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Louis-Philippe Rochon

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Keynes’s Finance Motive: a re-assessment. Credit, liquidity preference and the rate of interest

LOUIS-PHILIPPE ROCHON
New School for Social Research, 65 Fifth Avenue, New York, NY 10011, USA

This paper attempts to reconcile Keynes’s post-General Theory writings on the finance motive with the horizontalist approach, as advocated by Moore, Lavoie, Kaldor and many proponents of the Franco-Italian Circuit school. It is argued here that, as Keynes felt himself ‘gradually getting into an outside position’ with respect to the General Theory—which he saw as a transition away from classical theory—he came to adopt many aspects of the horizontalist position as well as that of the circuit approach, including the exogeneity of the rate of interest and the view that rates do not necessarily increase during economic expansions. Keynes’s post-General Theory writings therefore reject the theory of liquidity preference of the General Theory. It is suggested that, in their attempt to construct an alternative to orthodox monetary thought, post-Keynesians should abandon the confines of the General Theory, and focus instead on the views Keynes developed after the General Theory.

1. Introduction

Despite Davidson’s (1965) early attempt to draw attention to Keynes’s ‘finance motive,’ subsequent extensions and refinement of Keynes’s monetary ideas have largely ignored the theoretical importance, and the practical consequences, that Keynes’s post-General Theory articles have for monetary theory.

This criticism is aimed as much at orthodox economists as at post-Keynesians, who have chosen to emphasise the General Theory and its stock analysis, while ignoring both Keynes’s Treatise on Money and his later writings on money in the Economic Journal. As such, post-Keynesians often relegate Keynes’s other writings on money to a second-order level, or attempt to reconcile them with the General Theory—a strange endeavour given that Keynes himself recognised that the technical details of money had been left in the background.

This paper will therefore take a much deserved closer look at Keynes’s
post-*General Theory* writings on the finance motive, as well as at his correspondence and speeches, in an effort to shed light on how Keynes's thinking evolved in the area of monetary theory. Although Keynes never had the opportunity to develop fully his views on money after the *General Theory*, it is argued here that it is possible to piece together a coherent theory of money endogeneity that closely resembles the horizontalist position later defended by Kaldor, Moore and Lavoie. In a strange way, this paper contradicts Keynes's warning that the finance motive does not "deserve all this exegesis".

This paper is structured as follows. First, I will argue that Keynes's later writings on finance and interest rates represent a progression in his thoughts, and not necessarily a steadfast defence of the *General Theory*. Therefore, no attempt should be made to reconcile them with the Marshallian framework of the *General Theory*.

Second, I will briefly survey how the finance motive is generally treated within the post-Keynesian literature. Overall, post-Keynesians interpret the finance motive as a 'fourth motive' for holding money, and as such conflate the notion of money with that of credit or finance. This leads to much unnecessary confusion.

Third, I will offer an interpretation of Keynes's finance motive that is consistent with the Franco-Italian Circuit school. I will argue that this interpretation is consistent with endogenous credit and money theories, but offers a stronger foundation for building an alternative to the orthodox thought from which Keynes was attempting to escape.

Finally, I argue that Keynes increasingly appeared to favour a 'horizontalist' position, where the rate of interest is an exogenous variable and independent of the demand (and supply) for 'money' or finance. This suggests that Keynes would finally have broken free of orthodoxy, abandoning his liquidity preference theory of the rate of interest and, as a result, no longer would see the interest rate as a 'monetary' phenomenon. This is consistent with the position taken by Lavoie (1996, p. 276), who argues that 'whether the money supply is fully exogenous, or whether the money supply is endogenous but its curve is an upward-sloping shape, makes no difference whatsoever.' Hence, contrary to what Dow & Dow (1989, p. 162) claim, horizontalism is *not* a 'complete break' with Keynes.

What emerges foremost is Keynes's awareness of the clear sequence of events inherent in the circulation of money within a monetary production economy where bank credit is the principle agent financing investment and production. This is a significant departure from the *General Theory* and carries with it important consequences.

### 2. Keynes through Time

In considering Keynes's 'long struggle of escape ... from habitual modes of thought and expression,' post-Keynesians must make the assumption that this struggle was an ongoing process which did not end with the publication of the *General Theory*—especially with respect to Keynes's views on monetary theory. Rather, the *General Theory* should be seen as part of a sequential analysis which
ultimately culminated in Keynes’s rejection of his own liquidity preference theory of the rate of interest. Keynes himself considered his post-General Theory articles in this light.

As both Kaldor (1982) and the recanted Hicks (1982) observed, Keynes’s monetary analysis in the General Theory was still in the ‘monetarist’ tradition, thereby amounting to a modification—rather than to the abandonment—of the Quantity Theory. Keynes’s ‘moments of illumination’ therefore must have continued well after the publication of the General Theory.

