applied the term (i.e., multiplier) within his work soon thereafter, first in his publication *The Means to Prosperity* and then again within a follow-up article, aptly named "The Multiplier" (Wright 1956).

It is evident that Richard Kahn played a marked role in Keynes's life. This is undisputed. What is debated in economic circles is "the nature of Kahn's contribution to Keynes's thinking" and the degree to which Kahn influenced Keynes' ideas (Marcuzzo 2002; Samuelson 1994).

Kahn was an understated economist. Combining "empirical investigation and theoretical innovation," Kahn's *The Economics of the Short Period* made a "substantial" contribution to economic theory, at the time of writing (i.e., 1930) (Aslanbeigui and Oakes 2011; Kahn 1989; O'Shaughnessy 1994). Inspiring Kahn's work was Marshall's "concept of the 'short period'" (Kahn 1989). However, while Marshall introduced "the element of Time as a factor in economic analysis," he did not explore its significance in-depth (Kahn 1989; Aslanbeigui and Oakes 2011). In economics, moreover, time is inherently difficult to measure when "there is no hard and sharp line of divisions between "long" and "short" periods" (Kahn 1989). Markets fluctuate. There are periods of "fairly continual expansions" and periods of "sub-normal activity" (Kahn 1989). Typically, periods of "sub-normal activity" do "not deviate from the long-period norm" (Kahn 1989). However, it is when these periods of "sub-normal activity" (e.g., decreased trade) extend persistently beyond "a year or two" and industries "approach a static state, as opposed to a state of progress," that the importance of action in the "short period" becomes readily apparent (Kahn 1989). The purpose of Kahn's dissertation was to "trace the factors that combine to determine the price and output of the product of an industry in such a short period" (Kahn 1989). Before Kahn, Marshall, like "other economists," "devoted. . .little space to the short period," treating "short-period effects, for the most part, as mere modifications of long-period tendencies" (Kahn 1989). Kahn, however, recognized that "the short period is not the same at both ends – and never has been" (Kahn 1989; O'Shaughnessy 1994). According to O'Shaughnessy, Kahn's "development of Marshall's concept of the short period" gave Keynes an important tool which was used to great effect in *The General Theory* (O'Shaughnessy 1994). He states:

> Rejecting Marshall's emphasis on a relatively quick adjustment to a position of long-period equilibrium, Kahn stressed the empirical relevance of the concept of short-period equilibrium, especially when the required adjustment was in a downwards direction. Since, in the short period, the quantity of labour required to produce a given output is mainly determined by technical considerations, there is no question of factor substitution. (O'Shaughnessy 1994)

According to Pigou, Kahn's dissertation, written post-World War I, had accomplished something "much harder than answering questions," for Kahn had "found the right questions to ask" (Aslanbeigui and Oakes 2011). There is thus little doubt that Keynes' prominent work, *The General Theory*, was influenced by the work of his former student, Kahn.

Both Kahn and Keynes had an interest in Britain's post-war economy. Specifically, the issue of unemployment. For post-war Britain was riddled with "workers, able and eager to work" but "denied the opportunity" to do so (Party 1929). Each political party vying for electoral success had a "solution" (Party 1929). Of the competing agendas, one proved more important for the development of Kahn's ideas than any others, namely the assertion by Lloyd George during his 1929 election campaign that the Liberal Party could reduce unemployment by funding public works (e.g., building "road and bridges") without increasing "national or local taxation" (Kahn 1931, 1984; Party 1929). The ability to finance such proposals was, however, "a key concern for. . .opponents and proponents during the election campaign" (Kent 2007). It was in determining the viability of Lloyd Georges' proposal that Keynes (a life-long Liberal supporter) and Henderson were inspired to publish *Can Lloyd George do it?* It was also central to Kahn's study, "The Relation of Home Investment to Unemployment" (Kahn 1984). In describing the effect of the former work, Kahn (1984) later recalled that Keynes and Henderson's work within *Can Lloyd George do it?* "marked a milestone in the development of thought." It also inspired Kahn himself to examine Lloyd George's proposal, primarily "because of" the "arithmetical and logical problems which it raised" (Kahn 1984).

