

# THE KEYNESIAN ECONOMICS-ONCE MORE

by

A. R. ABDEL MEGUID

*University of Birmingham.*

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In this article, I have been concerned with :—

- (a) The static character of the Keynesian system.
- (b) The ambiguity of the concepts of saving and investment.
- (c) The limitation of the liquidity preference theory.
- (d) Some socio-economic fallacies.

## Introduction.

Keynes' General Theory is a treatise on short-run equilibrium and devotes only a few pages to the discussion of the business cycle. This discussion is far from revolutionary, whether or not we agree that the rest of Keynes' system is fundamentally novel. Keynes' main interest was in monetary theory and policy. The development of his thinking was directed towards pushing monetary theory back towards becoming a theory of output as a whole (1). His process can be traced in the transition from  $MV = PT$  to  $I + C = Y$ . The main concern of business cycle theory whether monetary or non-monetary has been with the fluctuations of income, output, and employment. In this sense we had half a century or more macro-economics before the general theory appeared (2). But there have been formal difficulties with both sides of the quantity equation. In the General Theory,  $MV = PT$  was replaced by  $I + C = Y$ . But one can readily see the old equation underneath.  $Y$  is  $PT$ : investment and consumption are the components of income through which monetary changes register their effects. Though not in the equation, the quantity

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(1) Keynes : *The General Theory* ; Preface, page VI.

(2) *Ibid*, page VII.

of money (together with the liquidity preference) determine the interest rate, which (in relation to the expected profit rate—the marginal efficiency of capital) determines the volume of investment. The demand for money is broken down into 3 strands that had been implicit in the analysis since Marshall.  $V$  become the multiplier, command-over-consumption-units becomes the propensity to consume, and the distinction between the decision to save and the decision to invest becomes the liquidity preference.

### **The Static Character of Keynesian System.**

The first criticism is methodological in character, yet dislike of controversies about method must not hinder one from realizing that important issues of substance may be involved. Keynes followed Cambridge tradition in using the concept of equilibrium under static conditions, *i.e.* tastes methods of production, and the like are generally assumed to be relatively unchanging. By employing the concept of income as the principle variable which determined consumption, and by emphasizing the rôle of expectations in entrepreneurial decisions, he broadened neo-classical economics to include situations of underemployment equilibrium. In Keynesian economics, the return of investment anticipated by entrepreneurs and the rate of interest which must be paid to lenders to part with their cash results in varying levels of stable income and employment. To the student of business cycle the paramount question is whether or not the Keynesian system, in which variables and structural relationships are said to determine a situation of stable equilibrium, is adequate for studying the cyclical phenomenon. In other words can a static theory, whose main object is to formulate the conditions under which employers will have no incentive to expand or contract employment, furnish a satisfactory base from which to set out on the journey of exploring the mechanisms that produce cycles?

Static equilibrium analysis must ignore the influence of the time factor and speed of the variables' reactions included in the system. Yet these considerations are the essence of the business cycle problem. Because of the lags in various parts of the

economy between the receipts of income and expenditures on consumption and investment a cumulative process is likely to develop. As this process unfolds, changes occur which might be incompatible with the conditions postulated in the static theory. Without a knowledge of the rate of change of the variables and the impact they have upon each other, one cannot tell whether the fluctuations will be more intensified or will dampen, and approach the equilibrium described by the theory.

The methodological differences between process analysis and instantaneous equilibrium analysis largely explains the disputes of the past decade centering around the concept of saving and investment. In the *General Theory* Keynes claimed that saving and investment are necessarily equal, Robertson, Ohlin and others maintained that investment may be greater or less than saving. Some writers, tired perhaps of these disputes, attempted to dismiss the matter by sayings that it was entirely a question of definition. But the issues could not be disposed off so readily, for behind the terminological controversies was the important consideration that the kind of definition one adopted determined the course of analysis.

