Keynes’s *General Theory*: valid only for modern capitalism?

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Economists, and Post Keynesians in particular, disagree about the generality or restricted applicability of Keynes’s *General Theory* – and, related to that, about the (in)appropriateness of seeking general theories. There are different interpretations of Keynes’s *opus magnum* in this respect. This paper focuses on just one of these interpretations, namely that according to which *The General Theory* is applicable only to a modern or sophisticated capitalist economy. From the viewpoint of such an interpretation, Keynes’s theory is seen as not truly general, but restricted instead to a special case. Let us call this the modern-capitalism or modernist interpretation. More specifically, this paper focuses on the versions of this interpretation that emphasize the financial institutions assumed by Keynes. ¹

The paper acknowledges, on the one hand, that Keynes did, in important parts of his theory, assume or put great emphasis on modern financial institutions. On the other hand, it argues that Keynes also developed the fundamental elements of a general theory of unemployment and potential instability under capitalism, without clearly disentangling these elements from more institutionally-specific ideas. Such a general theory applies to all types of capitalist economy and does not depend on the existence of modern financial institutions.

While emphasizing that Keynes’s theory is general in the latter sense, the paper will not pursue the issue of generality further and discuss if Keynes’s theory is more general than the

¹ Other versions emphasize the labour-market institutions and/or on the institutions of market structure. For references and discussion, see Dequech (1999b, 2002).
neoclassical theory and/or applicable to economic systems other than capitalism. As Paul Davidson (1994, 1996) has pointed out, Keynes did assert that the pre-Keynesian neoclassical theory was a special case of his more general theory and that his theory required less restrictive assumptions. These claims are examined elsewhere, in a more comprehensive discussion of the different interpretations of the generality of Keynes’s theory (Dequech, 2002).

The paper is organized as follows. Section 1 presents the main versions of the modern-capitalism interpretation. Section 2 considers some evidence in favor of the thesis that Keynes restricted his theory to a modern capitalist economy. Section 3 discusses an alternative interpretation. In the light of this interpretation, section 4 discusses the relation between investment, saving and the banking system, emphasized by one of the main versions of the modern-capitalism interpretation. Concluding remarks follow.

1. The modern-capitalism interpretation

Broadly defined, the modern-capitalism or modernist interpretation claims that Keynes’s theory is applicable only to a modern capitalist economy, such as the one that emerged at the end of 19th and beginning of the 20th century. Among the proponents of this interpretation, our attention will be focused, as explained above, on those who emphasize the financial institutions characteristic of modern capitalism.

For example, Hyman Minsky (1975: 11) refers to ‘The General Theory [as] quite clearly relevant only to a financially sophisticated capitalist economy’. Minsky also writes that ‘whereas classical economics and the neoclassical synthesis are based upon a barter paradigm – the image is of a yeoman or a craftsman trading in a village market – Keynesian theory rests upon a
speculative-financial paradigm – the image is of a banker making his deals on a Wall Street’ (Minsky, 1975: 57-58; ). As evidence in support of this interpretation, Minsky (e.g., 1977: 69) gives special weight to Keynes’s (1937) article in the *Quarterly Journal of Economics*.

Minsky contrasts what he calls ‘the village fair paradigm’ to ‘the Wall Street paradigm’. This brings images of late-19th- or 20th-century capitalism, with the dominance (if not the appearance) of financial institutions such as joint-stock companies, banks that are part of holdings that also own productive companies, large corporations, and the like. These images are reinforced by Minsky’s (1977) formulation of the ‘financial instability hypothesis’ as based on his interpretation of Keynes. ‘In the *General Theory*, Keynes adopts a City or Wall Street paradigm: the economy is viewed from the board room of a Wall Street investment bank. Theorizing starts by assuming a monetary economy with sophisticated financial institutions’ (Minsky, 1977: 61). Minsky presents his hypothesis as an interpretation of Keynes, but it should be noted that Minsky was less concerned with documenting this interpretation than with developing it as a theory that may or not reflect Keynes’s views (see, for example, Minsky, 1977: 62, 69 and Papadimitriou and Wray, 1998: 202).

Financial institutions also play a major role in James Crotty’s (1990) detailed attack on the idea that *The General Theory* is ‘a model of capitalism-in-general, equally applicable in all

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2 This does not seem to be invalidated by Dimski’s (1997: 503) identification of different usages of the term “Wall Street” in Minsky’s work, even though the one concerning the importance of debt-financing for investment could perhaps be used in less institutionally-specific contexts.

