Analysis on Keynes General Theory and the Transformation of Modern Capitalism

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Abstract
Beginning in the late 1950s during the industrial revolution, new classical macroeconomists began to disagree with the methodology employed by Keynes and his successors. Keynesians emphasized the dependence of consumption on disposable income and, also, of investment on current profits and current cash flow, through the concept of "The General Theory" principles. In addition, Keynesians hypothesized a Phillips curve that tied nominal wage inflation to unemployment rate. Meanwhile, in support to these theories, Keynesians typically traced the logical foundations of their model using introspection and supported their assumptions with statistical evidence. The result of this shift in methodology produced several important divergences from Keynesian Macroeconomics: that is, independence of Consumption and current Income (life-cycle permanent income hypothesis), irrelevance of Current Profits to Investment (Modigliani–Miller theorem), long run independence of inflation and unemployment (natural rate of unemployment), the inability of monetary policy to stabilize output (rational expectations) and lastly, irrelevance of Taxes and Budget Deficits to Consumption (Ricardian equivalence). Meanwhile, some eminent scholars ascribed modern capitalism to the financial institutions, Unemployment and inflation, business cycle, and fluctuations in Phillips curve assumed by Keynes. Although acknowledging some evidence in support of these modern interpretations of capitalism, this current paper argues that Keynes also developed the fundamental elements of a general theory of unemployment, business cycle and potential instability under capitalism, without having clearly unscrambled these elements from more institutionally specific ideas. Such a general theory applies to all types of capitalist economy, but still is institutionally specific, referring to capitalism. The paper extracts this more general message, which was partly obscured by Keynes's emphasis on modern financial institutions, investments and unemployment.
Keywords: Capitalism, Keynesianism, Phillips curve, Investment, Modern-Capitalism, "The General Theory" Unemployment, Financial Institutions and Neo-Keynesian and Classical Theory.

INTRODUCTION:

This topic is very important newsworthy issue in the macroeconomics debate. In order for me to discuss meaningfully as well as successfully to the above topic, it is very crucial for me to be very familiar with the concept and etymology of capitalism, academic perspective of capitalism, modern capitalism interpretation, Keynes and classic fundamental general theory, postwar Keynesianism and the other school of thought. Interestingly, Keynes developed the fundamental elements of a general theory of unemployment and potential instability under capitalism, without having clearly disentangled these elements from more institutionally specific ideas. Such a general theory applies to all types of capitalist economy, but still is institutionally specific, referring to capitalism.

In 1936 Keynes wrote a forward to the German edition about his General Theory. I learnt from the forward that the theory as explained by Keynes is much easier to be adapted to the conditions of a totalitarian state and the theory of production and distribution of a given production put forth under conditions of free competition and a large degree of laissez-faire (Keynes, 1936). Keynes further argued that his theory is a general theory. He explained that the theory is based on fewer hypotheses than the orthodox theory; it can also accommodate itself all the easier to a wider field of varying conditions. Empirically, the theory, after all, worked it out with a view to the conditions prevailing in the Anglo-Saxon countries where a large degree of laissez-faire still prevails, nevertheless it remains applicable to situations in which state management is more pronounced. And so it turns out that Keynes' critical point is that his theory, being a truly general theory, can be applied to explain any economy. There's nothing nefarious here, Keynes is simply making the point that his theory is remarkably robust in that it can explain how production and consumption takes place in pretty much any economy – not just in a market economy.

Several literatures asserted that to indict Keynes on this point would be basically the same thing as to indict a sociologist whose methodology could be applied to both a totalitarian state and a democratic one; or a doctor using the same anatomical descriptions to explain the functioning of the body of a healthy man and a sick one. In fact, it shows that Keynes' is a theory far more in the spirit of science than, for example, neoclassical theory, which only seeks to describe the functioning of rigidly defined market economies. Finally, the theory explained both the economy of Nazi Germany and that of the democratic US in the modern capitalist system. It is a fact that the theory is a transformation of the modern capitalism (*Sweezy, 1946 and Feldstein, 1981*).

