

Introduction by Paul Krugman to *The General Theory of Employment, Interest, and Money*, by John Maynard Keynes

SYNOPSIS:

Introduction

In the spring of 2005 a panel of “conservative scholars and policy leaders” was asked to identify the most dangerous books of the 19th and 20th centuries. You can get a sense of the panel’s leanings by the fact that both Charles Darwin and Betty Friedan ranked high on the list. But *The General Theory of Employment, Interest, and Money* did very well, too. In fact, John Maynard Keynes beat out V.I. Lenin and Frantz Fanon. Keynes, who declared in the book’s oft-quoted conclusion that “soon or late, it is ideas, not vested interests, which are dangerous for good or evil,” [384] would probably have been pleased.

Over the past 70 years *The General Theory* has shaped the views even of those who haven’t heard of it, or who believe they disagree with it. A businessman who warns that falling confidence poses risks for the economy is a Keynesian, whether he knows it or not. A politician who promises that his tax cuts will create jobs by putting spending money in peoples’ pockets is a Keynesian, even if he claims to abhor the doctrine. Even self-proclaimed supply-side economists, who claim to have refuted Keynes, fall back on unmistakably Keynesian stories to explain why the economy turned down in a given year.

In this introduction I’ll address five issues concerning *The General Theory*. First is the book’s message – something that ought to be clear from the book itself, but which has often been obscured by those who project their fears or hopes onto Keynes. Second is the question of how Keynes did it: why did he succeed, where others had failed, in convincing the world to accept economic heresy? Third is the question of how much of *The General Theory* remains in today’s macroeconomics: are we all Keynesians now, or have we either superseded Keynes’s legacy, or, some say, betrayed it? Fourth is the question of what Keynes missed, and why. Finally, I’ll talk about how Keynes changed economics, and the world.

The message of Keynes

It’s probably safe to assume that the “conservative scholars and policy leaders” who pronounced *The General Theory* one of the most dangerous books of the past two centuries haven’t read it. But they’re sure it’s a leftist tract, a call for big government and high taxes. That’s what people on the right, and some on the left, too, have said about *The General Theory* from the beginning.

In fact, the arrival of Keynesian economics in American classrooms was delayed by a nasty case of academic McCarthyism. The first introductory textbook to present Keynesian thinking, written by the Canadian economist Lorie Tarshis, was targeted by a

right-wing pressure campaign aimed at university trustees. As a result of this campaign, many universities that had planned to adopt the book for their courses cancelled their orders, and sales of the book, which was initially very successful, collapsed. Professors at Yale University, to their credit, continued to assign the book; their reward was to be attacked by the young William F. Buckley for propounding “evil ideas.”¹

But Keynes was no socialist – he came to save capitalism, not to bury it. And there’s a sense in which *The General Theory* was, given the time it was written, a conservative book. (Keynes himself declared that in some respects his theory had “moderately conservative implications.” [377]) Keynes wrote during a time of mass unemployment, of waste and suffering on an incredible scale. A reasonable man might well have concluded that capitalism had failed, and that only huge institutional changes – perhaps the nationalization of the means of production – could restore economic sanity. Many reasonable people did, in fact, reach that conclusion: large numbers of British and American intellectuals who had no particular antipathy toward markets and private property became socialists during the depression years simply because they saw no other way to remedy capitalism’s colossal failures.

Yet Keynes argued that these failures had surprisingly narrow, technical causes. “We have magneto [alternator] trouble” he wrote in 1930, as the world was plunging into depression.² And because Keynes saw the causes of mass unemployment as narrow and technical, he argued that the problem’s solution could also be narrow and technical: the system needed a new alternator, but there was no need to replace the whole car. In particular, “no obvious case is made out for a system of State Socialism which would embrace most of the economic life of the community.” [378] While many of his contemporaries were calling for government takeover of the whole economy, Keynes argued that much less intrusive government policies could ensure adequate effective demand, allowing the market economy to go on as before.

Still, there is a sense in which free-market fundamentalists are right to hate Keynes. If your doctrine says that free markets, left to their own devices, produce the best of all possible worlds, and that government intervention in the economy always makes things worse, Keynes is your enemy. And he is an especially dangerous enemy because his ideas have been vindicated so thoroughly by experience.

