

KEYNES ON CAPITALISM: REPLY TO HILL

ABSTRACT: *Greg Hill's recent article voices the Keynesian complaint that capitalism produces unemployment because there is no mechanism that coordinates decisions to save with decisions to invest. But resources that are not spent on current consumption are either "invested" as bank deposits or "hoarded" as cash. Deposits are lent out by banks to investors, who are informed by interest rates as to the degree of saving for future consumption that is taking place. And wage/price flexibility, as well as increases in the supply of cash, can avoid declines in real income and employment caused by increased cash holdings.*

In 1946, Henry Hazlitt wrote a little book called *Economics in One Lesson*. The economic "lesson" he referred to was that one must seek out the "unseen" or secondary consequences of human action. In examining the critique of the market offered by Keynes, and faithfully interpreted by Greg Hill ("The Moral Economy: Keynes's Critique of Capitalism," *Critical Review* 10, no. 1), we have to look carefully for the unseen. When we do, we will find that both Hill and Keynes misunderstand the operation of the unhampered market process, particularly its ability to coordinate savings and investment over time. The Keynesian critique of the market's ability to coordinate intertemporally rests on the claim that there is (virtu-

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ally) no relationship between decisions to save and decisions to invest, implying that saving can frequently occur without corresponding acts of investment. If so, then saving takes away from aggregate demand while no other activity steps in to take its place. This claim is false.

Because Keynesians tend not to examine what happens to what is saved, they treat saving as if it means resources are withdrawn and then set on a shelf somewhere. In the real world, however, saving that takes the form of increased deposit balances at banks is channelled into investment through the banking system. Saving that takes the form of “hoards” of cash does not idle resources as long as prices and wages are free to move downward in response, or as long as the banking system is structured so as to respond to the increased demand for cash with increased supplies of it. Keynes overlooked these possibilities, concluding that greater demand for cash would cause a decline in employment and output. The key to a more appreciative vision of the market’s intertemporal coordination powers is recognizing that what is not “spent” does not disappear into oblivion but must be devoted to some other use; indeed, it is not spending but saving that drives economic growth.

It is important to note that this more appreciative vision in no way need rest on an equilibrium-oriented understanding of the market. In other words, one can reject the perfect market vision that Hill attributes to neoclassical and (inaccurately) to Austrian economics, yet still make the case that markets are better at meeting the challenge of intertemporal coordination than any likely alternative.¹ All human institutions are prone to error, but markets contain feedback mechanisms that afford them a relatively high rate of error correction.

Must Markets Be Perfect to Be Good?

The difficulties with Hill’s argument begin with his description of the vision of the market adopted by “neoclassical and Austrian theory.” According to Hill, the Walrasian picture of a perfectly coordinated economy, effected by a hypothetical auctioneer, defines the vision that Keynesianism rejects. When this picture of perfect coordination is extended over time, as in the Arrow-Hahn-Debreu additions to Walras, individual plans are modeled to account for possi-

ble future states of the world, enabling actors to maximize utility no matter what the future holds. Thus the Walrasian world is one where “the harmonious coordination of individual decisions” is assured and “distributive shares are proportionate to the productive decisions of market participants” (36). For Hill, this vision of the market contains a moral implication: “Each participant’s economic fate is the result of the choices she has made within this ideal system of social interaction.” In the Walrasian vision we all get the most we can, and we all get what we choose and deserve.

There are numerous problems with this argument, not the least of which is that it is a straw man. It is surely true that the Walrasian vision is the dominant theoretical model informing modern economics. However, when neoclassical economists move away from abstract theory to describe real-world institutions and policies, the best among them (including two whom Hill [36] cites as exemplars of his point: Milton Friedman and P. T. Bauer) recognize the limitations of the Walrasian model. There are, moreover, other alternatives to Keynesian theory that reject Walrasian general equilibrium theory and its perfectionism.² One may recognize that the real world of the market will never match up to the perfectly coordinated Walrasian model, yet still allow for the possibility that the market will lead to a high, though imperfect, degree of coordination. To damn the real world of the market because it fails to reach the perfection of the Walrasian model is pointless unless one can also demonstrate the systemic superiority of an alternative. (It is worth noting that nowhere in his paper does Hill subject the political process to the same sort of critical scrutiny he gives the market. That is, he appears to assume that political actors and institutions will perfectly carry out Keynesian policies, never asking whether perhaps they may not suffer imperfections at least as great as those of the market.)