ETYMOLOGY AND DEFINITION OF CAPITALISM

As experts have underscored, it is very important to have an understanding of the fact that the term *capitalist*, meaning an owner of capital, appears earlier than the term *capitalism*. It dates back to the mid-17th century. *Capitalist* is derived from *capital*, which evolved from *capitale*, a late Latin word based on *caput*, meaning "head" – also the origin of *chattel* and *cattle* in the sense of movable property (only much later to refer only to livestock). The term "*Capitale*" emerged in the 12th to 13th centuries in the sense of referring to funds, stock of merchandise, sum of money, or money carrying interest. By 1283 it was used in the sense of the capital assets of a trading firm. It was frequently interchanged with a number of other words – wealth, money, funds, goods, assets, property, and so on (David Ricardo, 1817).

In addition, the *Hollandische Mercurius* used the term *capitalists* in 1633 and 1654 to refer to owners of capital. However, two developments paved the way for the emergence of modern capitalism; and both took place in the latter half of the 18th century. The first was the appearance of the physiocrats in France after 1750; and the second was the devastating impact that the ideas of Adam Smith had on the principles and practice of mercantilism.

By its nature and definition, the term capitalism from the academic perspective is defined as an economic system and an ideology based on private ownership of the means of production and their operation is for profit. In fact, the underlying characteristics of capitalism include private property, capital accumulation, wage labor, voluntary exchange, a price system, and competitive markets. In a capitalist market economy, decision-making and investment are determined by the owners of the factors of production in financial and capital markets, and prices and the distribution of goods are mainly determined by competition in the market.

In perusing David Ricardo 1817 article on principle of political economy and taxation, and many other literatures, I learnt that Economists, political economists, and historians have adopted different perspectives in their analyses of capitalism and have recognized various forms of it in practice. These include *laissez-faire* or free market capitalism, welfare capitalism, and state capitalism. Different forms of capitalism feature varying degrees of free markets, public ownership, obstacles to free competition, and state-sanctioned social policies. The degree of competition in markets, the role of intervention and regulation, and the scope of state ownership vary across different models of capitalism; the extent to which different markets are free, as well as the rules defining private property, are matters of politics and policy. Most existing capitalist economies are mixed economies, which combine elements of free markets with state intervention, and in some cases economic planning.

More importantly, Market economies have existed under many forms of government, in many different times, places, and cultures. The development of capitalist societies, however, marked by a generalization of money-based social relations, a consistently large and system-wide class of workers who must work for wages, and a capitalist class which dominates control of wealth and political power, developed in Western Europe in a process that led to the Industrial Revolution. Capitalist systems with varying degrees of direct government intervention have since become dominant in the Western world and continue to spread (*Sweezy, 1946 and Feldstein, 1981)*.

However, capitalism has been criticized for establishing power in the hands of a minority capitalist class that exists through the exploitation of a working class majority; for prioritizing profit over social good, natural resources, and the environment; and for being an engine of inequality and economic instabilities. Supporters believe that it provides better products through competition, creates strong economic growth, yields productivity and prosperity that greatly benefits society, as well as being the most efficient system known for allocation of resources.

THE MODERN-CAPITALISM INTERPRETATION

The modernist interpretation of capitalism 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, Hyman Minsky, William Ebenstein, John Micklethwait and many others. However, this interpretation is focused and emphasize on the financial institutions characteristic of modern capitalism. Taking for instance, Hyman Minsky (1975) refers to 'The General Theory [as] quite clearly relevant only to a financially sophisticated capitalist economy'.

In addition, 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). As evidence in support of this interpretation, Minsky gave a 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 were 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). Minsky presented 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 (Minsky, 1977 and Papadimitriou and Wray, 1998).

Very importantly, 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 times and in all places where the capitalist system dominates economic activity' (p. 762). Crotty (1990) 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 argued that Keynes's theory can be said to be general. According to 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 unknow ability of the future' (Crotty, 1990). 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. The volatile rentier expectations will, from time to time, violently unhinge investment demand' (Crotty, 1990). 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 it may has 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). Furthermore, 'the real world of 20th century capitalism' is, in Wells's (1991) interpretation, what Keynes meant by an 'entrepreneur economy.

KEYNES AND THE CLASSICS: EXPOUNDING OF "THE GENERAL THEORY" TO DEPICT THE MODERN CAPITALISM

To complete this very useful seminar paper, I took the time to peruse a variety of publications, literature, journals and articles on Keynesian General Theory and the Modern Capitalism. From the publications and other relevant sources, I learned the valuable lesson that Keynes sought to distinguish his theories from and oppose them to "classical economics", by which he meant the economic theories of David Ricardo and his followers, including John Stuart Mill, Alfred Marshall, Francis Ysidro Edgeworth, and Arthur Cecil Pigou.