Central to Lloyd George's campaign was employment, it being argued that the gainful employment of the country's "unemployed" population would have a positive and cumulative effect on economic progress. The "unemployment fund," at the time, paid a "cash disbursement of" £50 million per year in benefits to those without work (Keynes and Henderson 1929). Accordingly, if the government's proposed work program decreased the number of "unemployed," "relief" payments – including "the dole" – would "no longer be payable" to those members of society who had found work (Kent 2007). According to Keynes, this saving "alone would furnish between a quarter and a third of the total cost" of the government's proposals (Kent 2007). Further economic benefit, so it was predicted, would be found in the effects of increased consumption. For, a person "employed" spends more than a person "unemployed" (Kent 2007). Therefore, government "spending on public works" not only increases employment (decreasing unemployment payments), it also stimulates "greater trade activity" by increasing "domestic spending" and market "confidence" (Kent 2007). Government spending on public works would thus create a "cumulative effect." For "the greater trade activity" stimulated by the Government's initial investment in "public works" would go on to "make for further trade activity" (Kahn 1984; Keynes and Henderson 1929). Those directly employed by "public works" (i.e., primary employment) through increased spending and trade would stimulate a secondary wave of new employment (i.e., secondary employment).

Despite acknowledging this phenomenon, Keynes and Henderson, within their article, *Can Lloyd George do it?*, made "no attempt . . . to separate out the ratio of secondary to primary employment" (Kahn 1984). Despite believing the correlative relationship between government spending employment was “of immense importance,” they did not believe it was “not possible to measure the effects of” spending “with any sort of precision” (Kahn 1989). Keynes and Henderson, therefore, “so far as is known,” “made no estimate of the ‘multiplier’ – the ratio of the total additional employment (primary and secondary) to the primary employment” within their publication (Kahn 1984).

For Kahn, the “superficially obvious object” of his article was to estimate the “multiplier” (Kahn 1984). Kahn’s publication of “The Relation of Home Investment to Unemployment” thus both follows on from Keynes and Henderson’s *Can Lloyd George Do It?* and acts as a corrective to its obvious failings. The scope of Kahn’s publication, however, while examining the implications of Lloyd George’s proposal for reducing unemployment by funding “public works,” is restricted to the “arithmetical question” proposed by Lloyd’s Georges claims (Kahn 1931, 1984). Distinguishing between “primary” and “secondary” forms of employment (terms later adopted by Keynes in *General Theory*), Kahn set the foundation from which he was able to calculate the changes in employment resulting from government investment (as proposed by Lloyd George) (Kahn 1984). In determining how “Government investment” influences the “ratio of secondary employment to primary employment,” Kahn developed what became known as the “multiplier theory” (Kent 2007). Kahn’s “multiplier” demonstrates how “exogenous” investment can stimulate a cycle of increased income and consumption within a society (Meade 1993). For, increased employment stimulates favorably “the state of confidence” for consumer and “entrepreneurs” alike (Kahn 1984). Significantly, Kahn (1984) later noted, no “account of the large increase in employment everywhere resulting indirectly from the addition to the national purchasing power represented by the wages of the workers directly employed in this way” had been attempted by economists (Kahn 1984). In seeking to remedy this failing, Kahn’s theory was “designed to evaluate the amount of ‘secondary’ employment (in the ordinary consumption goods industries of a country) brought about by a given amount of ‘primary’ employment (in the production of capital goods)” (Kent 2007).

In reflecting upon the significance of “The Relation of Home Investment to Unemployment,” Keynes subsequently observed that Kahn’s,

> . . . argument in this article depended on the fundamental notion that, if the propensity to consume in various hypothetical circumstances is (together with certain other conditions) taken as given and we conceive the monetary or other public authority to take steps to stimulate or to retard investment, the change in the amount of employment will be a function of the net change in the amount of investment; and it aimed at laying down general principles by which to estimate the actual quantitative relationship between an increment of net investment and the increment of aggregate employment which will be associated with it. (Keynes 1936/2017)

According to Keynes, “in given circumstances a definite ratio, to be called the *Multiplier*, can be established between income and investment and, subject to certain simplifications, between the total employment and the employment directly employed on investment" (i.e., "primary employment") (Keynes 1936/2017). In other words, the "value of the *multiplier*" is the "rate at which 'every dollar spent by the government. . .create[s] several dollars of income'" (Scheall 2015). As a result, governments working to close the gap between "current spending and the level of spending . . . would ensure both zero inflation and zero unemployment" (Scheall 2015).