Recognizing the difference between the model of equilibrium and the real world of disequilibrium casts a different light on other aspects of Hill’s description of the neoclassical vision. First, to argue that each participant in the market receives remuneration in correspondence to the value of her marginal product requires that the economy is, in fact, in equilibrium. Since it is not, the wages actually paid to individuals may not reflect the value of their marginal products. Although the market will tend to penalize employers who overpay their workers, and employees who do not explore opportunities for higher wages, one cannot assume that wages *always*

equal the value of marginal products. In fact, real-world incomes are what they are because of some combination of productivity, luck, entrepreneurship, and pure, old-fashioned error. However, we need not believe that one's fate is entirely a result of one's choices in order to appreciate the market's coordinative powers. In fact, it is more proper to say that one's fate in the market, especially one's income, is largely the result of the choices *other people* make as to what they wish to buy and how much they are willing to pay for it. One's choices surely matter, but the choices of others matter at least as much.

A good portion of market income depends upon what Israel Kirzner (1989) has termed "entrepreneurial discovery." Both owners of resources and workers tend to look for new and better ways to deploy their assets or skills so as to make a profit. By seeing opportunities that others have not, either for producing output or filling a labor need, owners and workers can create wealth that did not previously exist. Their incomes result not from the value of their marginal contribution to a known production process, but rather from their alertness to opportunities that previously did not exist. One might "justify" market incomes on the ground that the market prompts more and better discoveries of new resources and production processes, and thus that the incomes earned by the discoverers of these goods encourage the creation of benefits for society as a whole.³

In the Walrasian world, there is no room for novelty and true individual judgment. Choices are indeed "automatic" in that once one assumes people are maximizing utility or profits, the "right thing to do" is functionally implied by the data at hand. The assumption that actors have the knowledge necessary to maximize in the way the model demands removes the uncertainty and judgment inherent in all real-world processes, including the market. Coordination in real-world markets is not automatic in the way the Walrasian model is, but rather requires that individuals make genuine choices in the face of uncertainty, and that producers (and financiers, as we shall see) make judgments about what to produce, how to produce it, and who should produce it. These guesses may be wrong, but entrepreneurs who tend to guess right will tend to get rich: that is, they will gain control over more capital in proportion to their ability to make good guesses as to its best future use. Markets are not automatic; they depend on the skilled judgments of

both consumers and producers, and those judgments may often be wrong. However, admitting that market participants can and do err is not fatal to the case for the market if its processes for error minimization and correction are superior to any likely nonmarket institutional alternative.

Hill (38, emphasis added) contends that, in the neoclassical view, if the public chooses to save more, “resources heretofore engaged in the production of goods to be consumed in the present are . . . *automatically* redeployed so as to increase the production of goods available for consumption in the future.” In real markets, however, resources do not get automatically redeployed. They are deployed by entrepreneurs who make choices about what to do and how to do it. Those choices are based on market signals (which can be more or less reliable, and are subject to the same errors that infect all kinds of human endeavor). Hill overlooks these real-world institutional processes, endorsing Keynes’s claim that saving would be socially beneficial only “if there was some mechanism, like the imaginary auctioneer . . . capable of coordinating the decisions of those who wished to save with the decisions of those who wished to invest” (39). Such a “mechanism” does exist: the banking system, or more generally, the financial markets. Of course, this mechanism does not perform its task with the perfection of the theoretical auctioneer, but to assert that *no* such system exists in the market is incorrect.

Saving and Borrowing in a Modern Banking System

Before moving to discuss the theoretical issues Hill raises, then, a brief overview of the operation of modern banks is in order. The primary function of banks is to bring together those who wish to save and those who wish to borrow in a manner that makes both activities easier and more profitable. Market actors who do not wish to spend all of their income on goods and services in the present can take a portion of that income and deposit it in a bank. This deposit is in fact a kind of loan to the bank, which in turn promises to pay interest to the depositor and/or to offer the depositor liquidity, by allowing him to “recall” a portion of his loan by writing checks against it. The depositor is able to store wealth unneeded at present and receive a pecuniary and/or nonpecuniary benefit in return.