Stripped down, the conclusions of *The General Theory* might be expressed as four bullet points:

- Economies can and often do suffer from an overall lack of demand, which leads to involuntary unemployment
- The economy’s automatic tendency to correct shortfalls in demand, if it exists at all, operates slowly and painfully
- Government policies to increase demand, by contrast, can reduce unemployment quickly

- Sometimes increasing the money supply won't be enough to persuade the private sector to spend more, and government spending must step into the breach

To a modern practitioner of economic policy, none of this – except, possibly, the last point – sounds startling or even especially controversial. But these ideas weren't just radical when Keynes proposed them; they were very nearly unthinkable. And the great achievement of *The General Theory* was precisely to make them thinkable.

How Keynes did it

I first read *The General Theory* as a student; then, I suspect like most economists of my generation, I didn't open it again for several decades. Modern academic economics is an endeavor dominated by the new. Often, a whole literature has arisen, flourished, and decayed before the first paper in that literature receives formal publication. Who wants to spend time reading stuff first published 70 years ago?

But *The General Theory* is still worth reading and rereading, not just for what it tells us about the economy, but for what it tells us about the nature of progress in economic thought. As an economics student, I enjoyed Keynes's flashes of wit and purple prose, but I labored through or skimmed his elaborate discussions of methodology. As a middle-aged economist with a couple of hundred papers behind me, and with some experience of the "struggle of escape" involved in producing a new economic theory, I read the book from a very different perspective – and with a sense of awe. Parts of the book that once seemed tedious are, I now understand, part of a titanic effort to rethink economics, an effort whose success is demonstrated by the fact that so many of Keynes's radical innovations now seem obvious. To really appreciate *The General Theory*, one needs a sense of what Keynes had to go through to get there.

In telling people how to read *The General Theory*, I find it helpful to describe it as a meal that begins with a delectable appetizer and ends with a delightful dessert, but whose main course consists of rather tough meat. It's tempting for readers to dine only on the easily digestible parts of the book, and skip the argument that lies between. But the main course is where the true value of the book lies.

I'm not saying that one should skip the fun parts. By all means, read them for the sheer enjoyment, and as a reminder of what Keynes accomplished. In fact, let me say a few words about those parts of the book before I myself get to the hard parts.

Book I is Keynes's manifesto, and for all its academic tone, and even its inclusion of a few equations, it's a thrilling piece of writing. Keynes puts you, the professional economist – for *The General Theory* was, above all, a book written for knowledgeable insiders - on notice that he's going to refute everything you thought you knew about employment. In just a few pages he convincingly shows that the then conventional view about the relationship between wages and employment involves a basic fallacy of composition: "In assuming that the wage bargain determines the real wage the classical school have slipt into an illicit assumption." [13]. From this, he quickly shows that the

conventional view that wage cuts were the route to full employment made no sense given the realities of the time. And in just a few more pages he lays out enough of his own theory to suggest the breathtaking conclusion that the Great Depression then afflicting the world was not only solvable, but easily solvable.

It's a bravura performance. Modern readers who stop after Book I, however, without slogging through the far denser chapters that follow, get a sense of Keynes's audacity, but not of how he earned the right to that audacity.

Book VI, at the opposite end of *The General Theory*, really is a kind of dessert course. Keynes, the hard work of creating macroeconomics as we know it behind him, kicks up his heels and has a little fun. In particular, the final two chapters of *The General Theory*, though full of interesting ideas, have an impish quality. Keynes tells us that the famous victory of free trade over protectionism may have been won on false pretenses – that the mercantilists had a point. He tells us that the “euthanasia of the rentier” [376] may be imminent, because thrift no longer serves a social function. Did he really believe these things, or was he simply enjoying tweaking the noses of his colleagues? Probably some of both.

Again, Book VI is a great read, although it hasn't stood the test of time nearly as well as Book I. But the same caution applies: by all means, read Keynes's speculations on the virtues of mercantilism and the vanishing need for thrift, but remember that the tough stuff in Books II through V is what gave him the right to speculate.