### The Concepts of Saving and Investment.

It is difficult to define saving in an exact sense; its definition remains among those "unsettled". The controversy that has raged ever since the appearance of the *General Theory* arises chiefly from the timelessness of the Keynesian system. The resulting difficulties are relieved nowise by his setting of saving equal investment. Because of his terminology the controversy has at times been quite bitter. Prof. Ellis expressed the difficulty involved when he observed that (1) "There is, for example an arithmetic, conceptual, or taxonomic sense in which  $S$  equals  $I$ ; this equation resembles the monetary equation of exchange, the equality of debit and credit sides in the balance of payment or the statement that quantity supplied in a market equals quantity purchased; all those are truisms. On the other hand there is a sense of tendency, causation, or operating forces in

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(1) H. S. Ellis: *Notes on Recent Business-Cycle Literature*; Review of Economic Statistics, August 1938.

the economic system, in which saving may tend to equal investment or vice versa, but since this implies the operation of forces (and not simply definitions) counter forces may cause saving to be unequal to investment; this resembles such statements as the quantity theory postulates that price varies with  $MI$ , as the tendency to equality of exports and imports, and the tendency of market price to rest at the intersection of demand and supply schedules".

Keynesians pass from one of these meanings to the other with implacable urbanity, for the time being lags are ignored. Lerner seeks to assure that there has been much other over nothing.  $S$  equals  $I$  is a piece of very "simple arithmetics", that it is "implicit in our definitions" and that "it has nothing to do with any kind of equilibrium" (1). Harrod considers that saving and investment "are really but one magnitude" for "they are necessarily and ineluctably equal" (2). Keynes, in answer to Hawtry's charge (3) that  $S$  and  $I$  are not only equal but identical, responded that they are "necessarily equal in the same way in which the aggregate purchases of anything on the market are equal to the aggregate sales" (4).

It does seem all the more certain that Keynes means by saving (or investment) what he wishes to mean, because he makes his system timeless.

### The Limitation of the Liquidity Preference.

The liquidity preference theory of interest as developed by Keynes is most provocative. Certainly neo-classical productivity theory has not filled in the holes, the explanation of the investment process and the appearance of interest as a price, any too well; it has been weak in relating the supply of money to saving and investment and specially in establishing the connection of  $S$  and  $I$  during disequilibrium periods. There is a large measure of agreement that Keynes's monetary theory of interest has

(1) Lerner: *Quarterly Journal of Economics* 1937-38, page 299. 304, 305.

(2) Harrod: *The Trade Cycle*, page 162.

(3) Hawtry: *Capital and Employment*, page 174.

(4) *Economic Journal*, 1937, p. 249.

caused economists to attach greater importance to the problem of the generation of income, and at the same time made them fully conscious of the problem of hoarding. But the critics of Keynes have pointed out that the liquidity preference factor need not be so magnified as to exclude other elements which heretofore has been considered relevant to the determination of the rate of interest. Keynes was wrong in maintaining that the loanable funds theory is essentially the same as the classic theory namely that the interest rate is determined by the supply and demand curves of saving. There are many sources of loanable funds other than savings *e.g.* bank credit, and dishoarding. On the demand side, loanable funds may be used for increasing working capital or fixed capital, replacing existing equipment, increasing consumption, and adding to inactive cash balances (1).

Critics of the theory that the interest rate is the price for inducing people to part with cash, have pointed out that Keynes' monetary theory does not exclude the factors of productivity and thrift. Productivity may disappear as an element influencing the interest rate in Keynes' saving-investment equation, but returns through the back door of his monetary equation, where the demand and supply of cash balances are equal. An increase in investment arising from a favorable effect upon the marginal efficiency of capital—whether due to inventions, optimistic expectations, or increased consumers' expenditure—will require an increase in cash for business transactions ( $M_1$ ). If the banks do not augment the supply of money, there will be less cash available for hoarding purposes to satisfy the desire for liquidity ( $M_2$ ), and will thus cause the interest rate to rise.

With respect to Keynes' contention that savings do not govern the interest rate since the supply curve of savings is not independent of changes in investment and income, his critics replied that the liquidity preference curve was in a similar position. Changes of income affect the demand for cash for business

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(1) Robertson : *Essays in Monetary Theory*, Chapter I. Robertson : *A Survey of Modern Monetary Controversy*, in *Readings in Business Cycle Theory*, p. 311-29. Haberler : *Prosperity and Depression*, p. 195-221.

transactions ( $M_1$ ) and thereby influence the supply of cash available for liquidity purposes ( $M_2$ )—assuming a fixed supply of money. According to Keynes, an increase in the propensity to save does not lower the interest rate, but, *ceteris paribus*, decreases income. However, a decrease in income involves both a drop in the transactions' demand for money and a greater supply available for cash balances. By this indirect route the thrift factor exerts its influence and lower the rate of interest. According to Robertson, however the route between savings and interest is more direct. An increase in propensity to save may directly affect the interest rate, by increasing the demand for securities: a rise in the price of securities is equivalent to the lowering of interest rate, the lower interest rate induces people to raise the proportion of their assets held in the form of cash; and the rise in cash holdings may result in a decrease of income.

