The Last Remake of the New Economics and the Old Economists: Comment

Mr. George S. Tavlas recently has undertaken to contribute to the doctrinal history of the quantity theory of money [24]. In the judgment of Mr. Tavlas, the work of William T. Foster and Waddill Catchings[1] [5; 6; 7] has been slighted and the theoretical frameworks of Keynes and the classics have been equated without warrant. The corrective that Mr. Tavlas tenders is itself adulterated, however. In this paper, I endeavor to lay to rest representations that I thought already decently buried. The character of controversy as it is, I doubt that I shall fully succeed. Nonetheless, I remain hopeful that this is, indeed, the last remake of *The New Economics and the Old Economists* [1].

I.

In my book, I pointed out that the sharp distinctions between pre- and post-1936 economics were drawn principally from analytical models rather than from historical descriptions. Typically, economists denoted a system of equations as "classical theory," and then "classical policy" was deduced from the model. Often, the policy deduced in this manner was represented as historically descriptive of proposals characteristic of economists prior to 1936. Thus, I had wished to examine the historical record to see whether the "old economists" actually proposed wage cuts and annually balanced budgets, the policies often deduced from classical models [1, 4–5]. When I concluded that, based on my study of 1930–35, "the analytical specifications concerning Keynes and the Classics do not square well with these historical observations," of course I meant that, historically, the old U.S. economists generally did not propose the policies so readily deduced from analytical models declared to

1. Catchings was a prominent investment banker (of Goldman, Sachs and Co.) as well as an iron and steel magnate. Foster was director of the Pollack Foundation for Economic Research, founded by Catchings. Both were close to the Hoover administration. Their ideas were underconsumptionist. They thought that the cause of overproduction was that consumers cannot buy the output at going prices. The evidence was the investment of too much savings rather than the failure to find investments for all the savings which people desire. Keynes would have disagreed with Foster and Catchings, arguing that, in periods of unemployment, a high level of investment would stimulate income and promote prosperity. The only sense in which Foster and Catchings were true to the Keynesian spirit was in opposing deflationary adjustment of falling prices. For brilliant criticisms of Foster and Catchings, see Hayek [9, 199–263] and Phillips, *et al*. [22, 59–64].

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represent theory prior to the publication of Keynes' *General Theory* [10]. I do not know where Tavlas got the idea or even what he means when he says that I "equate the 'analytical specifications concerning Keynes and the Classics' which gave rise to the similar proposals [24, 685]."

In a preview of coming attractions, as it were, I said in my book that "this study tries to demonstrate that a large majority of leading U.S. economists affirmed, as did Keynes, the usefulness of fiscal policy and the uselessness of money wage reductions in fighting business depression [1, 6]." Mr. Tavlas believes that my attempted demonstration "can only blur the very sharp differences between the U.S. economists, especially the residents at Chicago, and Keynes [24, 688]." What I showed in my book was that, historically, sharp differences in policy are more imagined that real. At least, this was true of 1930–35, the period that I studied.

Consider the 1931 meetings that were attended by Keynes as well as most Chicago economists and many other prominent U.S. and European economists. Henry Schultz, a Chicago stalwart, presented part of a paper that concluded that wage cuts would not reduce unemployment in a depression because (1) wage cuts reduced incomes and, in turn, aggregate demand, especially for consumer goods; and (2) thus, no additional labor was likely to be hired at lower wages since employers would see no market for any more output [21, 190 ff.]. There was no disagreement. Keynes said that he thought that the analysis was "extraordinarily good and most helpful," that he had "never seen it put quite so before," and that he had "very little to add to the actual scope of this or to criticize [21, 212]." Harvard's Summer Slichter concluded a later discussion when he said, "I think [wage-cutting] is practically a dead issue in this depression [21, 545]."

When expansionary public works programs were discussed, Keynes emphasized that, in the United States, "getting back to a state of equilibrium should be concentrated on the rate of interest [21, 303]."[2] Keynes explained that, in Great Britain, he had supported public works only because its economy was "such a center of an international system that we cannot operate on the rate of interest, because if we tried to force the rate of interest down, there is too much lending, and we lose our gold [21, 303]." "In Great Britain, one had to lay great stress on public programs," Keynes said, "but in this country I should operate on the rate of interest [21, 303]."

Lloyd Mints, a thoroughgoing Chicagoan, tried to exhort Keynes to concede a case for expansionary fiscal policy.[3] "As I understand your argu-

2. Throughout discussion, Keynes assumed that there was only *one* equilibrium and that at full employment. There is not as much as a hint on his part of an unemployment equilibrium. The other economists, however, argued that there were *infinite* equilibria, only one of which would be at full employment. The only exception among those who spoke up was, interestingly, Alvin Hansen, who, by assuming perfect competition, agreed with Keynes that there was never more than one equilibrium.