3 In a lesser-known restatement of the financial instability hypothesis, Minsky (1978: 95) makes it clearer that the integration of, and emphasis on, (sophisticated) financial institutions distinguishes this hypothesis from what is explicit in Keynes.
times and in all places where the capitalist system dominates economic activity’ (p. 762). Crotty (1990: 763) concedes that there is in Keynes’s theory a relatively abstract level of analysis that incorporates the defining characteristics of the capitalist economy. To this extent, he argues, Keynes’s theory can be said to be general. However, Crotty (1990: 763; also 768) continues, the concepts and categories of the general level of analysis ‘are designed to guide the institutional research that informs’ the theory located at a second, more specific level. For Crotty, *The General Theory* is mostly concerned with one specific stage of capitalist development, that of interwar capitalism. In particular, Keynes’s ‘theory of investment instability focused on the behavior of enterprise managers and wealthy rentiers and stressed the separation of ownership from management. … Because of this particular institutional structure of the investment decision, Keynes rooted his theory of the instability of modern capitalism in the unknowability of the future’ (Crotty, 1990: 764). Given the core institutions and practices of modern capitalism, ‘the assumption that the future is unknowable constitutes an adequate foundation for a theory of instability. … Volatile rentier expectations will, from time to time, violently un hinge investment demand’ (Crotty, 1990: 765-66).

Although referring to financial institutions with less emphasis than Minsky and Crotty, Paul Wells argues that Keynes’s main objection to neoclassical theory was that, although it may have been applicable to ‘the simpler economic environment of pre-Ricardian days’, it is not suitable for ‘the economic environment of modern industrial systems of finance capitalism’ (Wells, 1991: 340; also 361). Furthermore, ‘the real world of 20th century capitalism’ is, in Wells’s (1991: 341) interpretation, what Keynes meant by an ‘entrepreneur economy’ (or
‘monetary economy’), which Keynes contrasted to a ‘co-operative economy’ or ‘real-exchange economy’ in drafts of The General Theory (Keynes, 1979: 66-102).

Some more recent interpreters also emphasize the financial institutions of modern capitalism. Like Minsky, Vercelli (1991: 208) argues that the structural instability analyzed by Keynes depends on developed financial relations. The modern institutions related to the separation between ownership and control of firms are emphasized by John Davis (1994: 171), in whose opinion ‘Keynes’s historical diagnosis regarding the shift from enterprise to speculation is crucial to his overall project of explaining unemployment’. This view seems to be broadly shared by Olivier Favereau (1986: 253), for whom uncertainty would only have minor effects were it not for speculation in the stock exchange.

Victoria Chick’s (1983, chapter 9; 1986) version of the modern-capitalism interpretation also focuses on financial institutions, but of another kind: the ones characterizing different stages of development of the banking system. Thus she offers different reasons to circumscribe the applicability of Keynes’s theory, at least his theory of saving and the interest rate, to modern capitalism. The argument proceeds in three steps: (1) Keynes’s theory depends on investment not being determined by saving; (2) for this to happen, the banking system has to reach a stage at which it can lend to a multiple of reserves and finance investment ‘by the stroke of a pen’, independently of saving; and (3) at least in the case of English banking system, this stage was only reached in the late 19th or early 20th century.

Approvingly presenting Chick’s arguments, but referring more explicitly to Keynes’s General Theory as a whole, Geoff Hodgson (2001: 223) writes that ‘by the 1920s and the time of Keynes, banking institutions and the credit system had evolved to the point that investment could
and would precede saving. This was the quite specific historic period to which the allegedly \emph{General Theory} applied'.4

2. Some evidence in favor of the modern-capitalism interpretation

We must point out at least two important parts of Keynes’s theory where he does emphasize financial institutions that exist only in a rather sophisticated capitalism. One is his discussion of the state of long-term expectation, and the other is his discussion of the money demand or, more generally, liquidity preference. Especially for those who see uncertainty as an essential aspect of Keynes’s theory, it is necessary to note that these two parts of his theory are closely related to uncertainty. Let us look at each of them in turn.

