Keynes's analytical view of 'the long run'

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Keynes's Background and 'Treatise on Probability'

John Maynard Keynes (1883-46) known as the 'father of macroeconomics' had surprisingly little to say about 'the long run'. There are, as we shall see, good reasons for this attitude; but if we look carefully into his writings we will, fortunately, find interesting and important analytical views also of *the long run*. In any case one should be somewhat cautious to talk of the 'economics of Keynes', because it really did undergo significant changes during his (rather short) life.

Keynes was educated in Philosophy and Mathematics at Cambridge University (1902-05). Just after Keynes had graduated, he spent a kind of sabbatical year listening to lectures in economics given by among other Alfred Marshall (and his father John Neville Keynes). In 1906 he joined the annual competition for a job in White Hall. He came out second and chose The India Office. The work-load was light, which gave him enough spare time to work on a dissertation on probability theory, which could open the door for a fellowship at King's College, Cambridge. He was successful in 1909, which also gave him an opportunity to give lectures in neoclassical economics. Fortunately, he could continue his work on probability theory in the perspective of uncertainty.

In fact, his book 'Treatise on Probability' was not published until 1921. The focus point of the book is on the limited usefulness of conventional probability theory in human sciences when information is scattered, and lack of knowledge and information prevail. In such cases quantifiable knowledge on 1. possible outcomes, 2. frequences and 3. consequences are not existing, and the use of conventional probability theory might then be (i.e. is) a misleading guide to the future, CWK, vol. VIII.

This methodological conclusion is crucial for understanding the development in Keynes's approach to (macro)economic theory. He undertook a long intellectual travel from 'Indian Currency and

Finance', CWK, vol. I (1913) to 'The General Theory', CWK, vol. VII (1936), but all the way through with the intention to explain real world economic phenomena, Jespersen, 2012.

In this paper I will give an account on Keynes's analytical view on macroeconomics in the long run, which except for his essay '*The economic possibilities for our grandchildren'* was very sketchy.

What did Keynes say about 'the long run'?

The long run is a misleading guide to current affairs. In the long run we are all dead. Economists set themselves too easy, too useless a task if in tempestuous seasons they can only tell us that when the storm is past the ocean is flat again. (CWK, IV, p.65)

This quote extracted from *A Tract on Monetary Reform*, 1923 is written in the wake of the few years of high inflation during and just after the First World War. It is a characteristic of Keynes's theoretical approach mainly to focus on the short run. This attitude of leaving the long run aside became more and more dominant in his intellectual approach to (macro)economic theory. The following year Keynes concluded a paper summarizing the methodological background of *The General Theory* the following way: '*About these matters there is no scientific basis on which to form any calculable probability whatever. We simply do not know (Keynes, 1937: 213)*.

This methodological conclusion underlying the *General Theory* (and emphasized in 1937) was a logical following-up on his elaborated view on macroeconomic methodology: that the real world has to be understood as an open dynamic system. To assume that 'when the storm is past the macroeconomic system is flat again' (i.e. in a position of general equilibrium) – is not helpful, rather the opposite and often simply misleading!

Even though Keynes had witnessed a British economy with persistent high unemployment through the 1920s – nearly for ten years. He did mainly concentrate his theoretical contribution on the short run macroeconomic development leaving the long run aside. In his two volumes *A Treatise on Money*, (CWK, vol. V & VI) he tried to give a (monetary) explanation of why the 'tempestuous season' could drag on for quite a number of years within a conventional general equilibrium model. What were the monetary factors blocking the real sectors of the economy to adjust to full employment more quickly? Here, Keynes developed *the theory of liquidity preference,* which according to his analysis could explain, why the rate of interest could go on staying too high for nearly a decade and hereby preventing the real economy (especially due to low real investments) to establish full employment. His new arguments were an elaborated on the classical *'Quantity Theory of Money'* (QTM). He expanded the conventional/classical theory with the speculative motive of holding money (cash), which could make the rate of interest too high to match savings with real investments at full employment. But, Keynes had to admit (in *ToM*) that when the speculators at last realized (perhaps later rather than sooner) that they were wrong, the self-adjusting real sectors of the economy would overrule the speculators. Then the speculative demand for money would evaporate, the rate of interest fall, the classical QTM prevail and full employment be realized.