This position receives support from Keynes himself, who gave several indications that he grew increasingly dissatisfied with the General Theory. For instance, we know he intended on producing ‘footnotes’—‘in the course of the next year or so’—to help him in ‘re-writing and re-casting’ the General Theory. Moreover, in letters to Joan Robinson, Keynes gives evidence of his willingness to change his views. For instance, Keynes (1979, p. 185) writes that ‘I am trying to prevent my mind from crystallising too much on the precise lines of the General Theory.’ Later, Keynes would also tell Robinson that he felt himself ‘gradually getting ... into an outside position towards the book, and am feeling my way to new lines of exposition.’ Finally, in the preface to the German edition of the General Theory, Keynes (1973a, p. xxv; emphasis added) claims that he regarded the General Theory as ‘a transition away from the English classical (or orthodox) tradition.’ As such, Keynes admits that his views on money were not fully developed and, because they were in transition, they were certain to evolve some more.

All these examples should encourage post-Keynesians to abandon the confines of the General Theory, and look beyond it when considering Keynes’s attempts to build the foundations of a modern monetary theory of credit and production, distinct from neoclassical theory. When rereading Keynes, post-Keynesians should also keep in mind that Keynes benefited from a number of exchanges and correspondence with numerous colleagues on various specific and technical details of the General Theory (see Keynes, 1973a, 1979). We must assume that time gave him the benefit of thinking things through.

The Economic Journal articles must therefore be seen as a progression in Keynes’s thinking and not merely a clarification of his thoughts. In light of these comments, the post-General Theory articles become a better foundation for an alternative approach to neoclassical theory. They should not be seen as complementing the General Theory—conventional wisdom suggests that Keynes attempted to clarify the General Theory—but rather as replacing it. Therefore, no attempt should be made to interpret them within the Marshallian framework of the General Theory. They are not the ‘third edition’ of Keynes’s General Theory—as argued by Shackle (1967, p. 136)—but rather a whole new beginning, with new ideas and approaches. As Graziani (1984) has been arguing for some time now, the finance motive invalidates the General Theory in many respects.

1 Quoted by Moggridge, see Keynes (1973a, p. xviii).
3. The Finance Motive and Post-Keynesian Theory

In response to criticism raised in reviews of the General Theory by Ohlin (1937), Hicks (1936), Robertson (1936) and Hawtrey (1937), Keynes wrote four fairly short articles in the Economic Journal from June 1937 to September 1939. His motivation was partly rooted in what he considered was a disguised attempt by ‘classical’ economists to re-introduce the notion that the rate of interest was determined through the interaction of the demand and supply for saving. In these articles Keynes introduces the finance motive in order better to make the argument that the rate of interest is determined by the supply and demand for money, and that, in fact, investment is independent of a prior amount of saving.

Those who have looked at the finance motive have generally done so in an attempt to reconcile it with the model and framework of the General Theory (Davidson, 1965, 1972) where the supply of money is an exogenous stock. This has generally taken the form of advancing two fundamental ‘postulates’. First, the finance motive is considered as part of the demand for ‘money’; and second, the finance motive only comes into existence when the economy is expanding. In either case, the finance motive is considered a ‘minor amendment’ to Keynes’s overall framework (Asimakopulos, 1991, p. 109).

The first postulate is associated with most post-Keynesians, particularly Davidson (1965, 1972), Minsky (1975), Chick (1983), and Shackle (1967). Support for this position can be found in Keynes (1973a, pp. 209, 245, emphasis added) who, in his post-General Theory articles, clearly says that the ‘extra finance involved will constitute an additional demand for money.’ As such, any increase in the demand for finance will invariably lead to an increase in the demand for ‘money’. This argument takes one of two forms: either money is an ‘addendum’ to the transactions demand for money, or it is considered a ‘fourth motive’ for holding money. In a recent article, Bibow (1995, p. 648) argues the first point: ‘Keynes’s discussion of the finance motive is essentially an addendum to the transactions motive’. Davidson (1965) also defends this position.

Granted, there are some (Smith 1979) who disassociate the finance motive from the transactions motive, arguing that Keynes viewed the demand for finance as a distinctive motive for holding money. Nonetheless, the finance motive is still considered one of the motives for holding ‘money’.

As for the second postulate, Smith accepts the notion that the finance motive is needed only when the economy is growing. This view is shared by Wells (1981, p. 586), who argues that ‘the demand for finance (in Keynes’s sense) is positive only when the economy is growing, and nil when the economy is in equilibrium’ because ‘as long as aggregate demand is not rising, the economy automatically generates sufficient purchasing power to sustain its current equilibrium level of spending’. This view is shared by many post-Keynesians, such as Chick (1983), Davidson (1965, 1972) and Rousseas (1992).

4. Credit, Money and the Circuit

There exists, however, an alternative interpretation of the finance motive which has grown in importance in recent years. Its proponents reject both post-
Keynesian ‘postulates’. Associated with the Franco-Italian ‘circulationist’ school, this alternative interpretation takes the finance motive, not as an extension of the transactions demand for money, but rather as independent of it. Moreover, the demand for credit is independent of demand for ‘money’.