So now let's talk about the core of the book, and what it took for Keynes to write it.

Challenges to economic orthodoxy are a dime a dozen. At least once a month I receive a new book that purports to overthrow conventional economic wisdom. The vast majority of these books' authors, however, don't understand enough about existing economic theory to mount a credible challenge.

Keynes, by contrast, was deeply versed in the economic theory of his time, and understood the power of that body of theory. “I myself,” he wrote in the preface, “held with conviction for many years the very theories which I now attack, and am not, I think, unaware of their strong points.” He knew that he had to offer a coherent, carefully reasoned challenge to the reigning orthodoxy to change peoples' minds. In Book I, as Keynes gives us a first taste of what he's going to do, he writes of Malthus, whose intuition told him that general failures of demand were possible, but had no model to back that intuition: “[S]ince Malthus was unable to explain clearly (apart from an appeal to the facts of common observation) how and why effective demand could be deficient or excessive, he failed to provide an alternative construction; and Ricardo conquered England as completely as the Holy Inquisition conquered Spain.” [32]

That need to “provide an alternative construction” explains many of the passages in *The General Theory* that, 70 years later, can seem plodding or even turgid. In particular, it explains Book II, which most modern readers probably skip. Why devote a whole

chapter to “the choice of units,” which doesn’t seem to have much to do with Keynes’s grand vision? Why devote two more chapters to defining the meaning of income, savings, and investment? For the same reason that those of us who developed the so-called “new trade theory”, circa 1980, lavished many pages on the details of product differentiation and monopolistic competition. These details had nothing much to do with the fundamental ideas behind the new theory. But the details were crucial to producing the buttoned-down models we needed to clarify our thoughts and explain those thoughts to others. When you’re challenging a long-established orthodoxy, the vision thing doesn’t work unless you’re very precise about the details.

Keynes’s appreciation of the power of the reigning orthodoxy also explains the measured pace of his writing. “The composition of this book,” wrote Keynes in the preface, “has been for the author a long struggle of escape, and so must the reading of it be.” Step by step, Keynes set out to liberate economists from the intellectual confines that left them unable to deal with the Great Depression, confines created for the most part by what Keynes dubbed “classical economics.”

Keynes’s struggle with classical economics was much more difficult than we can easily imagine today. Modern introductory economics textbooks – the new book by Krugman and Wells included – usually contain a discussion of something we call the “classical model” of the price level. But that model offers far too flattering a picture of the classical economics Keynes had to escape from. What we call the classical model today is really a post-Keynesian attempt to rationalize pre-Keynesian views. Change one assumption in our so-called classical model, that of perfect wage flexibility, and it turns back into *The General Theory*. If that had been all Keynes had to contend with, *The General Theory* would have been an easy book to write.

The real classical model, as Keynes described it, was something much harder to fix. It was, essentially, a model of a barter economy, in which money and nominal prices don’t matter, with a monetary theory of the price level appended in a non-essential way, like a veneer on a tabletop. It was a model in which Say’s Law applied: supply automatically creates its own demand, because income must be spent. And it was a model in which the interest rate was purely a matter of the supply and demand for funds, with no possible role for money or monetary policy. It was, as I said, a model in which ideas we now take for granted were literally unthinkable.

If the classical economics Keynes confronted had been what we call the classical model nowadays, he wouldn’t have had to write Book V of *The General Theory*, “Money-wages and prices.” In that book Keynes confronts naïve beliefs about how a fall in wages can increase employment, beliefs that were prevalent among economists when he wrote, but play no role in the model we now call “classical.”

So the crucial innovation in *The General Theory* isn’t, as a modern macroeconomist tends to think, the idea that nominal wages are sticky. It’s the demolition of Say’s Law and the classical theory of the interest rate in Book IV, “The inducement to invest.” One measure of how hard it was for Keynes to divest himself of Say’s Law is that to this day

some people deny what Keynes realized – that the “law” is, at best, a useless tautology when individuals have the option of accumulating money rather than purchasing real goods and services. Another measure of Keynes’s achievement may be hard to appreciate unless you’ve tried to write a macroeconomics textbook: how do you explain to students how the central bank can reduce the interest rate by increasing the money supply, even though the interest rate is the price at which the supply of loans is equal to the demand? It’s not easy to explain even when you know the answer; think how much harder it was for Keynes to arrive at the right answer in the first place.

