The Economics of Keynes and Uncertainty in Theory

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Rediscovering Common Sense

By

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TABLE OF CONTENTS

Book III: Financial Markets

Book IV: Trade Cycle

Book V: Economic Management

PREFACE

Economic ideas are conceptual frameworks that shed light on how the economy operates. In 1936, John Maynard Keynes published his magnum opus, *The General Theory of Employment, Interest, and Money* (henceforth *The General Theory*), offering his ideas on how the economy works. This book reexamines Keynes's ideas to open the debate on his ideas and bring them to life again.

Since its publication, *The General Theory* has been subject to intense scrutiny in numerous books and articles. Swedish economist Axel Leijonhufvud said, "No other economic work in this century [the twentieth] has been the subject of anything even approaching the vast outpouring of commentary and criticism as Keynes's work has received."[1] So why another book about Keynes's ideas?

The central theme of Keynes's ideas is that uncertainty governs economics, especially the type of uncertainty so severe that it is impossible to assign a probability to outcomes, and this work pieces together his ideas on this central theme. The orthodox doctrine, which dominated the intellectual climate of Keynes's days, rested on the premise that people have all the information they need to base their decisions on and reach their best interests. Keynes believes economic ideas should take a realistic view of the economy to be useful in explaining economic life. To him, uncertainty rules economic life, not perfect information as assumed in the orthodox doctrine.

But *The General Theory* is often characterized as a work of profound obscurity with defects in its organization, not to mention prematurely published, requiring other scholars to interpret and restate its propositions. Today, academic and political establishments generally accept Keynesian economics as the main exegetical work of Keynes's ideas. The trouble with Keynesian economics is that it has failed to recognize uncertainty as the central theme in its interpretation of Keynes's ideas. Indeed, this failure traces its roots to the leading architects of Keynesian economics; uncertainty somehow eluded them. Thus, Keynesian economics was on the wrong track from the beginning.

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[1] Axel Leijonhufvud, *On Keynesian Economics and the Economics of Keynes* (London: Oxford University Press, 1968), 3.

The central theme usually holds all the ideas in any work together. With uncertainty missing, Keynesian economics found it difficult to assimilate itself into Keynes's ideas. The vast outpouring of commentary and criticisms mentioned above was partly due to this difficulty; if Keynes's ideas had been clear in Keynesian economics in the first place, such outpourings of commentary and criticisms would not have been necessary. But almost a century of intense scrutiny and commentary still did not help the economic profession get anywhere near Keynes's ideas, leaving them a mystery to this day.

What followed from this frustrating experience was a strange story. Instead of clarifying Keynes's ideas, Keynesians put Keynes on a "Procrustean bed," chiseling out and abandoning some of the chief elements of Keynes's ideas to fit them into their framework without uncertainty.[2] As a result, Keynesian economics moved further away from Keynes's ideas and became a "third body of analysis," wholly alien to and distinct from Keynes's ideas, further deepening the mystery of Keynes's ideas.[3]

Uncertainty is not entirely novel in economics; economic ideas based on uncertainty may include *asymmetric information*, *the prisoner's dilemma*, and *bounded rationality*, to name a few. But no attempt has yet been made to frame Keynes's ideas with uncertainty as the central theme. This work seeks to piece Keynes's ideas together with due recognition of uncertainty as the central theme. It may surprise the reader that the simple addition of uncertainty leads Keynes's ideas to be drastically different from Keynesian economics, which is accepted today as the main interpretive work of Keynes's ideas.

Keynes does not have the last word about how the economy works. But if one accepts that uncertainty rules economic life, Keynes's ideas offer a sensible and reasonable framework for dealing with reality. According to John Kenneth Galbraith, common sense is "what has always been believed."[4] Indeed, hardly anyone would dispute that uncertainty governs economic life. If so, Keynes's ideas would also be common sense—which led to the title of this work.