### Some Socio-Economic Fallacies.

1.—“*Investment by private enterprise does not depend alone on the amount of consumption and therefore upon the “underwriting of consumption” through continuous deficit spending*”:

What Keynes introduced as propensity to consume, we can only accept as one explanation of the conditions of a depressed economy, particularly when it is related to the desire for liquidity. It cannot be looked upon as a long run concept (1). The evidence statistical and theoretical does not seem to justify any other interpretation of it (2). The declining propensity to consume is if anything a short run concept, and it is only one of probably many forces feeding the cumulative downward movement of the cycle. In principle to argue that man is saving proportionately more out of his income than before is truly an irrational proposition. When not prevented from so doing, man is always trying to make the best use of his resources. He does not have overly many of them; or why the shift to the accumulation of

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- (1) See Frank H. Knight: *The business cycle, Interest and Money*, Review of Economic Statistics, Vol. 23, p. 57-58, May 1941.  
 (2) See M. Ezekiel: *Statistical Investigations of Saving, Consumption and Investment*, I and II, American Economic Review, Vol. 32, p. 22-49, and 272-307, March and June, 1942.

surplus in the form of cash or its equivalent. Underconsumption as a continuing phenomenon must still be explained.

The marxians, who quite early developed theories of underconsumption were probably influenced by the kind of investments made in Germany, Austria, France and other continental countries. There when an industrialist or a banker made his "pile", instead of expanding his industry, or making more industrial loans, he usually put his fortune into land (as is quite familiar with the Egyptian situation probably until now.) The investment in land may not be far removed from the seeking of excess cash balances or the liquidity that may be achieved by the holding of short-term government securities. But these shifts to liquidity are largely the effects of political uncertainty. If man wants to hold his wealth in such forms as yield a relatively small but assured income or in cash, it is because non-economic motives prompt him to take such irrational action. If our knowledge of the individuals' economic action and the reasons for it are to be extended, we must go beyond the implicit theorizing of the Keynesian school.

2.—*"Economic progress still requires saving and that underconsumption as a primary cause of depression is an illusion."*

3.—*"Economic progress still depends upon the advance of specialization of labor and machinery, and upon a climate favorable to "risk-taking" in the making of new investment."*

The rate of interest, once the pet of the Keynesians had fallen in regard. It must be admitted that empirical investigation seems to yield the conclusion that interest rates by themselves do not influence saving or investments decisively. Those who save are not much stimulated by higher rates, or discouraged by lower ones (1). Those who borrow likewise are not much encouraged by lower rates, nor discouraged by higher ones (2). Indeed it appears that interest rates should be looked upon as the resultant

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(1) This is not universally held. R. Harrod by use of a dynamic equation reaches the conclusions that the level of interest rates may be a material positive factor in stimulating savings. *Towards a Dynamic Economics*, p. 49.

(2) This too is not universally believed. The role of interest cost in housing and public utilities investment are often averred to be a leading if not decisive influence.

of monetary policy, and not the cause of either borrowers or savers behaviour.

Since the War, Keynesian economics has undergone a number of significant shifts. Faced with a condition of inflation as alarming and seemingly intractable, as the deflation Keynes faced when he wrote his book, the stagnation thesis has receded into the background of the theory. The difficulties for the determinacy of the theory have been increased by the new conditions, and its applicability to policy has become less clear cut (1). One of the new questions is the relative importance of monetary and fiscal policies. Control over the broad aggregates of the income equation, as against more specific (including direct controls) policies. In other words, is Beveridge's program for full employment (2), and that of the six Oxford economists (3), a logical following out of the Keynesian theory (as they assume), or a contradiction to it?

A. R. ABDEL MEGUID.

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- (1) The best illustration for this is the supposedly Keynesian policy pursued by Dr. Dalton in the postwar U.K. The misunderstanding of the Keynesian policy, or its vagueness can lead,—and in fact nearly did—the country to bankrupt.
  - (2) Lord Beveridge, *Full Employment in a Free Society*, London, 1944.
  - (3) *The Economics of Full Employment*, Oxford 1944.