3. Only six months later, leading economists again gathered in Chicago. Jacob Viner, sometimes credited or blamed as a founder of the so-called "Chicago School," and others again

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ment," Mints pointed out, "you want to reduce the interest rate in order to bring about an equivalence between saving and investment [21, 493]." Mints then tried to wring agreement from Keynes that public works would bring about precisely the same results, not through decreasing the rate of interest, but increasing the rate of investment. In other words, Keynes was counting on the interest rate to equilibrate saving and investment; whereas, Mints, on income. Acquiescing in Mint's understanding, Keynes granted only that, "I should use the public works program to fill in the interregnum while I was getting the interest rate down," and that, "I should be afraid of [public works] as a sole remedy [21, 494]."

To recapitulate, I did not "equate the 'analytical specifications concerning Keynes and the Classics' [24, 685]." I did show that the policy proposals of U.S. economists generally (1) were not those deduced from analytical models of classical theory and (2) were similar to those that, after 1936, were hailed as Keynesian. When Mr. Tavlas says of my book, "Davis is simply wrong to extend the valid analogy between the policy proposals of U.S. economists and those of Keynes, to the invalid analogy concerning analytic paradigms [24, 691]," I believe this to be a groundless criticism based on a misreading of my book.[4] Also, in criticizing my book—which, after all, is a study of 1930–35—I believe that Mr. Tavlas commits a serious error laid bare by the comments made by Keynes and other economists attending the 1931 Harris Foundation meetings. I am referring to Mr. Tavlas' criticism that:

> Furthermore, to state that these U.S. economists were less susceptible to the Keynesian virus because they already held Keynesian notions, is to haze the issue Keynes argued for public works and fiscal policy, and had little faith in the effectiveness of monetary policy during depression [24, 691–2].

I shall leave to the reader's judgment whether, as evidenced by his comments in mid-1931, Keynes argued for public works and had little faith in monetary policy. Also, Mr. Tavlas attributes to Keynes the point of view that "the easiest way of accomplishing the task of stabilization was through offsetting changes in government expenditure [24, 689]." While this attribu-

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argued strongly for expansionary public works programs. Only Alvin Hansen, who was still at Minnesota, seemed unmoved by the consensus:

> I have a feeling that public works has [sic] been accepted . . . too easily tonight. . . . There are a good many arguments against public works. . . . You can't put public works suddenly in motion without an enormous waste, and . . . they do react upon the private economy [20, 244–5].

Viner parried each of Hansen's thrusts against public works. Among his comments, Viner said that public works would have an altogether favorable reaction on business. Also, Viner emphasized that "so far as wasting is concerned, assume that there was thirty, forty, or fifty percent wastage, it would be thirty, forty, or fifty percent of the wastage involved now in the idle capital resources and the idle labor resources that are available and not being used [20, 245]."

4. I do not believe that I can be faulted for misleading Mr. Tavlas. The only pages to which he refers from my book are the last page and two pages from the introductory chapter. I think the language and meaning are clear in the places cited, but certainly the intent is clear in the intervening pages.

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tion must be qualified to be descriptive of Keynes in, say mid-1931, it seems an apt description of the point of view expressed in 1930–35 by any number of U.S. economists, including "the residents of Chicago." Indeed, even the U.S. reviews of the *General Theory* did not question policy at all. They challenged theory only. Among Chicago economists, Frank Knight [11], Henry Simons [23], and Jacob Viner [25], each reviewed the *General Theory*. They all agreed with Keynes on policy.

Furthermore, Mr. Tavlas suggests that, in a depression, "traditional monetary measures" are rediscounting and open-market operations, as though, prior to the influence of Keynes, economists endorsed such measures with confidence in their effectiveness [24, 689]. It was "Keynes, and especially his followers," Mr. Tavlas tells us, who "advocated deficits within a theoretical framework that featured the impotence of monetary policy during depressions [24, 685]." In fact, during 1930–35, countless U.S. economists pointed out that such measures would, in Mr. Tavlas' words, "fail, due to a lack of borrowers [24, 689]."

For example, Chicago's Paul Douglas clearly showed that such measures would be ineffective for the very reason that Mr. Tavlas cites, *viz.*, they would not stimulate borrowing [3, 118]. Douglas advocated budgetary deficits in part because the rediscount rate and open-market operations were "weak reeds [3, 118]." In a study for the National Bureau of Economic Research, Arthur D. Gayer flatly denied that monetary policy could stimulate aggregate demand during recessions [8] Gayer's argument was that the availability of funds for investment would not induce new investment because of low, if not negative, rates of expected return. The rediscount rate and open-market operations were impotent because they would not create bank deposits, increase consumer buying, or producer borrowing.