It can hardly be denied that in chapter 12 of \emph{The General Theory}, which deals with ‘The State of Long-Term Expectation’, Keynes gives great importance to the influence of the stock exchange on the formation of expectations, to the separation between ownership and management (p. 150-51), and to ‘the risk of predominance of speculation’ over ‘enterprise’, which in his view increased with the improvements in the organization of what he calls investment markets (p. 158). Likewise, his discussion of conventions in the investment decision (p. 152-53) and of the precariousness of these conventions (p. 153-158) is also focused on the existence of organized investment markets (p. 150-52). All these issues reappear in his 1937 \emph{QJE} article. Moreover, the existence of organized investment markets plays an important role in the

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4 A caveat should be noted that, according to Hodgson (2001: xiv), his book develops an argument largely at the level of meta-theory, not being intended to examine other authors’ theories in detail.
‘Notes on the Trade Cycle’ (chapter 22), particularly regarding ‘the later stages of the boom’ (Keynes, 1936: 315-16).

Let us now turn to Keynes’s treatment of the demand for money, which is part of larger discussions of liquidity preference and the determination of the interest rate. In chapters 13 (whose title is ‘The General Theory of the Rate of Interest’, emphasis added) and 15 of The General Theory, Keynes discusses three motives for demanding money or, more generally, for preferring liquidity: the transactions, precautionary and speculative motives. He would later add a fourth category: the finance motive. Keynes (1936: 168) identifies a necessary condition for the use of money as a reserve of value: ‘the existence of uncertainty as to the future of the rate of interest’. With such uncertainty, ‘if a need for liquid cash may conceivably arise ... there is a risk of a loss being incurred in purchasing a long-term debt and subsequently turning it into cash, as compared with holding cash’. The existence of uncertainty about the future of the interest rate creates ‘a further ground for liquidity-preference ... provided that there is an organised market for dealing in debts’ (Keynes, 1936: 169). This is the speculative motive. It is, in The General Theory, the motive most associated by Keynes with uncertainty, the one discussed in most detail – ‘both because it is less well understood and because it is particularly important in transmitting the effects of a change in the quantity of money’ (Keynes, 1936: 198, emphasis deleted) – and the one which most distinguishes his formal analysis of the money demand (pp. 199-200) from the neoclassical theory he was fighting. He lumps the transactions and precautionary demand for money together, making both of them a function of the level of current income, while the

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5 This led Shackle (1967: 209) to opine that Keynes’s theory of employment, as a formal system, was based on the speculative motive.
speculative demand is made a function of the current value of the interest rate, in comparison with its expected future value. The speculative motive does indeed require a specific institutional setting within the larger institutional context of capitalism. Even if not exclusive of 20th-century capitalism, the existence of an organized market for debts would not characterize the most primitive type of capitalism.

Both the state of long-term expectation and liquidity preference (including the demand for money) are considered in the theory of determination of investment, the most important component of aggregate demand, with the latter in playing in turn a crucial role in determining the level of employment, through its influence on expectations of future demand. The specific institutional setting to which Keynes refers in the two discussions just summarized appears, therefore, to be quite important in his theory. This lends support to the version of the modernist interpretation that emphasizes organized financial markets.

Regarding the other version of this interpretation, which emphasizes the stages in the development of the banking system, at least two different questions may be asked. First, did the banking system of England (or any other country) really reach the allegedly required stage only in the late 19th/early 20th century? This is a historical question and lies beyond the scope of the present paper. Second, does this version of the modern-capitalism interpretation correctly interpret Keynes’s theory? As a way of partly answering this question, it will be argued in section 4 that Keynes’s theory asserts that saving cannot determine investment, regardless of the development of the banking system.

3. Elements of a general theory of employment and potential instability under capitalism
There are grounds to find something general in Keynes’s theory, especially an explanation of unemployment and potential instability that does not depend on institutions which are specific to a certain variety or a limited group of varieties of capitalism. While Keynes’s emphasis on the financial institutions of modern capitalism favors the modernist interpretation, it is possible to argue that Keynes does provide the fundamental elements of a general theory of unemployment and potential instability under capitalism, i.e., of a theory applicable to any kind of capitalism\(^6\). In other words, one can argue that there is something between the ‘village fair’ and the ‘Wall Street’ paradigms mentioned by Minsky or, more precisely, that there is a broader paradigm of which ‘the Wall Street paradigm’ is one among other subsets\(^7\). The latter include what could be termed an ‘industrial district paradigm’ and even a ‘capitalist farm paradigm’, which deal with simpler varieties of capitalism. As should be clear from the preceding sections, it is by no means claimed here that this is the only or the right way of reading Keynes, just that it is a possible and useful one.