‘Money’, ‘credit’ and ‘credit-money’ are often used interchangeably by post-Keynesians, thereby leading to much unnecessary confusion. Whether this is the result of long-standing habits or not, it should be made clear that these are not the same concepts. In fact, money is not credit, and credit is not money. Credit is an *ex ante* variable which allows production to take place, and incomes to be disbursed. It is a flow.

On the other hand, money is an *ex post* variable. It exists only when credit has been utilised by firms. Once credit is expended, incomes are created out of which households express their demand for money for transaction, precautionary and speculative purposes, and their liquidity preference. Credit, or Keynes’s finance motive, is not seen as a ‘fourth motive for holding money’, nor is it a demand for ‘cash’. Hence, the demands for credit and money are different concepts; they are independent of each other.² It is, in fact, quite conceivable for the demand for money to be nil, while it is never the case that the demand for credit is nil. Hence, while the former is a flow concept, the latter is a stock concept, which is important in discussing portfolio decisions of household, and banks’ liability management practices.³

Such a distinction between money and credit is the result of seeing the economic process as a sequence of irreversible events and as the natural evolution of the monetary circuit. Credit is the starting point of the process, while the destruction of money is the end result.

At the heart of the post-*General Theory* articles, we find precisely this conception of the monetary circuit and, as a result, the notion of the financial circulation of money. First, we know that Keynes was well aware of the existence of a monetary circuit. For instance, Keynes (1979, p. 81) fully understood the Marxian notion of the production circuit in which an initial amount of money is exchanged for commodities which are then exchanged for a greater amount of money ($M - C - M'$).

Second, the notion of a circuit period distinct from the Marshallian short period of the *General Theory* was also well known to Keynes. The circuit period involves no time; it is, so to speak, an abstraction from reality. It is a logical construction of a sequence of events starting with investment plans (based on expectations) and moving on to the demand for credit, to the creation of money, and, ultimately, to the destruction of money and the reimbursement of debt.

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² Horizontalists in particular have emphasised this distinction. For instance, Moore (1995, p. 263) argues precisely that ‘money supply is determined by demand for credit, not the demand for money’—a distinction he made earlier (see Moore, 1989, p. 483). Similarly, Forman et al. (1985, p. 33) claim, ‘it is the demand for credit rather than the demand for money which is the necessary starting point for analysing the role played by monetary factors in determining the level of real economic activity’.

³ As Graziani (1985, p. 164) argues, ‘if a bank’s finance, while guaranteed, has not been used, the corresponding liquidity has not yet been created, and it is not possible to talk of the existence of liquidity’.
Keynes (1973a, p. 179-80; see also p. 185) eluded to such a concept in his rough notes from his 1937 lectures:

Time relationship between effective demand and income incapable of being made precise. In case of factors other than entrepreneurs and rentiers the two are more or less simultaneous. For the latter income becomes determinant and is transferred at varying subsequent dates. No definite relationship between aggregate effective demand at one time and aggregate income at some later time. This does not matter.... When one is dealing with aggregates, aggregate effective demand at time A has no corresponding aggregate income at time B. All one can compare is the expected and actual income resulting to an entrepreneur from a particular decision.

This position is the starting point for the development of a circuit which sees ‘credit–money’ as a flow rather than a stock. Combining Keynes's conception of the circuit with his finance motive, we obtain a theory of money endogeneity which relies foremost on the differentiation between credit and money, the role of commercial banks as ex nihilo purveyors of credit, the destruction of money, and the abandonment of the liquidity preference theory of the rate of interest.

The role of commercial banks, in particular, becomes a key element in the analysis. In the post-General Theory articles the central bank, while having been given a paramount role in the General Theory at the expense of commercial banks, is completely absent from the analysis, thus returning us somewhat to the Treatise. Rather, commercial banks are given the central role in determining the flow of credit. This suggests two things. First, Keynes endogenises the money supply; and second, the emphasis is placed on the relationship between entrepreneurs and commercial banks. This view is at odds with post-Keynesian views on money supply endogeneity and economic activity. In the former case, emphasis is placed on the relationship between banks and entrepreneurs, while in the latter example, the forces of economic activity lie principally with entrepreneurs and their ‘animal spirits’ while ignoring the fact that banks also have ‘animal spirits’ (Lavoie, 1984).

5. The Finance Motive, Banks, and the Financing of Production

For Keynes, investment is the primary determinant of economic cycles—the ‘causa causans’ of the system (Keynes, 1973a, p. 121)—and as such, emphasis should be placed on how investments are realised and financed. While the General Theory emphasises the role of expectations in determining the level of investment, little, if anything at all, is devoted to the financing of investment.

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5 In fact, as Lavoie (1986) reminds us, there is no mention of the central bank.