Economic ideas offering a sensible and reasonable framework for dealing with reality based on common sense are unlikely to disappear soon. Indeed, Keynes's ideas have survived for almost a century since the publication of *The General Theory*, despite misguided interpretation by Keynesian economics. They will undoubtedly survive for many more years;

[2] *Ibid.,* 35.
[3] *Ibid.,* 31.
[4] John Kenneth Galbraith, *Money: When It Came and Where It Went* (London: Andre Deutsch, 1975), 230.

in his assessment of Keynes's legacy, Robert Skidelsky states that Keynes's ideas could still be alive on the centenary of their publication.[5]

This book addresses a broad group of readers, including students in economics, economists, and general readers with limited exposure to economic ideas. Students and economists may find this book interesting as it offers an alternative view of Keynes's ideas that is drastically different from Keynesian economics. Professional economists may also find this book valuable in their search, currently underway, for new ideas in economic thinking.

Far-reaching anomalies, such as the Great Depression and the 2008 financial crisis, generally force economists to question accepted wisdom and explore new ideas. The Great Depression led to the fall of classical doctrine and opened the age of Keynes. The 2008 crisis also brought a similar fate to New Classical Economics, opening the door to new economic thinking. But the new one has remained elusive and has yet to emerge. If Keynes's view that uncertainty governs economic life is accepted as realistic, his ideas seem to offer a sensible and reasonable framework for dealing with economic reality. And there would be no need to look elsewhere for new economic thinking but to return to Keynes's ideas.

Returning to Keynes's ideas does not mean going back to Keynesian economics. Aside from its failure to recognize the central theme of Keynes's ideas, economic and political establishments rejected Keynesian economics in the early 1970s due to its failure to explain stagflation and the policy dilemma of dealing with it. The present work offers an alternative view of Keynes's ideas to which new economic thinking may return.

The present work could help students sharpen their understanding of financial markets and the economy. Keynes's ideas focus on uncertainty involved in savings and investment activities to explain the instability in economic life. The modern economy entrusts the coordination of saving and investment activities to financial markets, such as bond and stock markets, including banks. As financial markets play critical roles in coordinating savings and investment, which could lead to economic instability, Keynes's ideas involve a deep understanding of the financial markets and their effect on the modern economy.

This book may also interest general readers with limited exposure to economic ideas. Economic ideas are conceptual frameworks that shed light on economic activities carried out in everyday life, such as buying and

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[5] Robert Skidelsky, "Keynes's General Theory at 80," Palgrave Macmillan, https://www.palgrave.com/gp/blogs/business-economics-finance-management/new-perspectives-in-economics-and-finance/author-perspectives/keynes-general-theory-at-80.

selling goods and services. Thus, everyone is a player in the game and has an interest in understanding economic ideas. Furthermore, economic ideas also influence policy, which affects everyone in one way or another.

This work has made every effort to present Keynes's ideas as intuitively as possible, using simple language that is easily accessible to general readers. Economic ideas are often complex and beyond the reach of the broader population, and the heavy use of jargon and elusive phrases in explaining them adds more frustration. This work explains things in simple language, avoiding technical jargon as much as possible.

This work would not have been possible without the insight of many scholars on money and finance, the centerpiece of Keynes's theory. Professor Irving Fisher lays out the role of money in economic life on the theoretical level. Professor John Kenneth Galbraith, on the other hand, demonstrates money in action on the practical level going back to the Middle Ages. Axel Leijonhufvud shifts the focus and draws attention to a particular role of money at the root of the economic problem, i.e., a means to cope with uncertainty. Finally, Professor Robert Skidelsky clarifies the type of uncertainty underlying Keynes's ideas and how people cope with it.

This work owes the greatest debt of gratitude to my wife and two daughters, who have put up with me with patience and love over the several years this work has taken. Without their patience and encouragement, this book would not have seen the light of day. A great debt of gratitude also goes to many colleagues and friends who have read the manuscript either in whole or in part, offered critical but constructive comments, and sharpened my thoughts. To all, many thanks. Of course, any mistakes in facts or interpretation are my responsibility alone.