But the classical model wasn’t the only thing Keynes had to escape from. He also had to break free of the business cycle theory of the day.

There wasn’t, of course, a fully-worked out theory of recessions and recoveries. But it’s instructive to compare *The General Theory* with Gottfried Haberler’s *Prosperity and Depression*³, written at roughly the same time, which was a League of Nations-sponsored attempt to systematize and synthesize what the economists of the time had to say about the subject. What’s striking about Haberler’s book, from a modern perspective, is that he was trying to answer the wrong question. Like most macroeconomic theorists before Keynes, Haberler believed that the crucial thing was to explain the economy’s dynamics, to explain why booms are followed by busts, rather than to explain how mass unemployment is possible in the first place. And Haberler’s book, like much business cycle writing at the time, seems more preoccupied with the excesses of the boom than with the mechanics of the bust. Although Keynes speculated about the causes of the business cycle in Chapter 22 of *The General Theory*, those speculations were peripheral to his argument. Instead, Keynes saw it as his job to explain why the economy sometimes operates far below full employment. That is, *The General Theory* for the most part offers a static model, not a dynamic model – a picture of an economy stuck in depression, not a story about how it got there. So Keynes actually chose to answer a more limited question than most people writing about business cycles at the time.

Again, I didn’t understand the importance of that strategic decision on Keynes’s part the first time I read *The General Theory*. But it’s now obvious to me that most of Book II is a manifesto on behalf of limiting the question. Where pre-Keynesian business cycle theory told complex, confusing stories about disequilibrium, Chapter 5 makes the case for thinking of an underemployed economy as being in a sort of equilibrium in which short-term expectations about sales are, in fact, fulfilled. Chapter 6 and Chapter 7 argue for replacing all the talk of forced savings, excess savings, and so on that was prevalent in pre-Keynesian business cycle theory – talk that stressed, in a confused way, the idea of disequilibrium in the economy - with the simple accounting identity that savings equal investment.

And Keynes’s limitation of the question was powerfully liberating. Rather than getting bogged down in an attempt to explain the dynamics of the business cycle – a subject that remains contentious to this day – Keynes focused on a question that could be

answered. And that was also the question that most needed an answer: given that overall demand is depressed – never mind why - how can we create more employment?

A side benefit of this simplification was that it freed Keynes and the rest of us from the seductive but surely false notion of the business cycle as morality play, of an economic slump as a necessary purgative after the excesses of a boom. By analyzing how the economy stays depressed, rather than trying to explain how it became depressed in the first place, Keynes helped bury the notion that there's something redemptive about economic suffering.

The General Theory, then, is a work of informed, disciplined radicalism. It transformed the way everyone, including Keynes's intellectual opponents, thought about the economy. But that raises a contentious question: are we, in fact, all Keynesians now?

Mr. Keynes and the moderns

There's a widespread impression among modern macroeconomists that we've left Keynes behind, for better or for worse. But that impression, I'd argue, is based either on a misreading or a nonreading of *The General Theory*. Let's start with the nonreaders, a group that included me during the several decades that passed between my first and second reads of *The General Theory*.

If you don't read Keynes himself, but only read his work as refracted through various interpreters, it's easy to imagine that *The General Theory* is much cruder than it is. Even professional economists, who know that Keynes wasn't a raving socialist, tend to think that *The General Theory* is largely a manifesto proclaiming the need for deficit spending, and that it belittles monetary policy. If that were really true, *The General Theory* would be a very dated book. These days economic stabilization is mainly left up to technocrats in central banks, who move interest rates up and down through their control of the money supply; the use of public works spending to prop up employment is generally considered unnecessary. To put it crudely, if you imagine that Keynes was dismissive of monetary policy, it's easy to imagine that Milton Friedman in some sense refuted or superseded Keynes by showing that money matters.