6 We can assume a further relationship between banks and the central bank, specifying that, in Keynes’s finance motive, this relationship is not the primary reason for the endogenous nature of money. Money becomes endogenous because commercial banks can create credit and money ex nihilo. Money is endogenous because of the necessity of production. Moore (1988) and Kaldor (1982) have often appeared to put too much emphasis on the lender-of-last-resort property of central banking as the reason why money is endogenous.
Following criticism from Ohlin, Keynes introduces in his June 1937 article, the financing of \textit{ex ante} investment projects.

Essentially, Keynes (1973b, p. 219) argues that there exists an ‘interregnum between the intention to invest and its achievement’ during which firms incur costs associated with production. As such, they must first find appropriate venues to finance this investment: ‘an investment decision ... may sometimes involve a temporary demand for money before it is carried out ... Planned investment—i.e. investment \textit{ex ante}—may have to secure its “financial provision” before the investment takes place; that is to say, before the corresponding saving has taken place’ (Keynes, 1973b, p. 207). Keynes thus recognises the clear distinction between investment decisions and investment spending—a distinction which was clearly absent in the \textit{General Theory}. ‘Now, \textit{ex ante} investment is an important, genuine phenomenon, in as much as decisions have to be taken and credit or “finance” provided well in advance of the actual process of investment’ (Keynes, 1973b, p. 216).

Keynes makes clear that finance is needed irrespective of whether a firm is producing capital goods or consumption goods: ‘Investment finance in this sense [as an “advance provision of cash”] is, of course, only a special case of the finance required by any productive process’ (Keynes, 1973b, p. 208). ‘The production of consumption goods requires the prior provision of funds just as much as does the production of capital goods ... It is not an increase of investment as such which requires an immediate increase in “available funds”, but an increase of output \textit{whether for investment or for consumption}, or more strictly an increase in the turnover of transactions for any purpose ... [Finance] covers equally the use of the revolving pool of funds to finance the production of capital goods with the production of consumption goods’ (Keynes, 1973b, p. 283, emphasis added).

Keynes defines ‘finance’ as an ‘advance provision of cash ... required by the current decisions to invest’ (Keynes, 1973b, p. 208) and, alternatively, as the ‘credit required in the interval between planning and execution’ (Keynes, 1973b, p. 216, fn. 1). Keynes is therefore aware of a certain distinction between credit and money. If he insists on referring to credit as money, it is perhaps because, at this time, Keynes prefers staying as close as possible to the terminology of the \textit{General Theory}.

However, Keynes is clear that the necessary finance does not come from prior saving. He argues that ‘planned investment—i.e. investment \textit{ex ante}—may have to secure its “financial provision” before the corresponding saving has taken place’ (Keynes, 1973b, p. 207). According to Keynes and post-Keynesians, it is investment which generates saving, not the other way around as in neoclassical theory. As Keynes argues, ‘“finance” has nothing to do with saving. At the “financial” stage of the proceedings no net saving has taken place on anyone’s part, just as there has been no net investment’ (Keynes, 1973b, p. 209). Keynes considers the notion of a prior saving—or \textit{ex ante} saving—as ludicrous. In a footnote, Keynes indicates that ‘as for the concept of \textit{ex ante} saving, I can attach no sound sense to it’ (Keynes, 1973b, p. 210, fn. 1).

Of course, the independence of saving was recognised in the \textit{General Theory}; it was indeed the causal factor of Keynes’s model. But there, Keynes
does not explicitly discuss the importance of the banking system as he had done previously in the *Treatise* (see for instance, Keynes, 1971b, p. 96).

With respect to the possible sources of finance, there is initially some confusion in Keynes's work which appears to be cleared up later. Initially, Keynes argues that finance 'may be provided either by the new issue market or by the banks:—which it is makes no difference,' while later suggesting that finance is forthcoming 'more likely ... if he is financing himself by a new market issue than if he is depending on his bank' (Keynes, 1973b, p. 208). Keynes seems to be initially suggesting that finance is most probably made available, not through banks, but by the 'new issue market.' At the very least, Keynes is arguing that banks are only one of the possible sources of finance. But in the context of a monetary circuit, 'which it is' does 'make a difference.' In arguing that the new issue market is a source of fresh finance, Keynes is remaking the argument of *ex ante* saving determining *ex ante* investment since the corresponding saving is produced only once the investment has taken place.

In the context of a monetary circuit, there is a clear distinction between initial finance and final finance, which Keynes would later understand. In a circuit, production is financed through bank credit which is used to pay workers and out of whose income consumption-goods will be purchased. The resulting saving, as will be shown below, will either be used to purchase 'new issues' or will be hoarded and kept in bank accounts. Saving enters only at the end of the process, after wages have been paid.