***The Economic Possibilities for our Grandchildren:* the long run**

Although mainly taking this short run perspective Keynes wrote, nearly out of the blue, the short essay *The Economic Possibilities for our Grandchildren.* Originally it was presented as a special lecture to undergraduates; but following a lecture in June 1930 in Madrid Keynes did write the lecture up, and it was published in the weekly magazine *Nation and Antenaeum* in October, nearly on the day of the publication of *Treatise on Money.*[1]

In this paper Keynes took a for him exceptional long term view: '[T]ake wings into the future. What can we reasonably expect… … hundred years hence?'. (ibid, p. 322). Nothing, he immediately admitted, could be said definitively about this very long run economic prospect. In fact, his conclusion is that the long run is unforeseeable; but could partly be formed by economic policies.

We see in this essay that Keynes's mind had started working within an open (macroeconomic) analytical framework. Anything could happen in the long run, or rather, nothing could be said affirmatively about the (long term) future – due to uncertainty caused by ignorance, external & unforeseeable events together with political decisions. The long term outcome of the course taken by such an analytical macroeconomic system, what he later in *The General Theory* did call the *Quaesitum*, was not in any sense pre-determined by market economic forces, but rather influenced by conventions, structures and not least by political decision[2].

Within this essay Keynes admitted that he was in a kind of theoretical limbo caused by on the one hand the straight jacket of neoclassical long run general equilibrium analysis, which he had employed in *A Treatise on Money*, and on the other hand of his vision of how to live a good and respectable life. The latter building on ideas developed while he was student in Cambridge[3]. One gets the impression from the essay that Keynes visioned an abundance of produced goods in the future, which could make a slow, but in a 100 years' time also dramatical reduction in the number of working hours during a week not only possible, but preferred. In such a materially saturated economy we could at last '*return to some of the most sure and certain principles of religion and traditional virtue – that avarice is a vice, that the extraction of usury is a misdemeanour and love of money detestable….*' *But beware! The time for all this is not yet* (ibid, p. 331-2).

Obviously, Keynes was trapped within his neoclassical theoretical upbringing. A growing (macro)economy, i.e. the foundation of a rising material living standard required an increasing stock of real capital. Hence real investments have to be positive for another 100 years. Being a neoclassical economist real investment is determined by savings, and savings are within neoclassical theory incentivized by *avarice and usury and precaution*. Here, we find Keynes caught mid-stream. He is still confined by long run general equilibrium and full employment. Therefore, he had, somewhat

[1] Which can hardly be a coincident. See, CWK, vol. IX, p. 321

[2] Furthermore, this long run view is a fundamental change from his defeatist 1923-statement: *In the long run we are all dead.* The aim of this 1930-essay is nearly the opposite to prepare the open future for the coming generations!

[3] See, *Keynes's Vision* by Athol Fitzgibbons

regretfully, to conclude this essay in full correspondence with the 'fundamental equation' of his just published book (*ToM*):

For at least another hundred years we must pretend that to ourselves and to everyone that fair is foul and foul is fair; for fair is useful and fair is not. Avarice and usury and precaution must be our gods for a little longer. For only they can lead us out of the tunnel of economic necessity into daylight. (ibid, p. 331)

Hence, this essay demonstrates clearly that Keynes was not yet ready to give a theoretical explanation of why financial savings theoretically could be separated and hence persistently deviate from real investments (needed for full employment) even in the long run. Accordingly, a fulfillment of his vision of a *materially* saturated society for 'our grandchildren' required a continuously economic growth for another hundred years, which following his analysis in *ToM* has to be generated by capital accumulation! So, '[F]or at least another hundred years we [his 'children'] have to pretend to ourselves and to everyone that fair is foul and foul is fair; for foul is useful and fair is not' (CWK IX, p. 331).

In this essay we find Keynes intellectually 'midstream' (or perhaps in a state of schizophrenia) – halfway out of neoclassical macroeconomic, but less than halfway into the methodology of *The General Theory.* One should keep in mind that he had just published in October 1930 *A Treatise on Money*, (Keynes, 1930a), which was an painstaking attempt to elaborate on *The Quantity Theory of Money and Prices* that had occupied him for nearly four years.