The impression that *The General Theory* failed to give monetary policy its due may have been reinforced by John Hicks, whose 1937 review essay "Mr. Keynes and the classics" is probably more read by economists these days than *The General Theory* itself. In that essay Hicks interpreted *The General Theory* in terms of two curves, the IS curve, which can be shifted by changes in taxes and spending, and the LM curve, which can be shifted by changes in the money supply. And Hicks seemed to imply that Keynesian economics applies only when the LM curve is flat, so that changes in the money supply don't affect interest rates, while classical macroeconomics applies when the LM curve is upward-sloping.

But in this implication Hicks was both excessively kind to the classics and unfair to Keynes. I've already pointed out that the macroeconomic doctrine from which Keynes

had to escape was much cruder and more confused than the doctrine we now call the “classical model.” Let me add that *The General Theory* doesn’t dismiss or ignore monetary policy. Keynes discusses at some length how changes in the quantity of money can affect the rate of interest, and through the rate of interest affect aggregate demand. In fact, the modern theory of how monetary policy works is essentially that laid out in *The General Theory*.

Yet it’s fair to say that *The General Theory* is pervaded by skepticism about whether merely adding to the money supply is enough to restore full employment. This wasn’t because Keynes was ignorant of the potential role of monetary policy. Rather, it was an empirical judgment on his part: *The General Theory* was written in an economy with interest rates already so low that there was little an increase in the money supply could do to push them lower.

Consider Figure 1, which shows the rate of interest on 3-month Treasury bills in the U.S. from 1920 to 2002. Economists of my generation came of intellectual age during the 1970s and 1980s, when interest rates were consistently above 5 percent and sometimes in double digits. Under those conditions there was no reason to doubt the effectiveness of monetary policy, no reason to worry that the central bank could fail in efforts to drive down interest rates and thereby increase demand. But as the figure shows, *The General Theory* was written in a very different monetary environment, one in which interest rates stayed close to zero for an extended period.

Modern macroeconomists don’t have to theorize about what happens to monetary policy in such an environment, or even plumb the depths of economic history, because we have a striking recent example to contemplate. There are hopes as I write this that the Japanese economy may finally be staging a sustained recovery, but from the early 1990s at least through 2004 Japan was in much the same monetary state that the U.S. and U.K. economies were in during the 1930s. Short-term interest rates were close to zero, long-term rates were at historical lows, yet private investment spending remained insufficient to bring the economy out of deflation. In that environment, monetary policy was just as ineffective as Keynes described. Attempts by the Bank of Japan to increase the money supply simply added to already ample bank reserves and public holdings of cash while doing nothing to stimulate the economy. (A Japanese joke from the late 90s said that safes were the only product consumers were buying.) And when the Bank of Japan found itself impotent, the government of Japan turned to large public works projects to prop up demand.

Keynes made it clear that his skepticism about the effectiveness of monetary policy was a contingent proposition, not a statement of a general principle. In the past, he believed, things had been otherwise. “There is evidence that for a period of almost one hundred and fifty years the long-run typical rate of interest in the leading financial centres was about 5 percent, and the gilt-edged rate between 3 and 3 ½ percent; and that these rates were modest enough to encourage a rate of investment consistent with an average of employment which was not intolerably low.” [307-308] In that environment, he believed, “a tolerable level of unemployment could be attained on the average of one

or two or three decades merely by assuring an adequate supply of money in terms of wage-units.” [309] In other words, monetary policy had worked in the past – but not now.

Now it’s true that Keynes believed, wrongly, that the conditions of the 1930s would persist indefinitely – indeed, that the marginal efficiency of capital was falling to the point that the euthanasia of rentiers was in view. I’ll talk in a bit about why he was wrong.

Before I get there, however, let me talk about an alternative view. This view agrees with those who say that modern macroeconomics owes little to Keynes. But rather than arguing that we have superseded Keynes, this view says that we have misunderstood him. That is, some economists insist that we’ve lost the true Keynesian path – that modern macroeconomic theory, which reduces Keynes to a static equilibrium model, and tries to base as much of that model as possible on rational choice, is a betrayal of Keynesian thinking.