It is only in his December article, following criticism raised by Robertson, that Keynes (1973b, p. 217) clarifies this ambiguity by suggesting 'firstly, that [the entrepreneur] can obtain sufficient short-term finance during the period of producing the investment; and secondly, that he can eventually fund his short-term obligations by a long-term issue on satisfactory conditions'. Keynes sees this dual-sequential process as 'the characteristic one.' This suggests, rightly, the proper way of seeing a monetary circuit. Bank credit is used for production, and saving is used as a way of reimbursing the initial debt.

Further, Keynes (1973b, p. 210) argues that the 'finance required during the interregnum between the intentions to invest and its achievement is mainly supplied by specialists, in particular by the banks'. In the following paragraph, Keynes claims that the finance is 'wholly supplied ... by the banks', a situation which he claims is 'substantially representative of real life' (Keynes, 1973b, p. 219). Keynes (1973b, p. 285) reaffirms this position a year and a half later in his 1939 *Economic Journal* article: 'It is the rôle of the credit system to provide the liquid funds which are required first of all by entrepreneurs during the period before his actual expenditure, and then by the recipients of this expenditure during the period before they have decided to employ it'. In this last statement, it is clear that by 'credit system', Keynes has in mind commercial banks as the primary source of finance.7

Now, with respect to this finance, the banking system is usually not constrained. Keynes recognises the ability of banks to increase their 'financial

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7 In this sense, Keynes (1971a, p. 182) goes back to his views in the *Treatise*, where he argued that 'the first link in the causal sequence [of production] is the behavior of the banking system'.

commitments' on demand. The key rests with the banks' will to determine the money supply. This does not suggest that commercial banks will grant all requests for credit; Keynes (1971a, pp. 212–213; 1971b, pp. 364–367) recognises that there will always be a ‘fringe of unsatisfied customers’.8

Keynes (1973b, p. 210, emphasis added) writes 'the banking system chooses to make the finance available'. Also, Keynes states that 'unless the banking system is prepared to augment the supply of money, lack of finance may prove an important obstacle to more than a certain amount of investment decisions being on the tapis at the same time'. Clearly, Keynes rests the primary responsibility for economic activity squarely on the banks. In this sense, Keynes establishes two important points. First, he recognises that commercial banks have a role to play in determining the quantity of money. In essence, it was a tacit recognition that the supply of credit-money is demand determined: 'too great a press of uncompleted investment decisions is quite capable of exhausting the available finance, if the banking system is unwilling to increase the supply of money ...'. Yet this is only another way of expressing the power of the banks through their control over the supply of money (Keynes, 1973b, pp. 210–211, emphasis added). In fact, Keynes argues that banks are never resource-constrained and that they can lend as much as they wish. However, they may choose not to lend for a variety of reasons.

Also, Keynes recognises the importance of commercial banks in determining the 'pace of economic activity': 'the banks hold the key position from a lower to a higher scale of activity ... The investment market can never become congested through shortage of saving. This is the most fundamental of my conclusions within this field' (Keynes, 1973b, p. 222). Also, 'this is the explanation of why [the banks'] policy is so important in determining the pace at which new investment can proceed' (Keynes, 1973b, p. 219). The emphasis is therefore put on banks rather than entrepreneurs in determining the 'pace of economic activity'.

6. The Revolving Fund

In attempting to show the independence of investment from saving Keynes made use of the concept of finance as a revolving fund. The idea first appeared in his June 1937 Economic Journal article, although Keynes never made clear the underlying mechanics.9

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8 This is often a misunderstood component of horizontalism as well. Post-Keynesians (see Dow, 1996; Dow & Dow, 1989; Wray, 1992, 1995) usually interpret horizontalism as implying that banks will 'passively' accommodate all demand for credit (Jarsulic, 1989). This is not so. As Lavoie (1996a, p. 284) explains, 'the claim, quite legitimate, that banks have some restrictions on their lending does not call into question the validity of horizontalism'. Moreover, Moore (1995, p. 264) claims that 'in an overdraft system, bank accommodation of increased demand for funds by a credit-worthy borrower is in no sense extreme. It is instead completely normal, so long as borrowers remain within their allocated credit limits'.

9 Some post-Keynesians argue that finance is needed only when firms are increasing their levels of production. Support for this position may well be found in Keynes himself. This allowed many post-Keynesians, such as Davidson (1986, p. 101, emphasis added) to argue that 'the role of the
The revolving fund in Keynes is a fund of finance used repeatedly to finance production, irrespective of whether production or wages is increasing. To assume, as do most post-Keynesians, that the revolving fund is of importance only when production is increasing ignores important elements of the monetary circuit. First, it ignores the fact that after the production circuit is closed, money—that is, the initial finance used—has been destroyed. As such, for firms to start a new cycle of production—even if production or wages have remained constant—finance must be sought again. Each new circuit requires new decisions of production and new demands for credit. Otherwise, it would imply that current production does not require financing and, moreover, that in a stationary state, Keynes's finance motive becomes entirely irrelevant.