The theoretical propositions put forward in this section are elements of a theory that is less general than a theory intended to be valid for all economies at all times. They are,

\(^{6}\) In O’Donnell’s (1989: 125) view, this is the intended applicability of Keynes’s theory. When arguing this, O’Donnell does not, however, discuss Keynes’s emphasis on modern financial institutions or the possibility that Keynes may have suggested an even greater generality.

\(^{7}\) While still arguing that ‘the labeling of the volume The General Theory was stretching the use of language’, Minsky himself may have moved closer to this view as he wrote: ‘[t]he economics of Keynes is not a theory for all economies. It is a theory of capitalist economies’ (Minsky, 1996: 358). The lack of a reference to a particular stage in capitalist development does not necessarily imply, however, an abandonment of the modernist interpretation. In earlier writings, from a period when Minsky asserted the exclusive applicability of Keynes’s theory to modern capitalism, there are similar passages referring to capitalism in general (e.g. Minsky 1978: 92, 96).
nevertheless, intended to be valid to any capitalist economy and are general in this sense. These propositions are based on Keynes’s writings. Not all of them reproduce with a great degree of exactness what Keynes wrote; some of them, instead, reflect an attempt to extract from Keynes’s writings a general message that was in part obscured by Keynes’s emphasis on the institutions of modern capitalism. What Keynes wrote about modern capitalism is very insightful and important for an analysis of that type of economy, but it appeared, in *The General Theory* and related writings, entangled with ideas that are also insightful and important and that do not require the institutional setting of modern capitalism, being applicable instead to capitalism in general.

3.1. A ‘monetary economy’ and the search for pecuniary gain

Keynes’s theory is a theory of a ‘monetary economy’ or ‘entrepreneur economy’, his terms for what amounts to a capitalist economy. This point, as well as Keynes’s concept of monetary economy, is perhaps more explicit in the drafts of *The General Theory* than in the book itself. The ‘essential characteristic of an entrepreneur economy’ is the search for pecuniary gain: ‘The firm is dealing throughout in terms of money. It has no object in the world except to end up with more money than it started with’ (Keynes, 1979: 89; also p. 82). Indeed, these drafts include a rare positive reference to Marx, for pointing out that ‘the nature of production’ or ‘the attitude of business’ is “a case of M–C–M’, i.e of parting with money for commodity (or effort) in order to obtain more money” (Keynes, 1979: 81). The importance of money for production has been identified as a crucial point of convergence between not only between Keynes and Marx
(Davidson, 1989), but also between these two authors and the institutionalists, since Veblen and Mitchell (Dillard, 1980; Peterson, 1977; Wray, 1993).

In the original preface to The General Theory, Keynes’s claim to greater generality (on pp. xxii-xxiii) is immediately preceded by a reference to a monetary economy and to his method of analyzing such an economy as that which leads to a more general theory. ‘A monetary economy … is essentially one in which changing views about the future are capable of influencing the quantity of employment and not merely its direction’ (Keynes, 1936: xxii). As Keynes defines it, a monetary economy is not just a money-using economy. Indeed, during the transition towards The General Theory, Keynes (1933: 408-9) had written:

An economy, which uses money but uses it merely as a neutral link between transactions in real things and real assets and does not allow it to enter into motives or decisions, might be called … a real-exchange economy. The theory which I desiderate would deal, in contradistinction to this, with an economy in which money plays a part of its own and affects motives and decisions and is, in short, one of the operative factors in the situation, so that the course of events cannot be predicted, either in the long period or in the short, without a knowledge of the behaviour of money between the first state and the last. And it is this which we ought to mean when we speak of a monetary economy.

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8 On occasion, however, Dillard (1980: 255, 258) and Peterson (1977: 249) restrict their discussion of the monetary theory of production to ‘modern’ or ‘twentieth-century capitalism’ and to ‘an advanced capitalist economy’, respectively, which may obscure the fact that the essence of this theory applies to capitalism in general.
In these latter passages, from a paper entitled ‘A Monetary Theory of Production’, Keynes does not refer as explicitly as in the drafts of *The General Theory* to the search of pecuniary gain, but there are in *The General Theory* itself quite clear indications that Keynes is dealing with a capitalist economy. In chapter 3, the presence of profit-seeking firms is explicitly assumed (p. 23). So is the presence of workers who earn wages, paid in money – in fact, Keynes (1979: 78) also uses the expression ‘money-wage economy’ to designate his monetary economy.

It is thus in the context of a capitalist or ‘monetary’ economy that Keynes explains unemployment and launches his attack on Say’s law.