Is this right? On the issue of rational choice, it’s true that compared with any modern exposition of macroeconomics, *The General Theory* contains very little discussion of maximization and a lot of behavioral hypothesizing. Keynes’s emphasis on the non-rational roots of economic behavior is most quotable when he writes of financial market speculation, “where we devote our intelligences to anticipating what average opinion expects average opinion to be.” [156] But it’s most notable, from a modern perspective, in his discussion of the consumption function. Attempts to model consumption behavior in terms of rational choice were one of the main themes of macroeconomics after Keynes. But Keynes’s consumption function, as laid out in Book III, is grounded in psychological observation rather than intertemporal optimization.

This raises two questions. First, was Keynes right to eschew maximizing theory? Second, did his successors betray his legacy by bringing maximization back in?

The answer to the first question is, it depends. Keynes was surely right that there’s a strong non-rational element in economic behavior. The rise of behavioral economics and behavioral finance is a belated recognition by the profession of this fact. On the other hand, some of Keynes’s attempted generalizations about behavior now seem excessively facile and misleading in important ways. In particular, he argued on psychological grounds that the average savings rate would rise with per capita income (see p. 97.) That has turned out to be not at all the case.

But the answer to the second question, I’d argue, is clearly no. Yes, Keynes was a shrewd observer of economic irrationality, a behavioral economist before his time, who had a lot to say about economic dynamics. Yes, *The General Theory* is full of witty passages about investing as a game of musical chairs, about animal spirits, and so on. But *The General Theory* is not primarily a book about the unpredictability and irrationality of economic actors. Keynes emphasizes the relative stability of the relationship between income and consumer spending; trying to ground that stability in rational choice may be wrong-headed, but doesn’t undermine his intent. And while

Keynes didn't think much of the rationality of business behavior, one of the key strategic decisions he made, as I've already suggested, was to push the whole question of why investment rises and falls into the background.

What about equilibrium? Let me offer some fighting words: to interpret Keynes in terms of static equilibrium models is no betrayal, because what Keynes mainly produced was indeed a static equilibrium model. The essential story laid out in *The General Theory* is that liquidity preference determines the rate of interest; given the rate of interest, the marginal efficiency of capital determines the rate of investment; and employment is determined by the point at which the value of output is equal to the sum of investment and consumer spending. "[G]iven the propensity to consume and the rate of new investment, there will be only one level of employment consistent with equilibrium." [28]

Let me address one issue in particular: did Paul Samuelson, whose 1948 textbook introduced the famous 45-degree diagram to explain the multiplier, misrepresent what Keynes was all about? There are commentators who insist passionately that Samuelson defiled the master's thought. Yet I can't see any significant difference between Samuelson's formulation and Keynes's own equation for equilibrium employment, right there in Chapter 3: $\phi(N) - \chi(N) = D_2$ [29]. Represented graphically, Keynes's version looks a lot like Samuelson's diagram; quantities are measured in wage units rather than constant dollars, and the nifty 45-degree feature is absent, but the logic is exactly the same.

The bottom line, then, is that we really are all Keynesians now. A very large part of what modern macroeconomists do derives directly from *The General Theory*; the framework Keynes introduced holds up very well to this day.

Yet there were, of course, important things that Keynes missed or failed to anticipate.

What Keynes missed

The strongest criticism one can make of *The General Theory* is that Keynes mistook an episode for a trend. He wrote in a decade when even a near-zero interest rate wasn't low enough to restore full employment, and brilliantly explained the implications of that fact – in particular, the trap in which the Bank of England and the Federal Reserve found themselves, unable to create employment no matter how much they tried to increase the money supply. He knew that matters had not always been thus. But he believed, wrongly, that the monetary environment of the 1930s would be the norm from then on.

Look again at Figure 1, which shows what actually happened. Japan aside, the monetary conditions of the 1930s have not made a reappearance. In the United States the era of ultra-low interest rates ended in the 1950s, and has never returned (although we had a near-Japan experience in 2002-2003.) Yet the United States has, in general, succeeded in achieving adequate levels of effective demand. The British experience has been similar. And although there is large-scale unemployment in continental

Europe, that unemployment seems to have more to do with supply-side issues than with sheer lack of demand.