The bank receives the deposits of a number of savers and collects them together to lend out to those who wish to borrow. Borrowers, of course, pay the bank interest for the loans they acquire. The bank profits from the difference between the interest earned on its loans and the interest it pays to depositors.⁴ Depositors gain interest or checking services at relatively low search costs. In the absence of financial intermediaries like banks, those who wished to save (make loans) would have to search for individuals or firms who wished to borrow. This would be a time-consuming process and lenders would also have to spend resources learning about the risks associated with possible borrowers. By using banks, depositor-lenders dramatically reduce search costs and pass much of the risk and knowledge acquisition costs onto banks. In addition, because banks can make large quantities of diverse loans, their overall exposure to risk is lower than that facing an individual who tried to loan directly to firms or individuals. Borrowers, too, benefit from this relationship, because they would otherwise have to incur search costs in finding lenders; and because, as the banking system encourages saving by lowering the costs of doing so, borrowers have access to more savings than they otherwise would.

Banks effectively allow us to exchange time in the form of money. Savers are willing to defer their consumption until the future, while borrowers wish to consume more now than their current income or wealth will allow. Savers are willing to wait; borrowers want to telescope the future into the present. Banks coordinate the two.

The key to the coordinative powers of banks is the array of interest rates. The interest rates banks charge and pay serve as signals about the apparent willingness of savers to lend and borrowers to borrow. High interest rates suggest that savers are relatively reluctant to wait for the future (thus requiring significant compensation for giving up the power to consume in the present) and/or that borrowers are pushing relatively hard for funds. Low interest rates suggest that savers are comparatively patient (requiring little compensation for waiting) and/or that borrowers are comparatively uninterested in investing in projects that will not produce output until the future. As the time preferences of savers and borrowers move around, interest rates respond by shifting in the appropriate direction, broadly signalling to each group the aggregated desires of the other.

For example, if the public should suddenly desire to save more, banks will find themselves with more deposits. To attract additional borrowers for these funds, the banks will lower their interest rates, in the same way the seller of any product can induce a greater quantity demanded by lowering its price. The lower interest rate will signal to borrowers that more saving is taking place and that consumers are more willing to wait to consume. At the lower rate, borrowers can invest the loans in processes of production that will not produce output until the future, which coordinates with the increased patience of consumers.

It is important to note two things about this whole process. First, real-world banks and interest rates do not operate perfectly. Banks make mistakes about loans, guess wrong about the interest rates that will maximize their profits, and so on. Nonetheless, in broad terms, they do effectively facilitate intertemporal coordination day in and day out. Second, the ability of banks to charge interest rates that reflect the desires of borrowers and savers, to diversify their loans so as to minimize risk, and to provide an array of loans and services in forms and places consumers want, are all affected by various government regulations, institutions, and policies. If we wish to criticize the historical performance of actual financial markets in facilitating intertemporal coordination, we have to distinguish carefully those features of the banking system that are artifacts of government intervention from those that are inherent to the market.

Interest Rates and Intertemporal Coordination

Keynes objected to the idea of market-driven intertemporal coordination, famously remarking that a decision not to have dinner tonight does not simultaneously involve a decision about what good one will consume instead in the future (quoted, Hill 39). Keynes's objection slides from the accurate observation that an act of saving today does not comprise an order for a specific good in the future to the false claim that more saving reduces the demand for consumer goods without a corresponding increase in the demand for producer goods. This is the fulcrum of Keynes's denial that markets can intertemporally coordinate human choices. Although Keynes rightly notes that there is no market-generated signal about which specific goods should be produced in the future,

there are *general* signals that saving today requires the production of future goods. These general signals, interest rates, allow entrepreneurs to finance their sometimes competing visions of precisely what people will want in the future.

Keynes argues that increases in savings are responsible for economic depressions, because unfettered markets cannot coordinate savings with increased production for the future, resulting in unemployment in the present. To see why this argument fails, we need to distinguish between three possible forms of saving. If savings take the form of (1) direct loans via the financial market, or (2) indirect loans in the form of increased bank deposits, then these savings are indeed translated into increased investment by the banking system. Although banks and entrepreneurs might make errors about what specific goods will be demanded in the future, laissez-faire capitalism has no systematic inability, in either of these two cases, to coordinate the *aggregate* levels of saving and investment. And if saving takes the form of (3) cash holdings, then flexibility in prices and wages will prevent the burden of adjustment from falling on output and employment.