CHAPTER 1

INTRODUCTION

I. Keynes the Persuader and Redeemer

The Roman philosopher Seneca is said to have warned about silver-tongued persuaders who will talk people into believing almost anything: "Once you let [this] sort of person … into your home, … you will have someone regulating … the way you use your jaws as you eat, and in fact going just as far as your patience and credulity [permit]."[1] Hunter Lewis, a critic of Keynes, adds, "We did of course let Keynes into our global economic policy home, and our credulity has been stretched ever since."[2]

British economist John Maynard Keynes (1883–1946) may have stretched credulity, but the world let Keynes enter the global policy home in the first place. The question is, why? Keynes was renowned for his literary elegance and clarity, not to mention exceptional brilliance. Robert Skidelsky called Keynes "the greatest persuader in twentieth-century economics."[3] Keynes's linguistic skill and brilliance would undoubtedly have been irresistible.

However, it was the failure of the entrenched economic doctrine of the time, the classical orthodoxy, to provide salvation from the great misfortune of the 1930s, the Great Depression, that led the world to let Keynes enter the global policy home. The experience of the 1930s, which practically defined the age of Keynes, was traumatic for most economists at the time. It was not simply because the contraction was severe; the profession could not find a consensus for an action plan based on the entrenched doctrine.[4] This dismal intellectual climate naturally set the stage for questioning the

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[1] Seneca, *Letters from a Stoic*, XV, trans. Robin Campbell (London: Penguin, 1969), 61.
[2] Lewis, Hunter, *Where Keynes Went Wrong: And Why World Governments Keep Creating Inflation, Bubbles, and Busts* (Arlington, VA: Axios Press, 2009), 282.
[3] Robert Skidelsky, *Keynes: The Return of the Master* (New York: PublicAffairs, 2010), 58.
[4] Axel Leijonhufvud, *On Keynesian Economics and the Economics of Keynes* (London: Oxford University Press, 1968), 31.

received wisdom of the day and opened the door to new ideas; a far-reaching anomaly such as the Great Depression is usually accompanied by questioning the accepted wisdom and opens the ground for new ideas.

Keynes responded and put forward a series of innovations in theories and solutions to the great misfortune of his time in his magnum opus, *The General Theory of Employment, Interest, and Money* (hereafter referred to as *The General Theory*). It was published in February 1936 in Britain and a few months later in the United States. Keynes's success was phenomenal, especially in the United States, where he was accepted as "the Redeemer untainted by earlier dogmas that failed to provide salvation from the unparalleled catastrophe of the Great Depression," a "liberating revelation."[5]

But *The General Theory* was more than a liberating revelation; it also signaled a revolution in economic theory with a pioneering quality, ultimately leading to the development of modern macroeconomics. Thus, the world did not just welcome Keynes but also let Keynes occupy center stage in the global economic policy home. Moreover, a work with such revolutionary characteristics in economic thinking would not fade into obscurity but endure. Naturally, Keynes has remained the most influential economist of the twentieth century, with an unrivaled impact.

As writer John Cassidy notes, Keynes is long gone. However, his ghost still lives on and holds a firm grip on economic and political establishments: "Whenever the economy is humming … conservative [classical] economists dismiss Keynes's argument". For that matter, whatever theory one believes in does not matter when the economy is doing well. But when hard times reappear, as they inevitably do, "governments, regardless of their ideological predilections, almost always administer the Keynesian medicine [based on Keynes's advice, of course]."[6] Keynes's ideas have a grip on economic and political establishments not just in the United States but worldwide. It would hardly be an exaggeration to say that his legacy has shaped nearly all contemporary economic affairs worldwide.

The success of *The General Theory* and the fame it brought Keynes raises two obvious questions. One is why the entrenched orthodox doctrine failed to relieve the misfortune. The other is how Keynes himself explained the great misfortune and the solutions he proposed to provide salvation from the tragedy of his time. Contrary to their appearance, these questions are not mutually exclusive. The orthodox doctrine failed to explain the economic reality of the time, but Keynes did not discard it altogether. Instead, he based his theories on the framework of the orthodox doctrine but with

[5] *Loc. cit.*

[6] John Cassidy, *How Markets Fail* (New York: Farrar, Straus and Giroux, 2009), 174.

modifications to remedy its failure. Before delving into details, a brief overview of the orthodox doctrine and Keynes's ideas will help.