Why was Keynes wrong?

Part of the answer is that he underestimated the ability of mature economies to stave off diminishing returns. Keynes's "euthanasia of the rentier" was predicated on the presumption that as capital accumulates, profitable private investment projects become harder to find, so that the marginal efficiency of capital declines. In interwar Britain, with the heroic era of industrialization behind it, that view may have seemed reasonable. But after World War II a combination of technological progress and revived population growth opened up many new investment opportunities. And even though Ben Bernanke, the new chairman of the Federal Reserve, has warned of a "global savings glut," the euthanasia of the rentier does not seem imminent.

But there's an even more important factor that has kept interest rates relatively high, and monetary policy effective: persistent inflation, which has become embedded in expectations, and is reflected in higher interest rates than we would have if the public expected stable prices. Inflation was, of course, much higher in the 1970s and even the 1980s than it is today. Yet expectations of inflation still play a powerful role in keeping interest rates safely away from zero. For example, at the time of writing the interest rate on 20-year U.S. government bonds was 4.7%; the interest rate on 20-year "indexed" bonds, whose return is protected from inflation, was only 2.1%. This tells us that even now, when inflation is considered low, most of the 20-year rate reflects expected inflation rather than expected real returns.

The irony is that persistent inflation, which makes *The General Theory* seem on the surface somewhat less directly relevant to our time than it would in the absence of that inflation, can be attributed in part to Keynes's influence, for better or worse. For worse: the inflationary takeoff of the 1970s was partly caused by expansionary monetary and fiscal policy, adopted by Keynes-influenced governments with unrealistic employment goals. (I'm thinking in particular of Edward Heath's "dash for growth" in the UK and the Burns-Nixon boom in the US.) For better: both the Bank of England, explicitly, and the Federal Reserve, implicitly, have a deliberate strategy of encouraging persistent low but positive inflation, precisely to avoid finding themselves in the trap Keynes diagnosed.

Keynes didn't foresee a future of persistent inflation (nor did anyone else at the time.) This meant that he was excessively pessimistic about the future prospects for monetary policy. It also meant that he never addressed the policy problems posed by persistent inflation, which preoccupied macroeconomists in the 70s and 80s, and led some to proclaim a crisis in economic theory. (In fact, the models many of us use these days to explain the persistence of inflation even in the face of unemployment, notably "overlapping contracts" models that stress the uncoordinated nature of wage settlements, are quite consistent in spirit with what Keynes had to say about wage determination.) But failure to address problems nobody imagined in the 1930s can

hardly be considered a flaw in Keynes's analysis. And now that inflation has subsided, Keynes looks highly relevant again.

The economist as savior

As an intellectual achievement, *The General Theory* ranks with only a handful of other works in economics. I place the highest value on economic theories that transform our perception of the world, so that once people become aware of these theories they see everything differently. Adam Smith did that in *The Wealth of Nations*: suddenly the economy wasn't just a collection of people getting and spending, it was a self-regulating system in which each individual "is led by an invisible hand to promote an end which was no part of his intention." *The General Theory* is in the same league: suddenly the idea that mass unemployment is the result of inadequate demand, long a fringe heresy, became completely comprehensible, indeed obvious.

What makes *The General Theory* truly unique, however, is that it combined towering intellectual achievement with immediate practical relevance to a global economic crisis. The second volume of Robert Skidelsky's biography of Keynes is titled "The economist as savior," and there's not a bit of hyperbole involved. Until *The General Theory*, sensible people regarded mass unemployment as a problem with complex causes, and no easy solution other than the replacement of markets with government control. Keynes showed that the opposite was true: mass unemployment had a simple cause, inadequate demand, and an easy solution, expansionary fiscal policy.

It would be a wonderful story if *The General Theory* showed the world the way out of out of depression. Alas for romance, that's not quite what happened. The giant public works program that restored full employment, otherwise known as the Second World War, was launched for reasons unrelated to macroeconomic theory. But Keynesian theory explained why war spending did what it did, and helped governments ensure that the postwar world didn't slip back into depression. One can identify a number of occasions, most notably Japan in the 1990s, where depression-like conditions might well have returned without the guidance of Keynesian economics.