By establishing a "precise relationship. . .between aggregate employment and income and the rate of investment," we can thus see how Kahn's work was "integral" to the development of Keynes's "theory of employment" (Keynes 1936/2017). While the degree to which Kahn's work influences Keynes's is debatable, there is no doubt that Kahn – as both his "favourite pupil" and "Executor to Keynes' estate" as well as a close colleague – played a significant role in Keynes's life and the development of his economic theories (Fantacci et al. 2012; Kerr and Harcourt 2020).

Keynes: Towards a General Theory

The Great Depression of the 1930s was a "major turning point" in economic history (Crafts and Fearon 2013). Production rates fell, banks began to fail, and unemployment soared (Skousen 2007). Existing economic models (at the time) centered on "'long run' solutions" to the problem, solutions that did nothing to alleviate the troubles of financial strain imposed upon the people of the time (Keynes 1936/2017). Keynes believed economists "ought to. . . do better," do more to "alleviate some of that suffering," and more to aid the recuperation of the economy in the short term (Keynes 1936/2017). For, as he had famously stated in *A Tract on Monetary Reform*, "*In the long run* we are all dead" (Keynes 1929). Keynes acknowledged the failings of the capitalist or "free market" economy, specifically its inherent instability and its natural deterrence from full employment (Keynes 1936/2017; Skousen 2007). However, he also "argued that these failures had surprisingly narrow, technical causes" (Krugman 2018). As Keynes (1964: 379) expressed it,

> I see no reason to suppose that the existing system seriously misemploys the factors of production which are in use . . . It is determining the volumes, not the direction, of actual employment that the existing system has broken down.

To redress the economy's perceived faults, Keynes proposed a solution: a "revolutionary" solution (Keynes 1936/2017). Within *The General Theory of Employment, Interest and Money*, Keynes proposed that governments "deliberately running federal deficit and spending money on public works. . .would expand "aggregate demand" and restore confidence" (Skousen 2007). His reasoning was simple: "mass unemployment has a simple cause, inadequate demand, and an easy solution, expansionary fiscal policy" (Krugman 2018). In summing up his views on fiscal expansion, Keynes (1964: 129) provided a famous if somewhat flippant example:

> If the Treasury were to fill old bottles with bank-notes, bury them at suitable depths in disused coal-mines . . . and leave it to private enterprise on well-tried principles of **laissez-faire** to dig the notes up again (the right to do so being obtained, of course, by the tendering for leases of the note-bearing territory), there need be not more unemployment and . . . the real income of the community, and its capital wealth also, would probably become a good deal greater.

Keynes's *The General Theory* was not the cause of the world's subsequent recovery from the depression. Where governments pursued policies of fiscal expansion – as with Franklin Roosevelt's New Deal – it was typically done without guidance from Keynes's *General Theory*, which was not published until 1936. Nor did "Keynesian" policies bring about the end of the Great Depression. It was World War II that "restored full employment" (Krugman 2018). Keynesian economics is, however, credited with aiding governments in their fight to ensure "the postwar world" did not "slip back into depression" (Krugman 2018).

Keynes's *The General Theory* rethinks economics. In introducing his theory, Keynes informed his "fellow economists" that escaping from the "habitual modes of thought and expression" is difficult (Keynes 1936/2017). However, he goes on to say that such an escape is necessary in order to open the mind and accept the "new" and "extremely simple" ideas presented in his book (Keynes 1936/2017). While Malthus had previously recognized "failures of demand were possible," in the 1930s there existed no "model" to support such a line of examination (Krugman 2018). For Keynes, "classical" economic models are applicable for explaining economic behavior only in a "special case" – not the "general case." They are thus inapplicable to "the economic society in which we actually live" (Keynes 1936/2017; Skousen 2007). By way of illustrating this, Keynes convincingly refuted the "then conventional" understanding of the relationship between wages and labor (Krugman 2018; Keynes 1936/2017). Classical economic theory, Keynes says, bases its "theory of employment" on two "fundamentally wrong" "postulates": (1) "The wage is equal to the marginal produce of labour"; (2) "The utility of the wage when a given volume of labour is employed is equal to the marginal disutility of that amount of employment" (Keynes 1936/2017). Diverging from classical thought, Keynes conceived that:

> When employment increases aggregate real income is increased. The psychology of the community is such that when aggregate real income is increased aggregate consumption is increased, but not by so much as income. Hence employers would make a loss if the whole of the increased employment were to be devoted to satisfying the increased demand for immediate consumption. Thus, to justify any given amount of employment there must be an amount of current investment sufficient to absorb the excess of total output over what the community chooses to consume when employment is at the given level. For unless there is this amount of investment, the receipts of the entrepreneurs will be less than is required to induce them to offer the given amount of employment. (Keynes 1936/2017)

By examining the *actual* behavior of the economy – forgoing "the way in which we should like our Economy to behave," as is characteristic of classical economists – Keynes was able to propose a relatively "simple" solution to overcoming economically depressed markets (Keynes 1936/2017; Krugman 2018). For in his model, increased demand not only stimulated increased production, it also produced an increase in investment as employer's put in orders for new machines, factories, and transport.

Constructing an alternative theory, detached from the models of classical economy requires sophisticated thought. According to Keynes, the "real classical model" could be described as "model of a barter economy, in which money and nominal prices don't matter" (Krugman 2018). Guided by Say's law (i.e., "supply automatically creates its own demand, because income must be spent"), and denying interest rates play a significant role in managing the economy, Keynes argued that traditional economics was fundamentally misguided (Krugman 2018; Keynes 1936/2017). Central to Keynes's alternative model was an attempt to "discover what determines the volume of employment" (Keynes 1936/2017). To begin explaining his theory, Keynes provided an overview of the factors comprising a business cycle, notably income, investment, and employment. Of these three factors, Keynes argued that demand is key to this cycle (Keynes 1936/2017). Reinforcing the significance of demand, Keynes states, "All production" (and thus all employment necessary to facilitate production) "is for the purpose of ultimately satisfying a consumer" (Keynes 1936/2017). Identifying what factors influence a consumer's "propensity to consume" is, therefore, central to demand (Keynes 1936/2017). Accordingly, stimulation of these demand factors – including, the wage-unit, income, and capital-values (i.e., the value of one's home) – has the ability to influence the level of aggregate demand (Keynes 1936/2017). According to Keynes, "the propensity to consume is a fairly stable function" and "as a rule, the amount of aggregate consumption mainly depends on the amount of aggregate income" (Keynes 1936/2017). This insight is significant to understanding of employment. For it leads Keynes to conclude that "employment can only increase *pari passu* with an increase in investment; unless, indeed, there is a change in the propensity to consume" (Keynes 1936/2017). Furthermore, by establishing a "ratio" (i.e., multiplier) "between income and investment and... between the total employment and the employment directly employed on investment," Keynes was able to determine "the precise relationship, given a propensity to consume, between aggregate employment and income and the rate of investment" (Keynes 1936/2017). This "step is an integral part" of Keynes's "theory on employment" (Keynes 1936/2017).

What factors influence investment? This deceptively simple question requires a highly complex response. Prior to examining the question, Keynes outlined *why* a person may invest, noting that when a person "buys an investment or capital asset," they purchase "the right to the series of prospective returns, which" they expect "to obtain from selling its output, after deducting the running expenses of obtaining that output, during the life of the asset" (Keynes 1936/2017). In other words, people invest with the expectation of being better off than they would otherwise have been. By calculating the *marginal efficiency of capital,* investors are able to determine the net return they can expect to receive from a capital investment (Keynes 1936/2017; Krugman 2018). Keynes defined the *marginal efficiency of capital* as "being equal to that rate of discount which would make the present value of the series of annuities given by the returns expected from the capital-asset during its life just equal to its supply price" (Keynes 1936/2017). There exists, therefore, a relationship between "the marginal efficiency of capital" and "the rate of investment" (Krugman 2018; Keynes 1936/2017). Keynes, however, expanded on this finding, stating that "the rate of investment will be pushed the point on the investment demand-schedule where the marginal efficiency of capital, in general, is equal to the market rate of interest (Keynes 1936/2017). From this accurate insight, Keynes concluded that it is the "investment demand-schedule" (i.e., the depreciation or wearing out of past investment) and the "rate of interest" that influences investment (Keynes 1936/2017). In tying this insight with the volume of employment, it can be concluded that "employment is determined by the point at which the value of output is equal to the sum of investment and consumer spending" (Krugman 2018). Consumer spending is thus central to employment, spurring not only direct production but also increased investment. As Keynes stated, "since the expectation of consumption is the only *raison d'être* of employment, there should be nothing paradoxical in the conclusion that a diminished propensity to consume has" all things being equal, "a depressing effect on employment" (Keynes 1936/2017).