II. Orthodox Theory

In a community where the division of labor is the mode of production, people produce commodities and exchange them with other products they need. That being the case, they must produce what others desire; otherwise, they cannot acquire what they need. In a money-using economy, people sell the products of their labor for money and use that money to buy what they need. However, using money as a medium of exchange does not change the substance of the argument.

The orthodox theory rests on the premise that people have perfect knowledge about the needs and wants of others. As all commodities produced will be desirable, people can sell all their products to buy what they need. With the demand automatically accommodating itself to production, people will only have to decide how much to produce; how much to buy will depend on production.

But it would be in people's interest to obtain the largest possible share of products. As the share of products acquired depends on the surplus products of one's labor offered in exchange, people would expand production to the maximum. Producing commodities requires resources, of which labor efforts are the most important. Since people expand production to the maximum to acquire the largest possible share of products, they will also have to expand labor efforts to the utmost limit for production, generally termed "full employment" in economics.

Although all the commodities produced are desirable, production could exceed demand, leading to a general glut of commodities or deficient demand. The orthodox doctrine does not deny the possibility of deficient demand but views it as highly unlikely. However, even if this unlikely scenario develops, it will only be temporary, as a fall in prices and wages will quickly relieve the glut.

Businesses and industries generally organize production by hiring workers in the modern economy. Thus, it would be convenient to consider a fall in prices and wages with businesses and industries producing goods and households buying them with income from employment—this would not change the substance of the argument. An oversupply of commodities means weak sales and will force the prices of commodities to fall. The falling prices will encourage households to buy more goods while discouraging production, promptly abolishing excess. But when production decreases, part of the labor efforts previously devoted to production will also be redundant, leading to layoffs and unemployment.

As households derive income from employment, unemployment will also force households to accept lower wages. As wages fall, workers whose employment had previously been unprofitable to employers will now be hired, raising production. Although money wages are lower, prices are also lower, enabling workers to purchase larger quantities of goods. Besides, the money wages paid to a larger number of workers will also be able to provide sufficient means to purchase the increased output, and the economy will return to a state of balance, named "equilibrium" in economics, at or near full employment.

This process may also work in reverse, i.e., wages to prices. Wages are one of the major production costs. Falling wages with unemployment will accompany a comparable price fall, encouraging households to buy goods and businesses to produce more. As production increases, it will also encourage demand for labor services, and the money wages paid to a larger number of workers can provide sufficient means to purchase the increased output, abolishing excess and leading the economy to return to a state of balance.

On the other hand, if wages are not falling, neither will prices fall and relieve the general glut of commodities. As a result, the economy may be caught in a persistent production glut with widespread unemployment. Not surprisingly, orthodox economists saw wages' failure to fall as the root cause of the Great Depression. Thus, their recommendation to end the Great Depression was, "Do nothing to interfere with the reduction of wages in a depression," according to John Kenneth Galbraith (1908–2006).[7]

As the Great Depression unfolded, prices and wages took a free fall. But despite the hefty deflation in prices and wages, production and employment did not return to full employment level. Instead, they also took a plunge; output contracted by nearly a third from 1929 to 1932, and unemployment surged to just under a quarter of the labor force—in the following years, unemployment was even worse.[8] In short, while prices and wages took a free fall, production and employment also plunged.

It became clear that wages' failure to fall was not the cause of the economic slump and widespread unemployment. Keynes said, "It is not very plausible to assert that unemployment in the United States in 1932 was due to … labour obstinately refusing to accept a reduction of money

[7] John Kenneth Galbraith, *Money: When It Came and Where It Went* (London: Andre Deutsch, 1975), 219.
[8] *Ibid.*, 181.

wages."[9] With the lack of correspondence between the orthodox theory and economic reality during the Great Depression, it is hardly surprising that the economic profession could not reach a consensus on an action plan based on it and failed to provide salvation from unprecedented misfortune.