A central tenet of the classical view, known as Say's law, states that "supply creates its own demand". Meanwhile, the Say's Law can be interpreted in two ways. First, it theorized that the total value of output is equal to the sum of income earned in production is a result of a national income accounting identity, and is therefore indisputable. A second and stronger claim, however, that the "*costs* of output are always covered in the aggregate by the sale-proceeds resulting from demand" depends on how consumption and saving are linked to production and investment. In particular, Keynes argued that the second, strong form of Say's Law only holds if increases in individual savings exactly match an increase in aggregate investment.

Again, Keynes developed a theory that explained the determinants of saving, consumption, investment and production. In the theory, the interaction of aggregate demand and aggregate supply determines the level of output and employment in the economy. It is very important to note that because of what Keynes considered as failure to the "Classical Theory" in the 1930s, Keynes firmly objects to its main theory – adjustments in prices would automatically make demand tend to the full employment level.

Finally, the neo-classical theory supports that the two main costs that shift demand and supply are labor and money. Through the distribution of the monetary policy, demand and supply can be adjusted. If there were more labor than demand for it, wages would fall until hiring began again. If there were too much saving, and not enough consumption, then interest rates would fall until people either cut their savings rate or started borrowing.

POSTWAR KEYNESIANISM AS A MAJOR TOOL FOR THE TRANSFORMATION OF MODERN CAPITALISM

Keynes's ideas became widely accepted after World War II, and until the early 1970s, Keynesian economics provided the main inspiration for economic policy makers in Western industrialized countries. Governments prepared high quality economic statistics on an ongoing basis and tried to base their policies on the Keynesian theory that had become the norm in the modern capitalist economy. In the early era of social liberalism and social democracy, most western capitalist countries enjoyed low, stable unemployment and modest inflation, an era called the Golden Age of Capitalism.

In terms of policy, the twin tools of post-war Keynesian economics were fiscal policy and monetary policy. While these are credited to Keynes, others, such as economic historian David Colander, argue that they are,

rather, due to the interpretation of Keynes by Abba Lerner in his theory of functional finance, and should instead be called "Lernerian" rather than "Keynesian". Through the 1950s, moderate degrees of government demand leading industrial development, and use of fiscal and monetary counter-cyclical policies continued, and reached a peak in the "go go" 1960s, where it seemed to many Keynesians that prosperity was now permanent. In 1971, with the application of the "Keynesian General Theory", the Republican US President Richard Nixon even proclaimed "I am now a Keynesian in economics."

In the postwar era, Keynesian analysis was combined with neoclassical economics to produce what is generally termed the "neoclassical synthesis", yielding Neo-Keynesian economics, which dominated mainstream macroeconomic thought. Though it was widely held that there was no strong automatic tendency to full employment, many believed that if government policy were used to ensure it, the economy would behave as neoclassical theory predicted. This post-war domination by Neo-Keynesian economics was broken during the stagflation of the 1970s. There was a lack of consensus among macroeconomists in the 1980s. However, the advent of New Keynesian economics in the 1990s, modified and provided microeconomic foundations for the neo-Keynesian theories. These modified models now dominate mainstream economics.

MONETARISM AND KEYNESIANS IDEAS ON CAPITALISM (I.E. MIXED ECONOMY)

The Monetarists and Keynesians shared a common goal in the 1960s over the role of government in stabilizing the economy (i.e. in a capitalist economy). Both Monetarists and Keynesians are in agreement over the fact that issues such as business cycles, unemployment, and deflation are caused by inadequate demand. However, they had fundamentally different perspectives on the capacity of the economy to find its own equilibrium, and the degree of government intervention that would be appropriate.

Keynesians emphasized the use of discretionary fiscal policy and monetary policy, while monetarists argued the primacy of monetary policy, and that it should be rules-based. Since then, economists have largely agreed that central banks should bear the primary responsibility for stabilizing the economy, and that monetary policy should largely follow the Taylor rule – which many economists credit with the Great Moderation. The financial crisis of 2007–08, however, has convinced many economists and governments of the need for fiscal interventions and highlighted the difficulty in stimulating economies through monetary policy alone during a liquidity trap (i.e. the need for Keynes General Theory).