If I choose not to buy dinner tonight and keep the funds in my bank account, I give the bank control over those resources, which it can then loan out to producers for investment purposes. If I devote the resources that would have been used for dinner to increasing the size of my checking or savings account, then I have made those resources available for the production of future goods. Of course there is no guarantee of perfection in the bank's decision as to the recipients of these resources: an entrepreneur may not produce the precise goods I want in the future. But to expect perfection in this regard would be to hold the market to a standard beyond human capability.

Although it is true that my failure to buy dinner tonight means that "the restaurant owner will likely save less and spend less than she did out of her former higher income" (41), stopping the analysis here ignores the unseen. The fall in the restaurateur's income is offset by more income to the bank (in the form of interest on the additional loans it makes) and to the sellers of the various inputs that the borrowers purchase as part of their new investments. If the resources that would have gone to my dinner are channeled to a company that uses the loan to purchase a new machine, the seller of the machine, and any laborers who are hired to operate it, receive additions to their income that replace the income lost by the

restaurateur. Rather than paying cooks and farmers to provide me dinner tonight, I am, in effect, paying manufacturers and factory hands who are part of the process that builds an automobile I may buy next year. Keynesian arguments like Hill's focus on what *doesn't* happen to savings, but ignore what *does*.

In response to traditional arguments that interest rates are a function of time preferences and the productivity of capital, Keynes argued that interest rates are purely a monetary phenomenon (such that they could be continually lowered by increases in the money supply). Keynes's monetary theory of the interest rate has been subjected to cogent criticisms from a number of quarters. Most importantly, Keynes fails to distinguish, unlike many pre-Keynesian economists, between the "natural" rate of interest and the "market" rate. Individuals in their capacity as consumers have implicit preferences about how many present rather than future goods they wish to buy. If the real preferences of the public (as indicated by an unobservable but no less real higher "natural" rate) are for present consumption but the signal facing borrowers (a low "market" rate of interest) suggests that people are very much willing to wait before consuming, then firms will tend to invest in building too many long-term projects, like the capital goods necessary to produce more cars next year, and not enough short-term ones, like dinners tonight. When this intertemporal discoordination makes itself known, a recession will follow. The mismatch between intended saving and intended investment is caused by some systemic divergence between the natural and the market rates. In a large economy where many banks compete to gain the profits derivable from matching market to natural rates, the likeliest cause of a systemic deviation between them is monetary inflation.

Hill (50) argues that it is investment that determines saving, not the other way around. In one sense this is true: if the central bank creates an excess supply of money, and firms respond by borrowing it in order to purchase goods for future consumption, such investment must be financed by an act of saving somewhere. However, this saving is extracted from consumers through a redistribution of wealth created by the excess supply of money. Such "forced saving" conveys to producers a false expectation of the future demand for consumer goods. Producers will eventually discover that they have overestimated future demand; only voluntary saving can drive *sustainable* investments.

Of course, if we presuppose a general idleness of resources, as Keynesians frequently do, it should come as no surprise that if the banking system creates additional money, investment will be ignited. With idle workers and machines lying around, creating more money might provide the investment funds needed to activate them, and may also reduce their real prices so as to make them hireable given entrepreneurs' current expectations of the value of their marginal products. However, this presupposition leaves unanswered the question of why resources are idle in the first place, given our previous argument about the market's ability to facilitate intertemporal coordination. One possible explanation is that the supply of money has been insufficient to meet the demand to hold it, leading to a slackening of spending and a recession. If so, then Keynesians need to explain why modern economies are prone to such failures, keeping in mind that in almost all such economies, the money supply is produced not by market forces, but primarily by state-run or state-directed central banks. (It is also worth noting that no pre-Keynesian economist would have denied that "reflating" the money supply in the face of an excess demand for money would activate idle resources.)