III. Keynes's Theory

In contrast, Keynes's ideas rest on the premise that people do not know about the needs and wants of others. Without such knowledge, not all commodities produced will be desirable, and people cannot sell all their products to buy what they need. Since demand does not adjust itself to production, people cannot just decide how much to produce. Instead, they must decide how much to produce and buy independently of each other.

It might be asked how people decide how much to produce and buy. Without knowing what others want or need, the best people can do to decide on their production level is to base it on what others are willing to buy, i.e., sale proceeds. Since what others are willing to buy, or sale proceeds, could be at any level, production based on sale proceeds could also be at any level, not the maximum. Nor will people expand their labor efforts dedicated to production to the utmost limit, resulting in unemployment.

On the other hand, the demand for commodities consists of the sum spent on products devoted to consumption and investment. Since not all commodities produced are desirable, people will not buy all of them. Thus, whether commodities are devoted to consumption or investment, their demand could fall short of supply, leading to a general glut or deficient demand. In Keynes's world of uncertainty, a general glut is far from an unlikely possibility, as the classical theory suggests, but a norm. Since production depends on sale proceeds, the general glut will lead to a fall in production and employment, and the free market economy will be trapped in a slump with unemployment.

Aside from uncertainty about others' needs and wants, the demand for investment goods involves another uncertainty, which is more serious, leading Keynes to draw particular attention to the general glut of commodities devoted to investment. The modern economy entrusts the coordination of saving and investment activities to financial markets. In other words, people purchase long-term assets, such as long-term bonds and stocks, with their savings for future yields to finance future consumption.

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[9] John Maynard Keynes, *The General Theory of Employment, Interest and Money* (London: Macmillan Cambridge University Press for Royal Economic Society, 1973; first published in 1936), 9.

Entrepreneurs then use the proceeds from their sales to purchase commodities devoted to investment.

However, the return from long-term assets is uncertain, as it includes capital gain or loss from the changes in the nominal price, which is unknown. To cope with this uncertainty, people may keep part of their savings in money. When individuals hold a portion of their savings in money, the savings offered to entrepreneurs for purchasing investment goods will fall short of the total savings, leading to deficient demand for investment goods. Again, production depends on sale proceeds, and deficient demand for investment goods will slow down production and employment, leading to an economic slump with unemployment.

Savings held in money are also apt to change, hence the demand for investment goods. Money has little or no yield, and people will have to give up the return from long-term assets. The foregone return from long-term bonds includes capital gain or loss from the changes in the nominal price, and savings held in money will depend on it. Since the future long-term asset price is unknown, people must form expectations, and savings held in money will depend on them.

Expectations, though, are liable to change as they have no firm root to hold them steady. With changing expectations, capital gain or loss will also change, hence savings held in money and the demand for investment goods. With production depending on sale proceeds, when the demand for investment goods changes, production will also change, leading to fluctuations in production and employment. In other words, changing expectations of the future long-term asset price could also make the economy unstable, running into serious bumps and breakdowns now and then, such as in the Great Depression.

Clearly, at the root of instability is the disposition to hold savings in money to cope with uncertainty about the return from the long-term assets in which people invest their savings. People switch between money and long-term assets in financial markets, where the coordination of saving and investment activities is entrusted. Naturally, money and financial markets take center stage in Keynes's theory.

Keynes does not rule out a fall in prices and wages with weak sales led by the general glut. However, movements in prices and wages do not register all the relevant changes in the market when people act on imperfect information. Thus, falling prices and wages may not abolish the commodity and labor markets glut, as in the classical theory. Instead, people will react to the general glut by adjusting production at current prices, leading to an economic slump with unemployment and a somewhat delayed fall in prices and wages. To Keynes, therefore, the Great Depression, with its severe contraction in output and employment along with a free fall in prices and wages, was a crisis of deficient demand for commodities, not a crisis of production caused by the inability of prices and wages to abolish a glut, as orthodox economists believed.