Wages and price have an important relationship in the economy. In exploring their relationship, Keynes posed two questions: (a) "Does a reduction in money-wages have a direct tendency. . .to increase employment?" (b) "does a reduction in money-wages have a certain or probable tendency to affect employment in a particular direction" (Keynes 1936/2017)? Keynes not only looked toward his theory in order to answer these questions but, characteristically, also outlined how his theory filled the gap left by classical thought. Classical economics, specifically "Professor Pigou's *Theory of Unemployment*" says Keynes, has "no method of analysis" through which these questions are able to be answered (Keynes 1936/2017). For, classical theory "has nothing to offer, when it is applied to the problem of what determines the volume of actual employment as a whole" (Keynes 1936/2017). Keynes's theory on the other hand does. According to Keynes, a reduction in wages does *not* correlate with an increase in employment (Keynes 1936/2017). Instead, changes in employment levels are influenced by changes in aggregate demand (Keynes 1936/2017). Keynes nevertheless identified that there are various methods through which demand may be increased – each with varying degrees of success. In summary, Keynes observed that, "If, for example, the increased demand is largely directed towards products which have a high elasticity of employment, the aggregate increase in employment will be greater than if it is largely directed towards products which have a low elasticity of employment" (Keynes 1936/2017). If investment cultivates demand, it must therefore follow that money influences demand. It also follows that money primarily influences demand through the "rate of interest" (Keynes 1936/2017). However, this conclusion "presents a deceptive simplicity" (Keynes 1936/2017). For, the rate of interest is quantitatively affected by "the schedule of liquidity-preference," "the schedule of marginal efficiencies" and "the investment multiplier," each of which is individually defined by a further layer of factors, including wages (Keynes 1936/2017). Given these complexities, Keynes concluded that Government intervention is vital to ensuring a stable economic future.

A free market, free from any form of government intervention is inevitably subject to severe fluctuations in trade cycles. Free markets, therefore, in Keynes's estimation, typically fail to "provide for full employment" or an equitable distribution of "wealth and incomes" (Keynes 1936/2017). Accordingly, in summing up the need for government intervention in the economy, Keynes (2019) stated

> In conditions of *laissez-faire* the avoidance of wide fluctuations in employment may. . .prove impossible without a far-reaching change in the psychology of investment markets such as there is no reason to expect. I conclude that the duty of ordering the current volume of investment cannot safely be left in private hands.

Unlike traditional economists, Keynes also recognized the importance of interest rates in managing an economy (Keynes 1936/2017). For the "rate of interest" has the direct ability to influence economic activity (Keynes 1936/2017). Acknowledging that in a free market, "the rate of interest is not self-adjusting at a level best suited to the social advantage," Keynes asserted that government intervention in managing interest rates aids not only the alleviation of the "booms" and "slumps" of the market. It also has the ability to keep the economy in a "quasi-boom" state (Keynes 1936/2017). As Keynes stated:

> . . .the remedy for the boom is not a higher rate of interest but a lower rate of interest! For that may enable the so-called boom to last. The right remedy for the trade cycle is not to be found in abolishing booms and thus keeping us permanently in a semi-slump; but in abolishing slumps and thus keeping us permanently in a quasi-boom.