The role played by interest rates, the banking system, financial markets, and speculators therein is precisely to help us overcome the ignorance of the future with which Keynes is concerned. For example, the problem facing investors is determining the quantity and composition of the possible future demand for their product. There is no way to quantify such information with any precision, but the existence of a reliable interest rate signal provides general guidelines for entrepreneurs. By contrast, starting from the view that interest rates are mere "conventions," Keynesian central bankers would deprive entrepreneurs of any ability to peer into the future, even fallibilistically.

The Role of Wage and Price Flexibility

For aggregate levels of output and employment to maintain themselves when changes in time preferences lead to changes in the intertemporal composition of production, prices and wages will need to be flexible, especially downward, and the money supply must be flexible upward. Consider wages and prices first. Hill (42) argues

that when the public “over-saves,” “the first consequence of this . . . will be an unintended rise in inventories as unsold goods pile up. Firms, realizing they have overestimated demand, will soon cut back production.” But why will firms fail to respond to higher inventories by *lowering prices*? Lowering output prices would reduce the value of the marginal product of capital and labor, driving down nominal wages, but it would not reduce aggregate real wages.⁵ If more saving is taking place through larger bank deposits, then the withdrawal of funds from consumer-goods industries (providing dinner tonight) will lead to lower prices and wages in these sectors, while the inrush of funds into producer-goods industries (providing the machinery to make cars for next year) will push up wages and prices there. If the necessary flexibility is absent, then unemployment and output reductions must follow.

By neglecting these possibilities, the Keynesian scenario appears to assume that the money supply is fixed and that prices and wages cannot fall. Given those assumptions, greater savings must reduce aggregate output and employment. Hill (42) writes that “a reduction in one person’s expenditure during a given period entails, by logical necessity, a corresponding reduction in someone else’s income during the same period.” That is surely true of nominal income, but it is not “by logical necessity” true of real income if prices, wages, and the money supply are flexible. Thus, where increased saving is mediated by the banking system, it results in a shift of resources from consumer-goods industries toward capital-goods industries, requiring that prices and wages fall in the former and rise in the latter.

Sometimes, however, people may manifest a desire to postpone consumption not by increasing their bank deposits, giving the banks funds that can be lent out as investments in future production, but by trying to increase their stores of cash. This can produce three reactions: (1) the monetary system can provide additional cash for people to hold; (2) the price level can fall; and/or (3) the level of output and employment can fall. The Keynesian argument Hill repeats assumes that the third scenario is the only possibility. If either the first or second happens to a sufficient degree, there is no reason to expect the level of output and employment to fall when the public suddenly prefers cash. Let us explore the first two alternatives more closely, then.

A properly functioning laissez-faire monetary system should be

able to respond to an increased demand for cash by supplying what the public wishes to hold, and in so doing, avoid any adverse macroeconomic consequences.⁶ Cash is not fundamentally different than other goods or services; if the public wishes to hold more of it, there is no reason that the laws of supply and demand should take a holiday. Keynes assumed that cash is “barren” because it provides no yield to the holder, such that holding cash was socially wasteful. If one defines “yield” to be some sort of financial return, then Keynes was right, but the same is true of any other good or service. Compact disc players do not yield a pecuniary return, yet people choose to hold “stocks” of them because they provide a service—the playing of music. Cash is no different, in that it provides the service of being available to buy things. By Keynes’s logic, fire trucks standing in fire stations are “doing nothing” and yield no benefits. But they provide the benefit of being available for use when needed. In this way, cash is like any other good or service and the monetary system should produce it to the degree the public is willing to hold stocks of it.

If the monetary system provides additional cash when the public wishes to hold more, it replaces the lost spending of the public with additions to the money supply, preventing either falling prices or falling output. If the monetary system fails, however, and the supply of cash is not increased, then prices must fall and/or output and employment must fall. With price and wage flexibility, an uncompensated increase in the demand for cash will necessitate varying downward adjustments in prices and wages in all industries (not just consumer-goods industries). If those adjustments can take place, then employment, real income, and real output will not be affected. If, however, prices and wages cannot make this general downward adjustment, then the reduction in aggregate demand will cause declines in employment, income, and output.