As seen above, the economic reality during the Great Depression was a severe contraction in output and employment accompanied by a free fall in prices and wages. With the disparity between orthodox theory and economic reality, the economics profession naturally struggled to reach a consensus regarding a course of action. In Keynes's view, the lack of correspondence also undermined the classical orthodoxy and the reputation of the economics profession: "[I]ts [the orthodox theory's] signal failure for purposes of scientific prediction [economic reality] has greatly impaired, over time, the prestige of its practitioners [economists]."[10] The sour view Keynes held of the entrenched doctrine of the time is beyond doubt:

> The voices which … [tell] us that the path of escape is to be found in [the] strict economy [of the orthodox doctrine] and in refraining, wherever possible, from utilising the world's potential production [with corresponding demand], are the voices of fools and madmen.[11]

Since the cause of the tragedy was deficient demand for commodities, his advice for ending the depression was to offset it through policy interventions. Although he was accepted as the Redeemer, the time to put his advice into practice had not yet arrived. Instead, the classical orthodoxy and its recommendation of doing nothing to interfere with falling wages continued to dominate the economic and political establishments during the Great Depression—old habits die hard.

This course of action, or rather inaction, naturally excluded all public efforts from offsetting deficient demand and promoting recovery.[12] The result was a deep economic slump with waves of unemployment persisting for more than a decade until the outbreak of World War II when the spending on rearmament finally swept the deficient demand away. Only after World War II did Keynes's advice see the light of day under the name of "fine-tuning."

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[10] *Ibid.*, 33.

[11] John Maynard Keynes, *The Collected Writings of John Maynard Keynes XXI, Activities 1931-1939: World Crises and Politics in Britain and America* (London: Cambridge University Press for Royal Economic Society, 2012), 61. Also quoted in Skidelsky, 77.

[12] Galbraith, 198.

IV. Looking Ahead

Keynes's theory rests on the premise that people do not have all the relevant information on which to base their decisions and reach their best interests. This book puts Keynes's ideas together with uncertainty as their central theme. Uncertainty permeates every facet of economic activities. However, Keynes's main focus is on the inclination to hold part of savings in the form of money to cope with uncertainty regarding the returns from long-term assets, leading to severe instability in output and employment, as seen above. Given that money and finance dominate economic life today, the relevance of Keynes's ideas focusing on money and financial markets seems to have grown greater than ever.

Keynes's ideas build on the analytical framework of the orthodox theory. The only departure Keynes makes is to relinquish the assumption of perfect information and replace it with uncertainty. Since Keynes's ideas trace their roots to the orthodox theory, any work on Keynes must first come to grips with the orthodox doctrine. To prepare for the journey, therefore, Book I starts with Adam Smith's invisible hand, followed by Say's Law and others, the groundwork on which the orthodox edifice was built.

Book II focuses on Keynes's ideas on production, saving and investment activities, the rate of interest, and consumption. These topics are the same as those covered in the textbook versions of Keynesian economics, generally accepted as Keynes's ideas. The Keynesian reading of Keynes's ideas on these topics is not the same as that of the present work. The last chapter of Book II visits Keynesian economics to see how it fares in its interpretations. The examination of Keynesian economics is well justified, as it has dominated mainstream economics for the past few decades with its immense influence on economic and political establishments. The visit will also highlight the differences between the Keynesian interpretation and that of the present work on these topics and help sharpen the understanding of Keynes's ideas.

Book III returns to Keynes's theory under uncertainty and its variations. In his theory, the root of economic evils is the tendency to keep part of savings in cash instead of buying long-term assets, led by uncertainty about their future price. As financial markets are where people switch between long-term assets and money, they also share the blame. In short, the economic evils trace their roots to money and financial markets, including the bond and stock markets and banks. For additional details and clarity, this work examines each component of the financial markets individually in each chapter of Book III.