In calling for increased state intervention, Keynes was not, however, a proponent for socialism. Instead, he aimed to "save capitalism" from its own failings (Krugman 2018). In doing so, he believed that incentives such as "money-making" and "private wealth-ownership" were critical to ensuring that certain "activities" reach their full potential (Keynes 1936/2017). Keynes's remedy to a depressed economy, unlike "many of his contemporaries" (i.e., socialists, communists, fascists, etc.) vying for "government takeover," involved the government introducing policies to stimulate "effective demand" and revitalize the market in the relatively short term (Krugman 2018). For Keynes, the problem of mass unemployment was, in fact, relatively easy to solve (Krugman 2018).

Keynes and Hayek: The Debate

Keynes did not develop his revolutionary theory without controversy. Party to the "most famous" debate "in the history of contemporary economic thought" was John Maynard Keynes and "rival" economist, Friedrich August Hayek, who would later win a Nobel Prize in Economics (Bas 2011). Supporting "doctrines. . .in direct opposition to Keynes," it was Hayek who initiated the debate with a critical review of Keynes's work in *A Treatise on Money* (Bas 2011; Facchini 2016; Kahn 1984). In doing so, Hayek set out to "show up" Keynes's *Treatise* "as a theoretical dead end"

(Hayek 1935/2008). The debate that ensued spanned 2 years (1931–1932) and centered primarily on the interpretation of the content of Keynes book, and more specifically their differing views on the "nature of a free market economy" (Bas 2011; Facchini 2016). At the time of this debate, the global economy was already failing, evidence in Keynes's estimation that the "self-regulating" free market was *not* "self-regulating" (Keynes 1936/2017). As an exponent for "interventionism" (Facchini 2016), Keynes believed that markets could be stabilized by government policies without any detrimental effect on a nation's long-term productive capacities (Facchini 2016). Hayek, on the other hand, was a supporter of "laissez-fair" economics (Facchini 2016).

The debate between Keynes and Hayek was important not only in itself but also in terms of the theoretical conclusions that occurred as a result of their interaction (Bas 2011). The most obvious effect of the debate is found in Keynes's reaction, Keynes subsequently declaring that a desire to "re-shape and improve" his "central position" was behind his early withdrawal from the debate (Bas 2011). The main result of this reshaping of ideas is found in Keynes's publication of *The General Theory*, a work that displayed a "new elaboration of his model" when compared to that found within his previously published *The Treatise on Money* (Bas 2011). While the debate between the two economists ended, for the followers of their respective disciplines it was – and is – "indeed, ongoing" (Scheall 2015).

Hayek is renowned for his "profound and enduring" contribution to economic thought, most specifically his work on macroeconomics. In his first major work, *Prices and Production* – a study that was originally presented across four lectures at the University of London in 1930–1931 – Hayek outlined a novel theoretical proposal: that "industrial fluctuations" are caused by a "misalignment" between real loan interest rates and the "natural rate of interest" (Scheall 2015; Hayek 1935/2008). For, in Hayek's estimation, when real loan interest rates are "below" the "natural rate," economic instability – a precursor to economic collapse – ensues (Scheall 2015; Keynes 1936/2017). As Hayek observed, "unnaturally low interest rates lead in the short run to what appear to be positive effects that are inexorably reversed in the longer run: boom is eventually and unavoidably followed by bust" (Scheall 2015).

Hayek's solution to stimulating the trade cycle in depressed markets was markedly different to that of Keynes's. Keynes argued that by increasing consumer demand and elevating consumption levels (i.e., spending), economic "breakdown" could be curtailed (McNerney 2016). Thus, government intervention plays an important role in controlling market fluctuations. For Hayek, however, disrupting the *natural* order of the market had long-term consequences. Artificially "lowering interest rates," for example, manipulates monetary supply, thereby distorting the "structure of production by encouraging [the] production of temporarily early capital goods" (Ebenstein 2003). In times of depression, third-party management of interest rates thus creates an imbalance in the economy (Ebenstein 2003). For, "in the short run, increase in the demand for consumer goods can redirect production from longer temporal capital processes to the quick production of consumer goods, thereby entailing less capital investment in the longer temporal process" (Ebenstein 2003).

Hayek's point was that unnatural intervention "would discourage real investment," i.e., investment that usefully serves the long-term needs of the economy (Ebenstein 2003).