3.2. The determination of employment in the short period

Chapter 3 of *The General Theory*, which is better understood in the light of Keynes’s 1937 lecture notes on ‘Ex post and ex ante’ (Keynes, 1973c: 179-83), discusses the determination of employment and production by firms’ decisions. Because production takes time, these decisions have to be based on (short-term) expectations. Actual results influence production decisions only in the next period and through their effect on expectations. Firms have short-term expectations regarding costs and proceeds, which shape the aggregate supply and expected demand functions, respectively. In the simplified case of a closed economy with no government deficit or surplus, aggregate expected demand is the sum of aggregate expected consumption and expected investment. The level of employment (and, correspondingly, production) is the variable dependent on these two types of expected expenditure. Depending on these expectations, the aggregate level of employment does not have to be full employment.
How are short-term demand expectations formed? Keynes (1936: 50-51) assumes a conditional projection of the most recently realized results into the near future. In turn, realized results are determined by the actual expenditure decisions of consumers and investors. If producers’ expectations are fulfilled (a simplifying assumption made by Keynes), there is short-period equilibrium, which may be an unemployment equilibrium.

3.2. The rudiments of a theory of expenditure and the critique of Say’s law

Against Say’s law, in the same drafts of *The General Theory* where Keynes asserted the monetary character of production, he wrote: ‘For the proposition that supply creates its own demand, I shall substitute the proposition that expenditure creates its own income’ (Keynes, 1979: 81).

*The General Theory* also attacks Say’s law. In addition to explaining how employment is determined in the short period, chapter 3 presents the rudiments of a theory of expenditure. Expenditure decisions and production decisions have different determinants. Formally, the aggregate expected demand function and the aggregate demand function are different functions. What determines expenditure decisions? Keynes’s interest in discussing Say’s law leads him to examine the relation between expenditure and employment (and, by extension, production, which is closely related to employment). Now, when dealing with expenditure decisions, the level of employment (and production) is the independent variable, on which two types of expenditure depend – or do not depend. Indeed, the essence of the simple theory of expenditure in chapter 3 is that one component of aggregate demand varies with employment, or with
production, while the other does not. Thus, contrary to Say’s law, production and employment do
not determine all aggregate demand.

3.3. A more detailed theory of expenditure

Given the influence of realized demand on expected demand and, consequently, on
employment, and given the importance of explaining why not all aggregate demand varies with
the level of employment and production, Keynes goes on to examine in detail the determinants of
aggregate demand. He divides aggregate demand into consumption and investment. Investment
is more autonomous in relation to current income and, being dependent on the state of long-term
expectation, more affected by uncertainty.

a) Uncertainty, expectations and confidence

An important source of uncertainty about the future, especially the distant future, is the
possibility of non-predetermined structural changes, either in technology or in social and
political structure. Keynes (1937: 113-14) includes ‘the obsolescence of a new invention’, ‘the
prospect of an European war’ and ‘the position of private wealth owners in the social system’
 thirty years hence as examples of uncertain matters about which ‘we simply do not know’ - see
also Keynes (1936: 141, 252; 1973c: 287, 309). ‘The outstanding fact is the extreme
precariousness of the basis of knowledge on which our estimates of prospective yield have to be
made’ (Keynes, 1936: 149)

The state of long-term expectation, discussed (together with the notion of uncertainty) in
chapter 12 of The General Theory, depends not only on expectations themselves (forecasts), but
also on the confidence with which expectations are held. Confidence is related to the degree of
uncertainty. The notions of uncertainty and the state of expectation have a more general meaning that is independent of the existence of organized investment markets.\(^9\)

b) Investment, asset choice, and liquidity preference

Investment decisions are part of a larger process of asset choice. Capital goods are one among other types of assets from which decision-makers may choose, including money. These assets have, in different degrees, different attributes and different types of potential returns, such as liquidity premia, carrying costs and explicit yields, which are quasi-rents in the case of capital goods (Keynes, 1936, chapter 17). Money is not the only liquid asset (and liquidity preference is not synonymous with the demand for money), but in the present discussion other highly liquid assets and their organized markets shall not be emphasized, so as to make the argument independent of modern or sophisticated financial institutions.