This alternative approach makes sense given the nature of the monetary circuit in which money is first created and then destroyed. Money is created when a loan is granted to a firm for production and investment purposes. When the proceeds from the sales are received (assuming for now that all income is spent) firms can do one of two things: either they can use the proceeds to pursue production, in which case firms still have an outstanding debt toward the bank, or they can pay back their initial loan. The initial situation, however, makes no sense since the initial debt would remain unpaid and entrepreneurs would be paying interest costs. If the latter occurs, then firms need to renew their loans with the bank—a prospect which is not automatic.

Keynes's notion of a revolving fund suggests, however, one important point: whereas a constant level of credit can finance a given level of production, increasing output requires additional financing. Under no circumstances can a constant level of output be considered self-financing.

Support for this statement is offered by Keynes (1973b, p. 209, emphasis added): 'if investment is proceeding at a steady rate, the finance ... required can be supplied from a revolving fund of a more or less constant amount, one entrepreneur having his finance replenished for the purpose of a projected investment as another exhausts his on paying for his completed investment ... [it] looks after a flow of investment. It is a revolving fund which can be used over and over again'. Then, Keynes (1973b, p. 230, emphasis added) adds: 'a given stock of cash can provide a revolving fund for a steady flow of activity; but an increased rate of flow needs an increased stock to keep the channels filled'. Surely, this is a clear recognition that finance is required even to keep the level of production constant. Keynes is clearly describing the process of the banking system ... is to create additional short-term finance whenever entrepreneurs wish to increase the flow of real investment'. Similarly, Chick (1995, p. 30) has argued that 'saving generated by earlier autonomous expenditure can finance replacement investment in the stationary state. But when investment rises above former equilibrium levels, saving cannot effect the change.... The responsibility for financing investment above a previous equilibrium level rests with the institution which can grant credit independently of saving: the banks'.

10 It is in this context that Keynes's multiplier equals unity.

11 As Graziani (1987, p. 185) correctly observes, 'the mere fact of getting an amount of cash equal to the initial outlays does not give a firm free disposal on it'. Poulon (1990, p. 381) makes a similar claim: 'when the cancellation date of money comes into effect, firms reimburse their credit to the financial intermediaries using the revenues generated by the sales. Firms then ask for new credit in order to continue their production activities'.

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monetary circuit where the causality runs from investment decisions (expected or desired income), to finance (demand for credit), to investment, to effective income and saving (money).

Once the finance has been secured and put to productive use, firms are in a position to repay the bank once revenues have been received. This can be achieved in two ways: through consumption and through saving. Firms can recuperate their outlays by selling their commodities to consumers (capital-goods firms sell their capital goods to other firms). As for savings, they are channelled back to the firm through the purchase of long-run securities (new issue market). The firm, therefore, has two sources by which to recapture its initial outlays, which it then uses to pay back the credit-granting institutions. At this point, money is destroyed and the circuit comes to an end (unless there is hoarding, which is not discussed here).

Keynes was clear on the equal role of consumption and saving in retiring debt, having made several references to this idea. For instance, in his December 1937 article, Keynes (1973b, p. 221) writes, ‘for consumption is just as effective in liquidating the short-term finance as saving is. There is no difference between the two’. Then, in a 25 March 1938 letter to Shaw, Keynes (1979, p. 276) writes: ‘For the purpose of restoring liquidity consumption is just as good as saving. ... When income is created by the expenditure of the “finance”, it is a matter of indifference in this connection whether the recipients save or spend it. In either case liquid resources are increased by the release of the “finance” which has been temporarily held up’. Also, Keynes (1973b, p. 282) argues that ‘spending releases funds just as much as saving does’.

The conclusion to draw here is that Keynes did not see financial markets supplying fresh finance or financing investment, but rather as closing the circuit. The financial market supplies firms with the necessary funding—final finance—with which to pay back bank loans. As such, the consumer goods market and the financial market play similar roles.

7. Liquidity Preference and the Rate of Interest

What emerges in these articles is the fact that Keynes was aware of the existence of a monetary circuit outside the scope of the Marshallian short-period analysis of the General Theory. As time progressed, Keynes indeed was getting into ‘new lines of exposition’.

The remaining argument to fill the puzzle of Keynes’s evolving views on monetary theory remains the determination of the rate of interest. In the General Theory, Keynes introduced his liquidity preference theory of the rate of interest. As I will argue below, however, Keynes began moving increasingly away from this analysis toward the view that the rate of interest is an exogenous variable. On a few occasions, Keynes (1979, p. 263) suggests that his theory of liquidity preference was ‘far from complete’, and that ‘by itself [liquidity preference] does not carry us very far’ (see Keynes, 1973b, p. 213).