It is worth recalling in this connection that the capitalist economies of the 1920s and 1930s were far from unfettered by state supervision. All capitalist economies had central banks (in the United States, the Federal Reserve System) or similar regulatory regimes, and were bereft, especially in the American case, of a sufficiently flexible wage structure. Indeed, U.S. government policy in the aftermath of the stock market crash in 1929 was designed to *prevent* nominal wages from falling. A recent study by Richard Vedder and Lowell Gallaway (1993) shows that

the failure of money wages to fall in the downturn beginning in the fall of 1929 was largely a consequence of public-policy intervention by President Hoover and his political allies. As a consequence of this intervention, real wages rose rather than fell, and unemployment increased to previously unattained levels. The Great Depression was not a tragic example of market failure as is conventionally believed, but rather was an example of government failure. (89–90)

Keynes failed to recognize the role interest rates play in coordinating the demand for future consumption with the supply of present investment because he made the common mistake of examining only the immediately apparent consequences of economic actions. As Hazlitt pointed out, this mistake is exemplified by those who, in response to seeing a brick thrown through a storekeeper's window, revel in the thought of the new employment created for janitors, glaziers, police detectives, judges, and jailers. These people will, with the income they derive from this act of vandalism, buy more goods and services, increasing the incomes of their sellers, and so on. It begins to look like breaking windows is good for economic growth.⁷

The fallacy here is the failure to look deeply enough. The original storekeeper does indeed spend, say, \$100 repairing the window, but had it not been broken, he would have had a working window *and* the \$100, which he could have spent on something else. The money spent on replacing the window would have otherwise been spent on, say, a new suit of clothes. The difference between the two cases is that the resources spent on fixing the window only bring the storekeeper back to where he was, while the \$100 he would have spent on a new suit would have satisfied a previously unsatisfied preference. Thus breaking windows does not add to wealth any more than earthquakes, floods, or wars do, because the resources directly expended to repair the damage merely brings us back to where we were before.

Spending and the Sources of Wealth

Hill also endorses the Keynesian view that the poor are the engines of economic growth, since they spend a higher proportion of their income than the rich, driving firms to invest, produce, and employ:

Since it is spending, not saving, that generates income, and since the poor spend a larger percentage of their income than the rich, it follows that a nation's economic prospects can sometimes be improved by a redistribution of income from those classes which can find no further outlet for expenditure to those classes whose immediate needs can only be met by additional spending. Moreover, since it is precisely such an increase in spending that prompts firms to invest, a more equal distribution of income is not only apt to result in more current consumption, it can, if some resources are idle, also increase investment spending . . . because increased consumption and increased investment typically go hand-in-hand. (43)

Is it true, however, that spending generates income? To believe that it does, we must overlook the question of *where the power to spend comes from*. It is not spending that generates income, but income that generates the ability to spend. Income, as W. H. Hutt (1975, 18) argued, derives from the production of assets that can be sold at existing market prices.⁸ High wages per se are not the cause of spending. Spending presupposes the income earned by owners of productive goods or services priced to sell. That is, wage income is generated when a worker prices her labor services such that they are affordable in the labor market. Her subsequent purchases of other goods and services increase the productivity, and thus the wages, of asset owners in those industries. Similarly, the productivity of capital assets priced so as to clear the market is what generates their income, not the act of passing money from consumer to producer. Consumers can only spend the monetary value of their asset holdings, which derive from what they have previously produced and sold.

If the act of spending of money generated income, then countries with high rates of inflation, as measured by the quantity of money in circulation, should have the highest per capita incomes and growth rates. The evidence suggests otherwise.⁹ The line of causality is from productivity to wages to income to spending, not the other way around. Spending does not create jobs; being a productive worker who can fill a job profitably creates the ability to spend. This is not a chicken-and-egg problem. The process must start with production and the income it generates. The productivity of capital machinery and of human capital, the existence of which results from saving (not the spending of money), has created the elevated wage rates and previously unimaginable wealth of the West.

Spending power has to come from somewhere—namely, from increases in productivity.