Among the different types of return that an asset can provide, the liquidity premium must be highlighted for its connection with confidence. This connection is most explicit in the *QJE* article: ‘our desire to hold money as a store of wealth is a barometer of the degree of our distrust of our own calculations and conventions concerning the future. (...) The possession of money lulls our disquietude; and the liquidity premium which we require to make us part with money [or which we implicitly attribute to money] is the measure of the degree of our disquietude’. Thus, ‘fluctuations in the degree of confidence are capable of … modifying not the amount that is actually hoarded, but the amount of the premium which has to be offered to induce people not to hoard’ (Keynes, 1937, p. 116). In this *QJE* article, therefore, in contrast with *The General\(^9\)"

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\(^9\) In this sense, I agree with Shackle (1967: 132-33) that Keynes gave excessive weight to the Stock Exchange in chapter 12, although I do not necessarily agree with Shackle on what exactly the central core of this chapter is.
Theory, the precautionary motive for preferring liquidity is much more clearly associated with uncertainty. Even in The General Theory itself there are hints of an association with uncertainty when Keynes defines the precautionary motive (1936: 170; esp. 196) and relates it to the consequences of major changes in the quantity of money (p. 172). In addition, Keynes (1936: 240) briefly established an inverse relation between the liquidity premium and confidence.

While the value a decision-maker attributes to money depends on confidence, which depends negatively on uncertainty, the value he/she attributes to capital goods depends on optimism as to future demand, including spontaneous optimism. Optimism and confidence may not be sufficiently strong to lead people to part with the liquidity of money and make investment and consumption expenditures in the amount necessary to generate full employment.

A similar reasoning applies to those agents (including banks, if they exist) who can provide finance to firms. The liquidity preference of these agents is crucial in determining the volume of loans and other financial resources. Even if firms are willing to buy capital goods, investment may be deterred by the lack of internal finance and of external finance, in the latter case as a result of liquidity preference of other agents, a preference which, again, can be due to the precautionary motive. This problem may happen either when firms wish to keep investment

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10 Thus, Keynes’s 1937 QJE article, to which Minsky gives special importance when emphasizing modern financial institutions, can also be used in support of an alternative interpretation.

11 Keynes (1936, pp. 240n, 148n) also related the liquidity premium to the notion of weight he had presented in A Treatise on Probability, which is connected to confidence (more precisely, with the perceived degree of uncertainty). The link between liquidity premium and weight returns in a 1938 letter to Townshend (Keynes, 1979: 293). For further discussion and references, see Dequech (1999a).
in the previous level or when they wish to expand investment and thus demand liquidity for the finance motive.

3.4. Employment and the essential properties of money

The relative preference for liquidity of whatever decision-makers does not generate employment. Two properties of money, identified also in chapter 17, play a crucial role here. (A more precise definition of these properties, in terms not of levels but of changes in levels, will be presented below, when discussing changes in money wages. At this point, a rougher definition suffices.) First, money’s negligible elasticity of production means that the creation of money does not require that many people be employed to produce it. The same is true of other highly liquid assets. Thus, a high level of liquidity preference does not lead to a high level of employment. Second, money’s low elasticity of substitution means that there are not good substitutes for money as a reserve of value, so that the demand for money is not redirected towards assets of relatively low liquidity and high elasticity of production. The same is true of other highly liquid assets.

3.5. Persistent unemployment with flexible wages and prices

If there is unemployment, a fall in money wages and prices will not necessarily correct the problem and may even worsen it, as Keynes argued in chapter 19. This may due to, for example, an income and/or wealth redistribution effect (p. 262), an expectations effect, by which expenditures are postponed if a further wage reduction is expected (p. 263), and a debt-deflation effect (p. 264). Keynes (p. 263-64) also hinted at what I have termed a confidence effect
(Dequech, 1999b), caused by an increase in uncertainty. A decline in confidence leads to an increase in the liquidity premium of money and in liquidity preference. Because of money’s small elasticities of production and substitution, employment does not grow: ‘labour cannot be turned on at will by entrepreneurs to produce money in increasing quantities as its price rises in terms of the wage-unit’ and, one may add, as the demand for money increases as a result of a fall in confidence; and ‘as the exchange value of money rises [with the fall in wages and prices] there is no tendency to substitute some other factor for it’ (Keynes, 1936: 230-31). For all these reasons, unemployment may not be an ephemeral problem.

3.6. Potential instability

The preceding paragraphs indicate that Keynes’s *General Theory* and related writings contain the fundamental elements of a theory of employment which assumes the basic institutions of a capitalist economy, but does not require the existence of organized investment markets and other sophisticated financial institutions.