12 Keynes (1973b, p. 233) also claims that ‘saving has no special efficacy, as compared with consumption, in releasing cash and restoring liquidity’.
Moreover, if Keynes assumes that the rate of interest increases with the demand for money or finance, it is because he sees the money supply as essentially inelastic, as in the *General Theory*. But, Keynes argues, if the money supply is allowed to increase endogenously with demand, there is no reason for the rate of interest to increase—a clear recognition that the money supply curve can be horizontal. For instance, Keynes (1979, p. 222, emphasis added) argues that ‘during a boom the demand for money rises, and during a slump it falls off.... *If there is no great change in the supply of money* ... interest rates are likely to rise during a boom and to fall during a prolonged recession. *But this is all on the assumption that the supply of money is constant.* If the supply of money is suitably adjusted, then there is no necessary reason why interest rates need rise during a boom or fall during a depression.’

Keynes’s liquidity preference theory of the rate of interest should therefore be seen as a two-stage process, as Keynes himself recognised. First, Keynes argues that an increase in the finance required will impose pressure on the rate of interest. However, the actual movement in the rate depends not on the demand curve, but on the supply curve. In essence, Keynes argues that the rate of interest will rise only if banks refuse ‘to relax’ or apply the ‘appropriate’ monetary policy.

By including the finance motive in the theory of liquidity preference, Keynes (1973b, p. 209) fully acknowledges that ‘a pressure to secure more finance than usual may easily affect the rate of interest through its influence on the demand for money’. This position is consistent with his overall view of the rate of interest as a monetary phenomenon as espoused in the *General Theory*. But in his later writings, Keynes qualifies this statement by suggesting that it all depends on the ‘appropriate’ monetary policy (hence on the supply curve). In fact, Keynes recognises that a rise in economic activity may not lead to a rise in the rate of interest at all.

For instance, in a March 1937 letter to Hicks, Keynes (1973b, p. 80) claims unequivocally that ‘an increase in the inducement to invest *need not* raise the rate of interest. I should agree that, unless the monetary policy is appropriate, it is quite likely to’. While this passage is often quoted by post-Keynesians, the rest of it is not. This is unfortunate since Keynes (1973b, p. 80, emphasis added) specifically argues that the difference between himself and the ‘classicals’ precisely lies ‘in the fact that they regard the rate of interest as a non-monetary phenomenon, so that an increase in the inducement to invest would raise the rate of interest irrespective of monetary policy’.

Keynes returns to this argument by claiming (1973b, p. 209) that the rate of interest will rise ‘unless the banking system is prepared to augment the supply of money’. Elsewhere, Keynes (1973b, p. 231) suggests that if a rise in the rate of interest ‘is to be offset, there must be an increase in the quantity of money’. Moreover, in his December 1937 article Keynes (1973b, p. 222, emphasis added) argues that ‘the point remains, however, that the transition from a lower to a higher scale of activity involves an increased demand for liquid resources which

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13 See also Keynes (1973a, p. 231).
14 By ‘classical’, Keynes meant neoclassical (see Asimakopulos, 1991).
cannot be met without a rise in the rate of interest, unless the banks are ready to lend more cash ... at the existing rate of interest'.

Keynes credits the use of overdraft facilities with mitigating the effects of increases in the demand for finance. An 'obiter dictum' which Keynes (1973b, p. 223) argues is worth mentioning, is that banks do not 'pay great attention ... to the amount of their customers' unused overdraft facilities.... This is an ideal system for mitigating the effect on the banking system of an increased demand for ex ante finance.... In this event the transition from a lower to a higher scale of activity may be accomplished with less pressure on the demand for liquidity and the rate of interest'.

There thus appears to be some movement away from the General Theory. The definitive break, however, comes in correspondence and speeches that Keynes gives in the years to follow. These offer several indications that Keynes accepted the view that the rate of interest was an exogenous variable. For instance, Keynes (1980a, p. 149) writes, in a letter to Harrod (dated 19 April 1942), that 'in my view the whole management of the domestic economy depends upon being free to have the appropriate rate of interest without reference to the rates prevailing elsewhere in the world'. In a speech in the House of Lords on 23 May 1944, Keynes (1980b, p. 16) says, 'We intend to retain control of our domestic rate of interest, so that we can keep it as low as suits our own purposes, without interference from the ebb and flow of international capital movements or flights of hot money'.

Finally, in March 1945, Keynes (1980c, pp. 230–232, emphasis added) makes the following decisive statement on the issue: 'The monetary authorities can have any rate of interest they like.... They can make both the short and long-term [rate] whatever they like, or rather whatever they feel to be right ... Historically the authorities have always determined the rate at their own sweet will and have been influenced almost entirely by balance of trade reasons'.

In this last statement, Keynes in fact makes two distinct arguments. First, he suggests that banks have the ability to determine the rate of interest; that is, they are capable of determining the terms on which they 'are ready to become more ... illiquid' (1973b, p. 219). If, as a result of an increase in the inducement to invest the rate of interest 'need not rise'. then this must imply that the money supply curve is horizontal. This would be—in Keynes's own words—the 'appropriate' monetary policy.