MARXIST ECONOMISTS VIEWS ON PUBLIC CHOICE THEORY AS AN APPLICATION OF KEYNES GENERAL THEORY IN THE MODERN CAPITALIST ECONOMY

In 1946, a Marxist economist, Paul Sweezy criticized Keynesian economics, while admitting that there was much in the *General Theory*'s analysis of effective demand which Marxists could draw upon, described Keynes as in the last resort a prisoner of his neoclassical upbringing. Sweezy argued that Keynes had never been able to view the capitalist system as a totality. He further argued that Keynes had regarded the class struggle carelessly, and overlooked the class role of the capitalist state, which he treated as a *deus ex machina*, and some other points. While Michał Kalecki was generally enthusiastic about the Keynesian revolution, he predicted that it would not endure, in his article "Political Aspects of Full Employment". In the article Kalecki predicted that the full employment delivered by Keynesian policy would eventually lead to a more assertive working class and weakening of the social position of business leaders, causing the elite to use their political power to force the displacement of the Keynesian policy even though profits would be higher than under a laissez faire system: The erosion of social prestige and political power would be unacceptable to the elites despite higher profits.

James M. Buchanan criticized Keynesian economics on the grounds that governments would in practice be unlikely to implement theoretically optimal policies. The implicit assumption underlying the Keynesian fiscal revolution, according to Buchanan, was that economic policy would be made by wise men, acting without regard to political pressures or opportunities, and guided by disinterested economic technocrats. He argued that this was an unrealistic assumption about political, bureaucratic and electoral behavior. Buchanan blamed Keynesian economics for what he considered a decline in America's fiscal discipline. Buchanan argued that deficit spending would evolve into a permanent disconnect between spending and revenue, precisely because it brings short-term gains, so, ending up institutionalizing irresponsibility in the federal government, the largest and most central institution in our society.

Martin Feldstein argued also that the legacy of Keynesian economics–the misdiagnosis of unemployment, the fear of saving, and the unjustified government intervention–affected the fundamental ideas of policy makers. Milton Friedman thought that Keynes's political bequest was harmful for two reasons. First, he thought whatever the economic analysis; benevolent dictatorship is likely sooner or later to lead to a totalitarian society. Second, he thought Keynes's economic theories appealed to a group far broader than economists primarily because of their link to his political approach. Alex Tabarrok argues that Keynesian politics–as distinct from Keynesian policies–has failed pretty much whenever it's been tried, at least in liberal democracies. In response to this argument, John Quiggin, wrote about these theories' implication for a liberal democratic order. He thought if it is

generally accepted that democratic politics is nothing more than a battleground for competing interest groups, then reality will come to resemble the model.

Very importantly, Paul Krugman wrote "I don't think we need to take that as an immutable fact of life; but still, what are the alternatives?" Daniel Kuehn, criticized James M. Buchanan. He argued, "if you have a problem with politicians - criticize politicians," not Keynes. He also argued that empirical evidence makes it pretty clear that Buchanan was wrong. James Tobin argued, if advising government officials, politicians, voters, it's not for economists to play games with them. Keynes implicitly rejected this argument, in "soon or late it is ideas not vested interests which are dangerous for good or evil." Brad DeLong has argued that politics is the main motivator behind objections to the view that government should try to serve a stabilizing macroeconomic role. Paul Krugman argued that a regime that by and large lets markets work, but in which the government is ready both to rein in excesses and fight slumps is inherently unstable, due to intellectual instability, political instability, and financial instability.

CRITICISM: OPPOSITION TO CAPITALISM

Critics of capitalism associate the economic system with social inequality; unfair distribution of wealth and power; materialism; repression of workers and trade unionists; social alienation; economic inequality; unemployment; and economic instability. Many socialists consider capitalism to be irrational, in that production and the direction of the economy are unplanned, creating many inconsistencies and internal contradictions. Capitalism and individual property rights have been associated with the tragedy of the anti-commons where owners are unable to agree. Marxian economist Richard D. Wolff postulates that capitalist economies prioritize profits and capital accumulation over the social needs of communities, and capitalist enterprises rarely include the workers in the basic decisions of the enterprise.

Some labor historians and scholars have argued that unfree labor – by slaves, indentured servants, prisoners or other coerced persons – is compatible with capitalist relations. Tom Brass argued that unfree labor is acceptable to capital. Historian Greg Grandin argues that capitalism has its origins in slavery: "when historians talk about the Atlantic market revolution, they are talking about capitalism. And when they are talking about capitalism, they are talking about slavery. Historian Edward E. Baptist claims that slavery was an integral component in the violent development of American and global capitalism.

CONCLUSION

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 specification 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.

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