The same is true of a theory of potential instability. As indicated above, uncertainty in a capitalist economy does not exist only with organized financial markets. Accordingly, instability does not exist only as result of speculation about the future price of bonds or shares. Even ‘enterprise’ is marked by a great deal of ignorance about the future. Since expectations are formed and confidence in these expectations is held under uncertainty, both expectations and confidence are liable to sudden changes. They depend in part on ‘animal spirits’, including ‘spontaneous optimism’ and ‘the urge to action rather than inaction’, and this dependence is a source of instability, ‘[e]ven ‘apart from the instability due to speculation’, as Keynes (1936:
161) acknowledged. In addition, given the precariousness of the basis of knowledge, both expectations and confidence may undergo sudden revision in response to some new evidence, whether this response is undue or not. The financial institutions of modern capitalism may *exacerbate* the potential instability inherent in any capitalist economy\(^\text{12}\), but even in a capitalist economy without modern financial markets there would be uncertainty, unemployment and potential instability.

A few comments on Minsky, in particular, are in order at this point. As Papadimitriou and Wray (1998: 201) note, Minsky ‘wanted to distance himself from a tendency in Post Keynesian economics to push institutions into the background in order to develop ‘general theories’. What about a theory that applies to different types of capitalism? Minsky was not concerned with this. Again according to Papadimitriou and Wray, all of Minsky’s work focused on an economy with complex financial arrangements. It should be noted, however, that Minsky referred to earlier stages of capitalism\(^\text{13}\) and acknowledged the existence of instability, depressions and, at least implicitly, unemployment in simpler capitalist economies than the ones on which he concentrated. See, for example, Minsky (1990: 67); also Papadimitriou and Wray (1998: 207).

\(^{12}\) Although not concerned with the institutional specificity of modern capitalism or the properties of capitalism in general, Runde (1991: 143) also sees ‘particular institutional features of financial markets’ as reinforcing and even magnifying instability in Keynes’s view.

\(^{13}\) Minsky (1996) divides the evolution of capitalism into five stages: commercial capitalism; industrial capitalism and wild cat financing; financial capitalism and state financing; paternalistic, managerial, and welfare state capitalism; and money manager capitalism (see also Minsky and Whalen, 1996-97).
4. Investment, saving, and the banking system

Regarding the institutional characteristics of the banking system, emphasized by Chick’s version of the modern-capitalism interpretation, some important theoretical points can be made on the basis of the elements indicated above.

Say’s law can be seen as resulting from the combination of two propositions: (a) production generates all income, an income equal to the value of production; and (b) income determines expenditure. Both (a) and (b) are contradicted by Keynes’s proposition that ‘expenditure creates its own income’: production does not generate all income, because it is expenditure that creates income; and income does not determine expenditure, because it is created, or determined, by expenditure. Income is generated when goods or services are sold, not when they are produced. Part of total income may be generated in the process of production, not by production itself, but by whatever expenditure is necessary to undertake production. One type of income, in particular, is certainly not created during the production process: the income of the entrepreneur, that is, profit. The expenditure that generates this income is made not during production, but only when the finished product is sold (Keynes, 1936: 53; 1973c: 180).

In the simplified case discussed by Keynes, expenditure consists only of consumption and investment. In any accounting period, saving, by definition, is ‘the excess of income over consumption’. ‘Saving is in fact a mere residual. The decisions to consume and the decisions to invest between them determine income’. Since expenditure determines (or ‘creates its own’) income, in the aggregate investment necessarily is equal to and determines saving (Keynes, 1936: 64: also 375). Current investment, therefore, cannot be logically preceded by current saving nor financed by it.
Nor is investment determined, or financed, by previous saving. Depending on specific institutions, investment can be financed by different sources, such as: credit money created *ex nihilo*\(^\text{14}\); credit provided by banks on the basis of previously existing money deposits (which, depending on the development of the banking system, may or may not be a multiple of reserves); credit or other form of finance directly provided by the non-banking public on the basis of its cash reserves; and the potential investor’s own money reserves in the form of deposits and cash. Indeed, so can any form of expenditure (so that expenditure is not absolutely limited by current income). Even if there is no credit money created *ex nihilo* and deposits are not a multiple of reserves, the other sources may be available. Existing money deposits (even if they are not a multiple of bank reserves) and money reserves owned by the non-banking public (including the potential investor) are not saving, on the definition given above, which refers to a *flow*. They are *part*—the part held *in the form of money*—of the total *stock* of *wealth*. The total stock of wealth may have increased over the past periods as a result of saving in each period, but this stock itself is not saving. In fact, saving, as Chick (1983: 186) acknowledges, leads to a comparatively small addition to the total stock of wealth. Moreover, the fraction of this stock that is held in the form of money depends on the public’s *liquidity preference*, as does the decision to provide credit for willing investors.