There has been nothing like Keynes's achievement in the annals of social science. Perhaps there can't be. Keynes was right about the problem of his day: the world economy had magnet trouble, and all it took to get the economy going again was a surprisingly narrow, technical fix. But most economic problems probably do have complex causes and don't have easy solutions. Of course, I might be wrong. Maybe there are narrow, technical solutions to the economic problems of today's world, from lagging development in Latin America to soaring inequality in the United States, and we're just waiting for the next Keynes to discover them.

One thing is certain: if there is another Keynes out there, he or she will be someone who shares Keynes's most important qualities. Keynes was a consummate intellectual insider, who understood the prevailing economic ideas of his day as well as anyone. Without that base of knowledge, and the skill in argumentation that went with it, he

wouldn't have been able to mount such a devastating critique of economic orthodoxy. Yet he was at the same time a daring radical, willing to consider the possibility that some of the fundamental assumptions of the economics he had been taught were wrong.

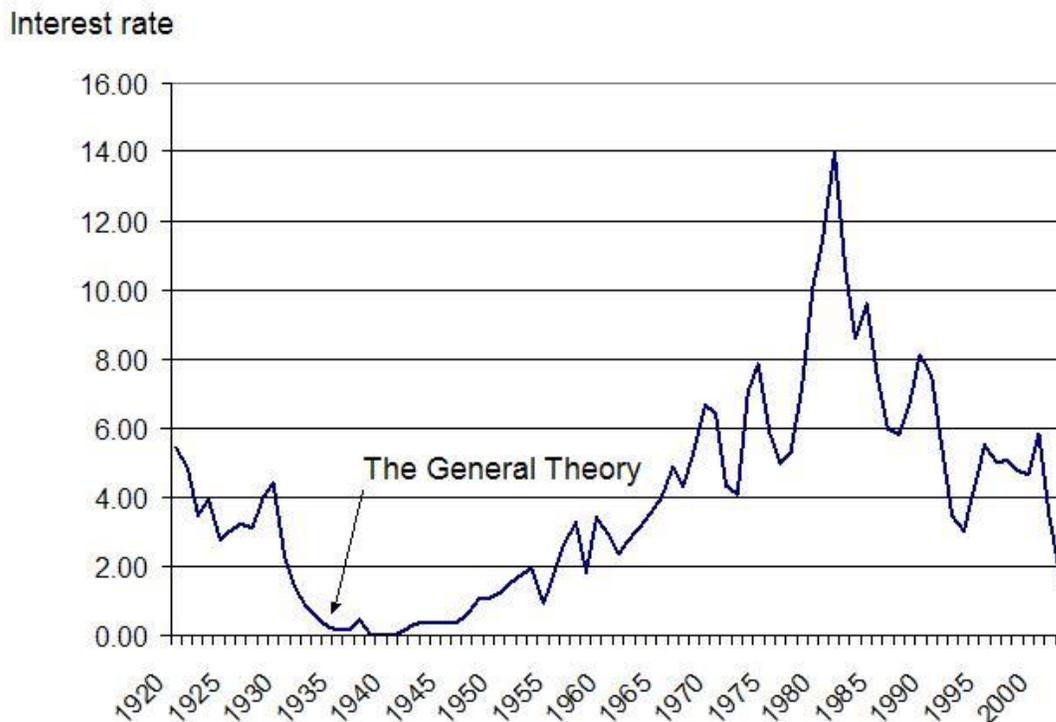
Those qualities allowed Keynes to lead economists, and the world, into the light – for *The General Theory* is nothing less than an epic journey out of intellectual darkness. That, as much as its continuing relevance to economic policy, is what makes it a book for the ages. Read it, and marvel.

1 For a hair-raising account of the coordinated effort to prevent American students from learning Keynesian economics, read David Colander and Harry Landreth's *The Coming of Keynesianism to America*, Edward Elgar, 1996.

2 "The Great Slump of 1930," reprinted in *Essays in Persuasion*.

3 Gottfried Haberler, *Prosperity and Depression*, League of Nations, 1937.

FIGURE 1



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