Hayek's critical review of Keynes's *The Treatise on Money* ignited a debate that would outlive both parties. Central to the debate was Hayek's criticism of Keynes's incomplete analysis of a "capital theory" (Scheall 2015; Facchini 2016). While Keynes acknowledged that a more thorough analysis would have improved his study, he was of the opinion that publication of the work was "too pressing to wait for an adequate theoretical analysis" (Scheall 2015; Facchini 2016). According to Hayek, Keynes's "fallacious theory of capital" was the root of many problems within his work. For, from this theory stemmed an "obscure analysis of investment" and an "unsatisfactory account of profits" – central factors of an economy (Hayek 1931b; Zouache 2008). While Hayek agreed "perfectly" with Keynes's assertion that the profits achieved by "entrepreneurs" has a direct influence on an entrepreneur's business, he also sensibly observed that there exists a correlation between profits and the level of investment undertaken by entrepreneurs (Hayek 1931b). As a result, Hayek disagreed with Keynes's account of "why profits arise" and "with his implication that only changes in 'total profits' ... can lead to an expansion or curtailment" in production (Hayek 1931b). According to Hayek, Keynes's assessment led one to believe "that *any* change in the amount of capital per head of working population is equivalent to a change in the average length of the roundabout process of production" (Hayek 1932). He went on to say:

> ... his [Keynes] exclusive insistence on new investment and his neglect of the process of re-investment makes him overlook the all-important fact that an increase in the demand for consumers' goods will not only tend to stop new investment, but may make a complete reorganisation of the existing structure of production inevitable-which would involve considerable disturbances and would render it impossible, temporarily, to employ all labour. (Hayek 1932)

What Keynes is ultimately discussing within his *Treatise on Money,* according to Hayek, are "shifts in the money streams and the consequent changes in price levels" (Hayek 1932). He goes on to say that "It seems never to have occurred to him that the artificial stimulus to investment, which makes it exceed current saving, may cause dis-equilibrium in the real structure of production which, sooner or later, must lead to a reaction" (Hayek 1932). Ultimately, Hayek says, Keynes's explanation of a trade cycle dictates that the central factor influencing an economic "boom" is *not* "the increase in investment, but the consequent increase in the prices of consumer's goods and the profit which is" subsequently gained (Hayek 1932). He goes on to provide three key reasons why Keynes's proposal would consequently fail in practice, namely: the stimulus is not able to be maintained indefinitely, increased consumer demand may lead to a "decrease in investment," and finally it may "produce a decrease" in "general activity and employment" (Hayek 1932).

Keynes's response to Hayek's critique is surmised in a relatively short article, *The Pure Theory of Money. A Reply to Dr. Hayek* (Keynes 1931). Within this paper, Keynes surmised that many of the faults identified and examined by Hayek were in fact misinterpretations of his work. Moreover, Keynes suggested, where Hayek's criticisms were true they did not detract from the fundamental concepts that Keynes had outlined. Referencing the content of Hayek's publication *Prices and Production* throughout, Keynes's reply evolves to become in part a review of Hayek's book. Careful to emphasis what he perceived to be a fundamental failing of Hayek's work in his response to Hayek, Keynes reviews the concepts within *Prices and Production* stating:

> This book as it stands, seems to me to be one of the most frightful muddles I have ever read, with scarcely a sound proposition in it beginning with page 45, and yet it remains a book of some interest, which is likely to leave its mark on the mind of the reader. It is an extraordinary example of how, starting with a mistake, a remorseless logician can end up in Bedlam. Yet Dr. Hayek has seen a vision, and though when he work up he has made nonsense of his story by giving the wrong names to the objects which occur in it, his Khubla Kahn is not without inspiration and must set the reader thinking with the germs of an idea in his head. (Keynes 1931)

Following the publication of his response, Keynes withdrew from the "debate" (Bas 2011).

As a result of the three articles Hayek authored in *Economica* "reflecting" upon Keynes's work in the *Treatise on Money* – and Keynes's response to this intellectual assault – Hayek's critique "dominated" the academic journal (i.e., *Economica*) "for a full year" (Ebenstein 2003; Hayek 1931b, 1932). Several generations on, the questions that emerged from the debate still inform and divide economists, managers, business leaders, politicians, and governments. What is the best response to a slowing economy? Is it government intervention, directed towards full employment and increased demand? Or, should instead, society seek instead to bolster the supply-side factors in the economic equation: profits, higher productivity, greater efficiencies? As in the time of Hayek and Keynes, these questions remain deeply divisive.