Admittedly, the credit available for investment would be restricted if the banking system could not create credit money *ex nihilo* nor lend to a multiple of reserves, but even in this case investment would not be determined by saving, be it the saving of the current period or the

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\(^{14}\) By this I mean what happens when the central bank allows the causal sequence to run from loan demand to loans, and then to deposits and finally to reserves. This corresponds to stage 4 in Chick (1986).
saving of any previous period. Priority should be distinguished from causality. Indeed, in the absence of adequate credit, investment in the current period would have to be preceded by some saving that took place in some of the previous periods, but it would still not be determined by saving. It would be determined by the accumulated money reserves, on which saving does have an influence, and by the liquidity preference of the money-holding public (in addition to the expectations and confidence of potential investors). Not all the money saved over previous periods and now forming an accumulated stock will necessarily be directed towards financing investment (or other kinds of purchase of producible goods), since there can be hoarding15. Uncertainty would still imply that the level of hoarding due to the precautionary motive is not necessarily zero, even in the long run. In addition, in any particular accounting period, if the stock of money hoarded decreases in response to a weakening of the liquidity preference of the money-holding public16, the amount of funds available for investment may increase even if saving does not increase or falls in the immediately preceding period. Thus, regardless of how long the accounting period is, current investment is relatively autonomous from, and not determined by, previous saving – and it still determines current saving.

Moreover, when discussing the applicability of Keynes’s theory to concrete stages in capitalist development, it should be borne in mind that most of The General Theory dealt with a simplified case, abstracting from government expenditures and their financing. If one adds this to

15 Referring to saving (as distinct from the liquid part of the total stock of wealth, emphasized here), Chick (1983: 190) recognizes that ‘not all saving need go to finance investment as long as there is a market for seasoned securities’. Instead of this possibility, hoarding is emphasized here, for it can occur even in a simple capitalist economy.

16 If this is to happen, it must be through a reduction in the liquidity premium of money (see Keynes, 1936: 174).
his theory, then it is possible for growth to result from government expenditures financed by fiat money (provided by a central bank), following which the expansion in the money supply and the accumulation of money reserves (either in the form of profits retained by firms or not) could also allow private investment to grow, even when the banking system is not very developed. It is possible, thus, for the financing of government expenditures to be at the origin of one of the solutions to the problem of increasing the money supply and providing the liquidity demanded by private investors due to the finance motive.

In conclusion, in the absence of a banking system capable of multiplying deposits, not to mention creating credit money *ex nihilo*, the autonomy of investment and other expenditures would certainly be greatly reduced, as would the potential growth of the economy. However, the above-indicated elements of a Keynesian theory of unemployment and potential instability under capitalism, as well as Keynes’s refutation of Say’s law, would still be valid. Unlike several other propositions by Keynes (particularly those concerning how a rise in investment over the previous level can be financed, in the simplified case that abstracts from government expenditures and their financing), they do not depend on the assumption of such a developed banking system.

5. Concluding remarks

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17 Keynes’s understanding of the nature of a capitalist economy would actually be helpful in revealing the endogenous incentive to a development of the banking system. A capitalist economy at the same time stimulates and needs growth. Growth requires credit, and banks, since they also seek profits, have an incentive to provide an increasing amount of credit, when demanded, as long as there is a confident expectation of gain (see also Wray, 1990: 56-57, 128).
Although not clearly disentangling them from more institutionally-specific ideas, Keynes put forward the fundamental elements of a general theory of unemployment and potential instability that can help our thinking about any type of capitalist economy, including early or simple ones, which have also experienced unemployment and instability. The institutional setting to which these theoretical propositions apply is at the same time specific (capitalism) and general (any kind of capitalism). The potential relevance of this kind of proposition does not mean that the specific institutions of particular stages in capitalist evolution are irrelevant – but their relevance depends on the specific purpose of the analysis.

Attention to institutional specificity is certainly very important when discussing policies, but even then a general theory may be useful. For example, a general explanation of unemployment under capitalism does not depend on wage and/or price rigidity, and thus supports a rejection of policy proposals to make wages or prices more flexible so as to solve the problem of unemployment. Similarly, because such a general theory is not specific to a more recent stage of capitalism, it would also imply a negative assessment of any policy proposal to solve the unemployment problem by restoring some earlier or simpler form of capitalism.

References