Hill follows Keynes not only in believing that spending creates income, but that it creates investment. This is problematic in several ways. First of all, it ignores the cost of investing. While greater spending for a specific good may well raise the expected returns from investing in its production, investors must also consider the cost of borrowing the resources to undertake that investment. Automobiles may be in great demand, but if the cost of the funds necessary to build automobile factories is too high to produce a positive net yield from car sales, the high demand for output will not lead to a high level of investment. Second, greater demand for one good can stimulate investment in that good only by drawing resources and, therefore, investment away from other goods. By the same token, only potential spending on consumer goods deriving from new income created through increased productivity can raise the total demand for investment, rather than just reshuffling its previous level. Attempting to stimulate investment demand by fiat (through inflation), then, will bid up input prices, frustrating the attempt to increase profits and income.¹⁰

On the other hand, no pre-Keynesian economist would have denied that *if resources are idle*, increased demand for consumer goods can stimulate the demand for investment. The question is the cause of idle resources. Vedder and Gallaway document one cause of idleness: a general overpricing of labor caused by government policy. Another possibility is investor-entrepreneurial error. In a *laissez-faire* economy, however, when entrepreneurs make erroneous investments, they will tend to be liquidated because of their unprofitability. Idleness caused by entrepreneurial error would show no systemic patterns, being an irremovable feature of a world of uncertainty and fallible human beings. Similarly, individuals or companies may price labor or capital resources too high to sell, but such errors will be random and, in the absence of policies which prevent flexibility, they will tend to be corrected under penalty of unemployment or bankruptcy. What lends unwarranted credibility to the Keynesian project is its assumption—plausible (though incorrect) during the Great Depression, when Keynesianism first gained popular acceptance—that idle resources are the norm, or that a systemic, economy-wide idling of resources is a likely product of *laissez-faire* capitalism.

Speculation and Capitalism

Hill also argues that, in the past, the lack of markets for ownership rights meant that owners and firms were tied together for the long run, forcing them to have longer time horizons. The stock market, however, has weakened this tie, so that today, such long-run relationships are less frequent. Moreover, the efficiency of the stock market means that speculators are always on the prowl for quick profits resulting from movements in stock prices. Since those prices largely reflect the expectations of other market participants, the way to profit in the stock market is not by picking stocks that produce products people will want to buy, but stocks *others* think will perform well. Of course their expectations are simply expectations about everyone else's expectations, so stock prices are moved, according to Keynes, by mass psychology rather than underlying fundamentals. As Hill (55) interprets Keynes:

Capital gains . . . do not necessarily accrue to those who have performed a useful service in accurately forecasting the future needs of households and businesses, but often times fall to those who have accurately predicted how other investors will assess a particular stock, a talent which provides no useful service at all.

It is undoubtedly true that in the short run, many stock prices move around as traders attempt to cash in capital gains. However, not all stock owners are in the market for short-term gains and even those who are recognize that stock prices do respond to fundamentals such as debt/equity ratios, quarterly profit reports, and the like. Some stock owners are more interested in the voting rights and management influence that comes with stock ownership than the quick gains that can be made through short-term turnover. Stock is, after all, a form of ownership and thus a claim on the net worth of the firm. If a firm's net asset value is \$1 million and it has issued 100,000 shares of stock, each share is worth \$10. The actual market price will diverge from that number due to diverse expectations about the firm's future performance. But, should the firm liquidate, each share owner would be entitled to a pro rata share of the firm's net worth. Thus stock prices are not created out of thin air. They may indeed fluctuate in the short term as expectations of expectations change, but the value of stock is ultimately

anchored to the net worth of the firm. The share owner's stake as a residual claimant gives him reason to care about the long-run performance of the firm.

This concern sometimes plays itself out in a corporate takeover, where one individual or group thinks the targeted firm could be run more efficiently and produce more profits under different management. One way to install new management is to buy up stock and thus voting rights. In the case of a takeover, the purchasers need to hold the stock for a period of time long enough to put their new management plans into action. Selling out in three days because the stock rose slightly on the news of the intended takeover will not get them the larger long-term gain they believe can be made through better management. Those efficiency gains will manifest themselves in an increase in the net worth of the firm and, therefore, the value of its stock.

Normally, firms do not liquidate and stock owners never receive a precise pro rata share of the net worth of the firm. When a stock owner sells under normal circumstances, there has to be a buyer on the other side of the transaction willing to part with a monetary value that is greater than the seller's assessment of the value of the stock. It is these divergent expectations of future performance (buyers are relatively more optimistic than sellers) that create stock-market trades in the first place. As with entrepreneurship, the market offers great rewards, in terms of control over capital, to those traders whose expectations are more accurate.