Book IV combines all components of the financial market together in a framework, often termed the trade or "business cycle." The discussion begins with cyclical movements in output and employment in mild forms. But the system can veer far off its ordinary course and skid into extreme instability in economic life now and then. In other words, output and employment vary widely from one extreme to the other, i.e., from euphoric expansion in economic activities to a violent collapse, shaking the system to its foundation.

The General Theory is almost exclusively devoted to pure theory; it treats policy matters somewhat implicitly, as the progression of the theoretical argument dictates—there is not even a chapter on policy in *The General Theory*. Nonetheless, Keynes is often accused of contributing to the idea of active management of the economy. Before closing the present work, Book V pays a brief visit to the instruments of economic management Keynes proposed—i.e., monetary and fiscal interventions—and examines their problems. Aside from economic management instruments, Keynes also offered some reform measures to deal with deficient demand for investment goods permanently, which many would consider drastic or radical. To conclude the present work, the last chapter examines the defining characteristic of Keynes's theory and its contributions to economic theory.

The General Theory sums up Keynes's ideas for the most part, and the present work draws primarily on it. But the present work frequently draws attention to the collection of his essays, *Essays in Persuasion*, published six years earlier in 1931, as many of the ideas found in *The General Theory* trace their roots to those essays.[13] Keynes is somewhat self-deprecating and skeptical of the influence of those essays in this collection. In the preface, Keynes writes, "HERE are collected the croakings of twelve years—the croakings of a Cassandra who could never influence the course of events in time."[14] This skepticism turned out to be unfounded, for some of those croakings have been the foundations for *The General Theory*, the most influential work in modern economics.

At the outset, a word of caution seems to be in order. This work does not maintain that one can find everything in the following pages in *The General Theory*. In other words, it goes beyond what Keynes said, especially on money and the financial markets. Given the profound complexity of *The General Theory*, as is often said, any attempt to fully understand such a work will inevitably be speculative.

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[13] John Maynard Keynes, *Essays in Persuasion* (New York: Classic House Books, 2009; first published in 1931).
[14] *Ibid.*, 1.

The aim here is to get a feel for what Keynes appears to have in mind, ideas that have been overlooked or missed—it is to gain a "*Gestalt*-conception" of Keynes's vision of a modern capitalist economy, in Axel Leijonhufvud's (1933–2022) words.[15] In this attempt, excessive degrees of freedom will not be acceptable; Keynes's name commands immense authority, and it would be tempting to attribute one's own ideas to him. But if Keynes's views appear beyond a reasonable doubt, taking the context as a whole, it seems desirable to bring them out and reopen the debate.

[15] Leijonhufvud, 10.

BOOK I

CLASSICAL THEORY

CHAPTER 2

THE DAWN OF MODERN ECONOMICS

I. Mercantilism and Francois Quesnay

Economic theorists and practitioners viewed the economy as a collective entity from the sixteenth to late eighteenth centuries. This view led to the belief that a nation's wealth was defined by its stockpile of precious metals, such as gold and silver, an idea known as "bullionism." Precious metals are, by definition, limited in supply. However, a nation's currency in those days also represented a certain fraction of an ounce of gold, and amassing gold was still possible through an influx of money with a favorable trade balance.

Economic theorists and practitioners naturally considered a favorable trade balance advantageous for a country. Over time, this thought led to a more dogmatic view, known as "mercantilism," that government control of foreign trade was paramount in enriching a nation. The practical consequence of mercantilism was not just government control of foreign trade; it led to frequent European wars and colonial expansion in search of precious metals.

French economist Francois Quesnay (1694–1774) was one of the first economists to change the notion of the wealth of a nation in his seminal work *Tableau économique*, published in 1758.[1] In sharp contrast to the accepted view of his day, he portrayed the economy as a system of interacting parts, not a collective entity. Since the economy is not a collective entity but a system of interacting parts, the precious metals owned by a nation cannot define its wealth. Instead, the economy's wealth is derived from products, of which each interacting part contributes to the production and takes a share. These changes in thinking were revolutionary, breaking away from the tradition of mercantilism, and ushered in the dawn of a new era in economics, providing the foundation for the development of modern economics.