Conclusion

Across his academic career, Keynes spoke to the central issues of his time, creating insights and debates that remain central to our time. A member of the British delegation responsible for the drafting of the *Treaty of Versailles*, Keynes vehemently opposed to the harsh peace terms. The purpose of his first major book *The Economic Consequences of the Peace* was "to show that the Carthaginian Peace is not *practically* right or possible" (Keynes 1919/2005). The "Germans could not pay what they had not got," nor was it in the best interests of Europe for Germany to be transformed into an "inefficient, unemployed" nation with no hope of economic recovery (Dimand 2019; Keynes 1919/2005).

Evident within the final chapters of *The Economic Consequences of the Peace* is a clear interest in macroeconomic factors, and the relationship between political decisions and economic outcomes. In pursuing these themes, Keynes's ideas were influenced by his one-time student, Richard Kahn, an economist who conceived the "Multiplier Theory," i.e., the "rate at which 'every dollar spent by the government. . .create[s] several dollars of income" (Scheall 2015). In building upon Kahn's insights in his *The General Theory*, Keynes transformed not only economics but also politics through his attack on the "reigning orthodoxy of classical economics" (Krugman 2018). Unlike his classical counterparts, Keynes recognized that within a free market, decreased demand can lead to not only "involuntary unemployment" but also a vicious economic circle whereby falling consumer demand led to further reductions in both demand and production (Krugman 2018). Arguing that a free market is – if left to itself – often incapable of providing "full employment," Keynes' proposed a theory that would "save capitalism" rather than destroy it (Keynes 1936/2017; Krugman 2018). In doing so, Keynes proposed that government intervention in the form of "policies" aimed at regulating "effective demand" (Krugman 2018; Keynes 1936/2017). In aiming to increase consumer demand, Keynes argued, the main short-term objective is not increased levels of individual wealth but rather a greater *inducement* to invest. For, as Keynes (1936/1964: 31–32) explained in his *General Theory*,

> If in a potentially wealthy community the inducement to invest is weak, then, in spite of its potential wealth, the working of the principle of effective demand will compel it is reduce its actual output, until, in spite of its potential wealth, it has become so poor that its surplus over its consumption is sufficiently diminished to correspond to the weakness of the inducement to invest.

Although Keynes was no socialist, his ideas nevertheless represented a profound questioning of the role of market competition in liberal democratic societies. No one recognized this with greater clarity than Hayek, one of the twentieth century's greater defenders of competition and free markets. In critiquing Keynes's work in 1931–1932, Hayek observed that Keynes was trying to steer economic thought in a relatively new direction, attempting to "amalgamate" his "new ideas with the monetary teaching tradition in Cambridge" (Hayek 1931b). According to Hayek, this attempt was unsuccessful. His thoughts on the matter were communicated within three articles (two with written substance) written in response to Keynes publication, *The Treatise on Money*. Despite referring to Keynes works as "undeniably. . .magnificent," Hayek is largely critical of the publication, finding faults in many key elements including, prices, investment, and capital (Hayek 1931b, 1932). In providing his criticisms of Keynes, Hayek was not only giving voice to what became a powerful anti-Keynesian tradition during the closing decades of the twentieth century, he also provided a spur to Keynes, forcing him into a thorough reconsideration of his own principles; a reconsideration that found fruit in Keynes's *General Theory*.

As management historians, we still live in the shadow of the Keynes-Hayek debate. Divisive as this debate has been, we can nevertheless hardly pursue our own analysis without an understanding of economics in general and this debate in particular. For, as Keynes once said:

> . . .the ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed, the world is ruled by little else. Practical men, who believe themselves to be quite exempt from any intellectual influences, are usually the slaves of some defunct economist.

Cross-References

▶ Conflicting Understandings of the Industrial Revolution and Its Consequences: The Founding Figures of British Management History
▶ Economic Foundations: Adam Smith and the Classical School of Economics
▶ Intellectual Enlightenment: The Epistemological Foundations of Business Endeavor
▶ Neo-classical Thought: Alfred Marshall and Utilitarianism
▶ The Marxist Opposition to Capitalism and Business

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