In less normal circumstances, such as when a firm is being taken over, the buyer, in this case the acquiring firm, usually offers a premium price for the firm's stock. A takeover is a form of liquidation in a sense, as the owners of the acquired firm sell out their ownership stake for cash and the firm ceases to exist as an independent entity. Here too, the premium price is still related to the perceived potential value of the acquired firm's assets. The buyers are "betting" that they can generate more value out of those assets than is the case at the moment. Current owners face the choice of selling out now at the premium price or staying along for the ride with the new management. It is because stock ownership is a legal claim to a pro rata share of the firm's net worth that stock prices are not just epiphenomena of mass psychology but, instead, have some connection to the firm's underlying fundamentals.

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If Keynesians such as Hill wish to condemn capitalism, they will have to do it on grounds other than Keynes's denial that markets can produce intertemporal coordination. One can, and Keynesians often do, point to the recessions and depressions experienced by market economies as apparent evidence of Keynes's claim. But, as I have argued, markets do contain institutions that produce intertemporal coordination. The history of really-existing capitalism is full of various government interventions (most notably by central banks) into those coordination processes. Because these interventions can prevent markets from coordinating the preferences of savers with those of investors, we have to be very careful to distinguish whether historical examples of apparent market failure are the result of some inherent inability of markets or of the deleterious, if unintended, consequences of government intervention.

NOTES

1. Roger Garrison (1986) has thus viewed the Austrian-school position as occupying a "middle ground" between the perfection presupposed by general equilibrium theory and the systematic discoordination posited by Keynesianism.
2. Foremost among these is the Austrian school, which, contrary to the suggestions made by Hill, neither accepts that the Walrasian model describes the real world, nor that it is very useful in understanding real-world economic processes. Nonetheless, Austrians generally believe that the market, though imperfect, does a better job at most, if not all, economic tasks than does the political process. For overviews of the Austrian perspective which reflect these views, see Lavoie 1985, Boettke, Horwitz, and Prychitko 1994, Vaughn 1994, and O'Driscoll and Rizzo 1996.
3. This view is defended by Israel Kirzner (1989).
4. Because the interest earned on loans is the primary source of revenue for banks, bankers have powerful incentives to make sure they make loans to firms that will guess correctly about which specific goods will be demanded in the future. If they extend credit to firms that guess wrong, those firms will not generate the revenue needed to pay back the interest, or even the principal, on the loans.
5. Whether prices and wages can ever be flexible enough to avoid reductions in output and employment in the face of an excess demand for money is not clear. Some economists have harkened back to the pre-Keynesian monetary theorists and have begun to argue that wage and price rigidities are severe enough so that a policy of adjusting the nominal money supply

to changes in demand is superior to trying to allow the price level to fall. See Yeager 1986 on the problem of sticky prices, and Selgin 1988 and Horwitz 1996 on the role of a flexible money supply in avoiding those problems.

6. Many have argued that a truly laissez-faire banking system would take the form of so-called "free banking." On the relationship between Keynes and free banking, see Horwitz 1989. General works on free banking include Selgin 1988, Dowd 1989, Glasner 1989, and White 1996.
7. Ironically, the ultimately unproductive activities of, in this example, the janitors, glaziers, detectives, etc., do count toward GDP "growth." One major problem with using GDP as a measure of wealth is that it does not distinguish between expenditures that create wealth, those that transfer wealth, and those that simply restore wealth to its previous level. The expenditures needed to clean up after a building is burned down in a riot are not distinguished from those that create new products or services. Such concerns are of paramount importance in making judgments about the health of economies suffering from inflation, which induces all sorts of expenditures that do not create wealth but simply try to protect it from the effects of depreciation.
8. Hutt's argument here is, as he recognizes, "pure orthodoxy" in its derivation from various pre-Keynesian economists, especially J. B. Say. See Hutt's 1979 critique of Keynesianism.
9. On the relationship between inflation and economic growth see Fischer 1991 and Barro 1995. Of course, all such statistics need to be read in light of the point made in n7 about the way in which GDP figures overstate the health of inflation-ridden economies.
10. See Hayek's (1941, 433-39) excellent discussion of what he calls "Mill's fourth postulate."

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