Second, Keynes (1980a, p. 149) indicates that the rate of interest is a 'political' variable influenced by the central bank's reaction function. The rate of interest may be influenced by a variety of economic factors, such as political instability, inflation, and the value of the national currency. In Keynes's era, however, the important 'political' characteristic—the 'specific circumstances of the times'—was the balance of trade.

We are thus far from the model of the General Theory, where the rate of interest is a 'monetary phenomenon' determined by the supply and demand for money. It now appears that Keynes has come around to accepting the exogeneity of the rate of interest. These references indicate that Keynes now rejects the notion of an automatic mechanism regulating the base rate of interest. In
essence, Keynes rejects his own liquidity preference theory of the determination of the rate of interest.

Where then does this leave Keynes’s theory of liquidity preference? It is clear that, interpreted in the way in which Keynes presented it in the General Theory, the above discussion suggests Keynes’s theory of liquidity preference is irrelevant. This does not mean, however, that it cannot be interpreted in a way which would make it consistent with Keynes’s description of the monetary circuit. On this issue, Keynes offers no insights on how best to achieve this; nor does he suggest other ways of interpreting liquidity preference.

Post-Keynesians have for some time argued that the definition of liquidity preference in the General Theory is too restrictive (Mott, 1985–1986), although perhaps appropriate given the confines of its two-asset model. As such, identifying liquidity preference with the demand for money ‘resembles a scenario without a recognizable cast of actors’ (Chang et al., 1983, p. 420). In such a context, liquidity preference ‘is not of much interest’ (Dow & Dow, 1989, p. 148).

The question then becomes how to develop a broader definition of liquidity preference. Some post-Keynesians have argued for a generalised theory of liquidity preference, interpreted in such a way as to capture Keynes’s insights on uncertainty and ‘animal spirits’. In this sense, liquidity preference would be inversely related to the degree of confidence with respect to future, unknown events (Runde, 1994). Reise (1992), Lavoie (1996a) and Moore (1988) have linked this view to the behaviour of commercial banks. This would suggest, as Lavoie (1984, p. 791) does, that

When bankers begin losing some of their high ‘animal spirits,’ though they are aware of the fact that their new behaviour will harm the economy, they prefer to restrain their creation of credit-money. They know that those banks that are the least affected by the recession are those banks that show the most moderation. For this reason, it is quite possible for the banking system to start reducing its creditlines just when firms need extended loans.

A possible way of representing this ‘generalised’ liquidity preference is to examine the spread between various rates of interest. As Dow & Dow (1989, p. 148) argue, ‘liquidity preference, then, in practice determines the difference between the interest rate on liquid deposits and on less liquid substitutes. The monetary authorities set the rate at the short-term end of the spectrum; liquidity preference (along with other considerations) determines the mark-up to long-term rates’. Similarly, Mott (1985–1986, p. 224) argues that ‘liquidity preference in such a context would have to do with the level of the liquidity premium in the term of interest rates’.

8. Conclusions

The importance of Keynes’s post-General Theory articles, along with his later writings on liquidity preference, credit, and the rate of interest, represents a critical development in his thinking on monetary matters. Unfortunately, these
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articles are still largely ignored by post-Keynesians, despite their emphasis on flow analysis and the need to finance investment and production.

Despite the analysis presented above, it is recognised that Keynes’s articles on the finance motive and capital formation are not always clear and precise. Rather, they contain a number of conflicting passages, and it is often difficult to discern clearly both the meaning and the intent of Keynes’s post-General Theory arguments.

In reading these articles, however, I have kept in mind two important elements. First, Keynes’s stated objective was to break away from ‘classical’ thought; and second, that the General Theory, and the analysis of money contained within, were for Keynes a ‘transition’ away from ‘classical’ thought. As such, Keynes’s Economic Journal articles on finance must not necessarily be interpreted within the context of the General Theory. Rather, they must be read as part of an attempt to build an alternative to orthodox thought. Fortunately, Keynes left us some clues on how to do this.

What can be concluded with some assurance is that following the publication of the General Theory, Keynes (1) realises that the supply of money is endogenous; (2) sees the rate of interest as an exogenous variable, thereby rejecting his liquidity preference explanation of rates of interest; (3) recognises that interest rates need not rise during expansions, provided the banking system adopts the ‘appropriate monetary policy’; and (4) offers glimpses into a theory of the monetary circuit in which money is first created by finance through the activity of banks (initial finance), and finally destroyed by the repayment of debt (final finance).

In their attempt to construct an alternative explanation of the monetary process, post-Keynesians should turn to Keynes’s Economic Journal articles, and drop endogenous explanations of the rate of interest, as Keynes did. As Lavoie (1996b, p. 534) argues, ‘circuit theory provides the monetary foundations of a proper analysis of monetized production.... it constitutes the proper foundations to a non-orthodox theory, which itself must be part of a larger non-orthodox research programme encompassing effective demand as well as value theories’.

References

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