Also, at the 1932 meetings of the Harris Memorial Foundation, Irving Fisher suggested consideration of a laundry list of monetary measures [20, 198 ff]. The other economists, including the many Chicago economists who attended, dismissed the twenty-four measures [17]. Harold Moulton, of the Brookings Institution, was particularly outspoken for borrowing from the Federal Reserve and spending the proceeds for public works and the relief of unemployment. The differences between expansionary monetary and fiscal policy, Moulton said, was that deficit financing was money "spent in the market [setting] up a chain of demand all the qay back through the economic system [20, 224–8]." Among others, Jacob Viner agreed wholeheartedly. "What you probably need," Viner said, "is a means whereby the banks can take up the increased government indebtedness . . . and the funds getting to the consumers through public expenditure [20, 228–9]."

This position was reaffirmed in the 1934 *Report on Economic Reconstruction* [4], which included Viner, Alvin Hansen, and J. M. Clark among its commission members. The general report included the argument that increasing the

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supply of money by means of a low rediscount rate supported by open-market operations could be effective only if measures were taken to increase the demand for credit as well as its supply. The report also pointed out there is a surplus of idle funds during depression. The problem was, according to the report, the unwillingness to borrow [4, 34–5].

Thus, based on "traditional theory," as Simons called it [23, 1017], economists were concerned about the possibility of a "bank reserves trap."[5] Monetary policy could increase bank reserves, but such monetary measures as the rediscount rate and open-market operations were not likely to stimulate borrowing. An increase in the money supply could be trapped in bank reserves. Expansionary fiscal policy, however, directly stimulated spending, and, if supported by expansionary monetary policy, the funds borrowed to finance the deficit would be there in excess of bank reserves, so that no "crowding out" of private borrowing was likely.

II.

Mr. Tavlas champions the contributions of Foster and Catchings. Mr. Tavlas says that they asserted that (1) "the validity of Say's Law . . . holds only under conditions of pure barter," and that (2) "the introduction of money . . . upsets the full-employment equilibrium of Say's world" [24, 686]. Mr. Tavlas continues to say that, "in criticizing the applicability of Say's Law within a monetary economy, Foster and Catchings launched a lengthy attack upon classical economics much like Keynes was to do a decade or so later in the *General Theory* [24, 686]." The inexactitudes in these comments contribute to a misunderstanding of Keynes' attack and of Say's Law in classical economics.

First, in the *General Theory*, Keynes' reference to Say's Law [10, 18–19] is to J. S. Mill's *Principles* [16]. Keynes infers that Mill denies therein the possibility of general gluts of commodities. This is a peculiar allegation, inasmuch as Mill's "denial" is in a chapter, "Of Excess of Supply," which lucidly describes "commercial crises" involving "an excess of all commodities above the money demand . . . , what may be indiscriminately called a glut of commodities or a dearth of money [16, 574]." In the passage that Keynes quotes in the *General Theory*, Mill is discussing a barter economy, and a general oversupply or an excess of all commodities over the demand is denied by Mill. However, later in the same paragraph and in subsequent sections of the chapter, Mill considers a money economy. Mill clearly states that one of the complications of introducing money is that general gluts of commodities are possible. Mill then discusses "commercial crises" or excess supplies of commodities in some detail.

5. The "bank reserves trap" should not be confused with Keynes' "liquidity trap." However, sometimes the argument is stated as an "excess reserves trap" and, because of the similarity between the two, they are classified under the same "liquidity trap" heading.

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Axel Leijonhufvud [13, 101] has said that, had Keynes finished reading the paragraph and the rest of the chapter, he could not have attributed Say's Law to Mill.[6] Leijonhufvud believes that Keynes was careless. Robert Mundell speculates whether Keynes was careless or perpetrating a historical error calculated to win over disciples to the belief that there was a fatal logical defect in the classical system [19, 108 ff.]. There is evidence [2] that Keynes was careless, apparently "quoting" Mill from a secdonary source! The evidence is that, at the time he was writing pages 18–19 of the *General Theory*, Keynes read the passage that he "quotes" from Mill in either Marshall [14, 19; 15, 154] or Hobson [18, 102]. By carelessly quoting Mill from a secondary source that did not extend to Mill's discussion of general gluts of commodities, Keynes misrepresented Mill and contributed to a historical error that persists and, to this day, beckons others to its propagation.

The observations that Say's Law holds only for a barter economy and that gluts of commodities as well as unemployment are possible in a money economy are clear in Mill. Thus, Foster and Catchings' criticism of the applicability of Say's Law within a monetary economy could hardly be regarded as launching a lengthy attack upon Mill. While their criticism *is* an attack "much like Keynes was to do . . . in the *General Theory* [22, 686]," this is not to say that it was any more informed or pertinent than that of Keynes. Foster and Catchings may have represented their criticism as pertinent and informed, but their criticism would have been directed more appropriately at bad applications of classical theory. This criticism, however, was common to many economists, especially "residents at Chicago."

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6. At least not in the sense later given it by Lange [12], Leijonhufvud [13] says.

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