In October 1930, where the real economy nearly had collapsed in the Western world, Keynes was unfortunately not yet ready to undertake the needed open system analysis. He was stuck in the neoclassical long run general equilibrium closed analysis. The full transformation had to wait another six years, before he could give the theoretical foundation of not only short run, but also long run need of government intervention to stabilize the macroeconomic system not only with regard to 'effective demand'; but also to understand the longer term challenges (and possibilities) related to improved technology, rising population and in today's world: climate changes. Even governments cannot know the future with any kind of certainty; so what could they do, except to reduce individual and social risk through precaution and by protection against potentially (somewhat unknowable) irreversible consequences of uncertain events.[4]

Keynes was really caught in this essay between conventional neoclassical long run analysis, and his 'early beliefs' of a good life, see CWK, vol. 9[5]. As we shall see, Keynes argued that the potential future growth rate was conditional to rising productivity and the number of weekly working hours. So, a reduced number of working hours could go hand in hand with a growing economy, if the former was reduced more slowly than the productivity generated growth of production.

[4] One could use the climate challenge as a very relevant and present example of this lack of certain knowledge.
[5] 'My Early Beliefs' given as a talk to the Memorial Club in 1938, but not published on Keynes request until after he was dead.

So, in a perspective of two generations, i.e. our grandchildren, weekly working hours could be more than half. Hence, Keynes concluded the essay the following way:

‘chiefly, do not let us overestimate the importance of the economic problem, or sacrifice to its supposed necessities other matters of greater and more permanent significance’. (*ibid*, p. 332).

Obviously, he had the economics of a ‘good society’ on his mind, where ‘love, truth and beauty could be our guiding motives’.

The long run: supply and demand factors are equally important

If capital increases, say, 2 per cent per annum, the capital equipment of the world will have increased by half in twenty years, and seven and a half times in hundred years. Think of this in material things – houses, transport, and the like. (ibid, p. 325)

In this essay Keynes called the rather persistent unemployment in Britain during the 1920s for *technological unemployment*. Two sentences later he states: ‘but this is only a temporary phase of maladjustment’. The idea that demand could be lacking in a longer term perspective did not (yet) occur to him in 1930.

As we know Keynes path-breaking contribution in *The General Theory (GT)* was the innovative concept of ‘Effective Demand’, (GT, chapt. 3) with the specific meaning of the intersection between aggregate demand and aggregate supply! Keynes’s analysis of macroeconomic development in GT has all the way through Mashall’s picture of a pair of scissors in the background: demand ***and*** supply. This is within macroeconomics very innovative, because neoclassical macroeconomics in the long run is only driven by supply factors. But in the middle of the 1930’s supply was no binding limit on economic growth and had not been since the early 1920s. Keynes’s main concern in the 1930s became – for obvious reasons – to explain: why is demand continuously lacking behind potential supply? causing persistent unemployment (and misery).

Accordingly, the real novelty of the GT was to ask the heretical question: ‘Why is potential supply not creating its own demand? This is not to say that ‘potential supply’ is not important; but it was not in the 1930s a binding restriction on economic development in any meaningful sense.

That situation did change during the war. When Keynes in November 1941 presented the annual budget for next year in Parliament, he had to propose higher taxes and a compulsory savings scheme to limit private demand. But this extraordinary situation did not prevent him from explaining his new theory of effective demand when giving a radio talk in 1942. Here he said about the future economy:

The first task is to make sure that there is enough demand to provide employment for everyone. The second task is to prevent a demand in excess of the physical possibilities of supply (Moggridge, 2010, p. 219).

Although being in the middle of the war Keynes echoed his 1930-essay when concluding the radio talk by saying:

'In the long run almost anything is possible'. (ibid, p. 220)

No doubt Keynes's mature macroeconomic analysis built on two legs: demand and supply. To him the real challenge was to figure out how to make demand follow the ever increasing productivity to prevent rising unemployment. Because increased productivity does not create it own demand.

So, the real challenge for the politicians is to make plans into an uncertain future, where material needs little by little might become saturated:

I look forward, therefore, in days not so very remote, to the greatest change which has ever occurred in the material environment………..there will be larger and larger classes and groups of people from whom problems of economic necessity have been romoved (CWK, IX, p. 331)

This vision is made possible by the increased productivity caused by accumulation of real capital. So, Schumpeter's analysis of 'Creative destruction of real capital' was obviously not a part of Keynes's new macroeconomic understanding.

To the contrary in this essay Keynes is sketching a future, where the growth of the potential material production is nearly unlimited, and it is up to the politicians to decide on the volume of the future production which should be realized. He made a simple calculation of a potential growth rate of 2 per cent per annum going on for 100 years. The outcome was an increased GDP of nearly eight times. Then he asked the reader: Is this what we want? Or should the politician decide to reduce working hours, so more and more people could live a life, where they were working less hours and had more leisure time to pursue 'love, beauty and truth'. Today, Keynes would, presumably, also have made a consideration of the impact on environment and climate of an ever growing GDP.