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[1] Francois Quesnay, *Tableau économique* (1758; reproduced in facsimile for British Economic Association, 1894).

Adam Smith (1723–1790), the British philosopher, elaborates on Quesnay's thoughts.[2] Smith's explanation begins with the three social classes as interacting parts, each contributing to the production and taking a share of products in return.[3] The first is the proprietors of the land, who improve the land, buildings, drains, enclosures, etc. The second is farmers and country laborers who cultivate the land. The third is the artisans and manufacturers who produce manufactured products and the merchants who trade one thing for another.

The economy also produces three products, each by one of the three social classes: agricultural products, manufactured goods, and the service of commerce for trading one thing for another. Of the three, however, Quesnay takes the products of the land, i.e., agricultural products, as the only source of a country's wealth. As agriculture played a major role in the economy in his time, the emphasis on agricultural products in determining the wealth of a nation was hardly surprising.

Since the products of the land alone constitute the source of a country's wealth, those who have contributed in any respect towards the wealth are only the first two classes: the proprietors, farmers, and laborers. By contrast, the class of artisans, manufacturers, and merchants adds nothing; it merely diverts labor and capital from the land. Thus, the first two are the productive classes, and the last is barren and unproductive.[4]

The three social classes, as interacting parts, then share products in exchange for their products and services. Agricultural products duly belong to the first two classes, the proprietors of the land, farmers, and country laborers, as they contribute to their production. The first two classes then furnish the artisans, manufacturers, and merchants with materials for their work and fund their subsistence, such as corn and cattle, including their profits, in return for manufactured products and services that the third class produces.[5] In short, the third class is maintained and employed at the expense of the other two.

In Quesnay's days, the social strata were established mainly by birth, with little or no mobility among different classes, and each stratum had its designated role in contributing to the production and taking a share of products. To Quesnay, therefore, the division of the three social classes and the force governing their interactions were simply the natural order of things to which the workings of the economy were subject. As is clear, the portrait

[2] Adam Smith, *The Wealth of Nations* (New York: Bantam Dell, 2003; first published 1776), 842–75.
[3] *Ibid.*, 844.
[4] *Ibid.*, 847.
[5] *Ibid.*, 850.

of the economy Quesnay paints is an inevitable product of his time—economic ideas are products of their time.

Though a product of his time, Quesnay's portrait of the economy was nevertheless revolutionary, and Quesnay's followers believed that it was "one of the three great inventions which have contributed most to the stability of political societies, the other two being those of writing and money."[6] In due course, Quesnay's idea gave birth to a school of economic thought, the first of the modern kind, named the "physiocrats." As the products of the land determined a nation's wealth, physiocrats linked the interest of the landlords and the cultivators to the interest of society, encouraging economists and public officials to pay close attention to the net increase in these products.

II. *Laissez-Faire*

To Quesnay, the interactions among the three classes, each contributing to the production and taking a share of products, were the natural order of things. The economy, however, does not operate in isolation—it works in the context of economic organizations, politics, ideology, and so on. In particular, the involvement of politics could lead to a situation in which government restraint and regulation would favor a certain industry or protect home industries against foreign competition to promote the good of society.

Quesnay says that these government actions violate the natural order, and their consequences are always contrary to the very end for which they are intended.[7] For example, as the products of the land determine the economy's wealth, governmental restraint and regulation could favor and promote agriculture over the artisans, manufacturers, and merchants for the general good of society. But preferring agriculture to other industries would inevitably reduce the number of artisans and manufacturers.

However, artisans and manufacturers are the most important in the markets for raw products from the land, as they buy not only the material for their work but also the means for their subsistence. Thus, the diminishing number of artisans and manufacturers would reduce the home market for raw produce and discourage agriculture, contrary to the intended goals of such regulations. With a falling number of artisans and manufacturers, it would also raise the price of manufactured produce relative to raw produce, further discouraging agriculture.

[6] *Ibid.*, 863.
[7] *Ibid.*, 856.