Furthermore, when Keynes in *GT* had deliberated himself from the chains of neoclassical economics, he took a rather negative attitude towards the rentier class. Those people who could make a living out of interest received from the financial wealth (the dead hand!) or of rent from owing (often inherited) real estates (land and houses produced long ago in the past). These people – the leisure class – did not contribute constructively to the economic society. To the contrary they were like vampires extracting money from the productive classes (entrepreneurs and workers) and could do it, because real capital is still scarce. When real capital in the future has been abundant, Keynes suggested 'tongue in chick' to commit 'euthanasia of the rentier'.

It sounded more dramatic than it was meant to be[6]. In fact, the death of the rentiers would come by itself in a saturated economy, where growth has stopped. In this case the yield from real investments becomes zero and no dividend is extracted from the productive economy to the rentier class. Then they have to live out of their (according to Keynes - undeserved) wealth. To Keynes a positive rate of

[6] "It will be, moreover, a great advantage of the order of events which I am advocating, that the Euthanasia of the Rentier, of the functionless investor, will be nothing sudden, merely a gradual but prolonged continuance of what we have seen recently, in Great Britain, and will need no revolution." chapter 23 of *GT*.

real interest should be considered as a tax on real investment, which held back real capital accumulation and hence, the 'possibilities of working time reduction for our (grand)children'.

Concluding remarks

[Keynes] brought in the State to redress the failings of society, not because he loved it, but because he saw it as the last resort, Skidelsky, 1992, p. xv

This essay is interesting for a number of reasons. When it was written in 1930 the Western world experienced the most dramatic economic crisis – ever. But the academic establishment of economists hardly responded by reconsidering their theoretical foundation, see for instance Pigou, 1933 (*The Theory of unemployment*). And as we have seen, even Keynes was somewhat sluggish in breaking with the neoclassical paradigm in his essay. But then, while the deepening of the crisis stayed on, Keynes's revolutionary contribution to macroeconomic methodology and theory (i.e. shift of analytical paradigm) came quite quickly. A number of short pathbreaking papers we published during the first half of the 1930s culminating with The General Theory in February 1936, see Jespersen, 2012.

Unfortunately, it is still a matter of dispute to what extent the shift of paradigm was understood even by devoted so-called Keynesian economists just before and after the 2nd World War.[7] The converted Keynesian economists' focus was primarily on demand management policies and used at the best only parts of *GT* to give theoretical support for this policy. The analysis of the supply side was left aside, which later in the 1970s became an Achilles Heal for especially the 'ISLM'-economists.

For 20 years Keynes's name was nearly washed out in macroeconomic textbooks. As a consequence of the unemployment crisis in early 1990s a self-proclaimed New Keynesian Economic School (NKE) emerged with Gregory Mankiw as one of the main promoters. The label 'New Keynesian' was a misnomer, because the theoretical model was confined within a general equilibrium system with a neoclassical microeconomic foundation and there was hardly any reference to *GT* at all. Short run phenomenon of unemployment (the only Keynesian element) was caused within the model by sluggish adjusting wage level, which, in fact, came very close to the model Pigou had presented in his 1933-book *The Theory of Unemployment* explaining the economic crisis of the 1930s by 'rigid wages'.

So, in many ways macroeconomics has to-day come round full cycle from the pre-Keynes aera to the post-Keynes aera. Here 'our grandchildren' are left on their own or rather on the conditions set by the politicians (balanced budget) and Central bankers (positive real rate of interest).

[7] Joan Robinson (with very few contemporary colleagues) felt that she was the only one proceeding on Keynes original thoughts. The later established Post-Keynesian Society took Keynes's word: 'About the future we cannot know' rather literarily while concentrating their contributions to macroeconomics on the short run (with very few exceptions).

Therefore, Keynes's 1930-essay (and of course the General Theory) was (and still is) an important stepping stone to understand that the macroeconomic system is an open system, the future is uncertain and government policies can make for the better.

This insight Keynes practiced during the war and when he designed the Bretton Woods agreement in 1944. He expressed this view on economics and politics very clearly, when he stepped down as editor of *The Economic* Journal in 1945:

Economists are the trustees, not of society,
but of the [economic] possibilities of society, Harrod, 1951, p. 161

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