

THE GREAT DEPRESSION OF 1929 AND 2008 :

A conventionalist updating of Keynes' s diagnosis in *General Theory of employment, interest and money*

PLAN

- Objectives of the paper
- 4 keys from General Theory
- 1. From conventional economics to the economics of conventions, and vice-versa
- 2. The 'Wittgenstein hypothesis' and Keynes's view of economic theory as a social practice
- Conclusion
- Selected References

SUMMARY

The “economics of conventions” is a research program in social science (including economics) born at the end of the 1980s – but the first (and the greatest) conventionalist economist is Keynes, when he attempted to give a new account of the 1929 crisis, in his major work *The General theory of employment, interest and money* (1936). Some of its most innovative features could not have been perceived before the retrospective look offered by the “economics of conventions”. By stressing the role of conventions, the conventionalist economists make it clear, for the first time, that 1929 crisis must be traced back in Keynes's thought to twin “bad” conventions, one about the link between the financial system and the productive system, and another one about the link between the “ideas” distilled by mainstream economic theory and the ruling ideas within the political, economic and social spheres. This duality between economy and economics seems to apply as well to the present crisis, which suggests that its roots may be deeper than we generally think- and the solutions more difficult.

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OBJECTIVES OF THE PAPER

→ Comment 4 pieces of « General Theory » (of which 3 are well known, if not well exploited, and 1 seem to be a purely methodological one)

- Revisit some research about the *writing* of the GT
 - distinction of a radical and a pragmatic project
 - possible deep methodological influence of Wittgenstein
- Understand how academic economists can exert such a deep influence in the economic / social / political world, although nobody can read and assimilate their writings
- Bring to the fore some deep analogies and some deep differences between 1929 and the present crisis

→ the 4 excerpts (together) are 4 keys towards reaching these objectives

FOUR KEYS FROM THE *GENERAL THEORY OF EMPLOYMENT, INTEREST AND MONEY*

KEY 1

Chapter 1, § unique [The General Theory]

“I have called this book the *General Theory of Employment, Interest and Money*, placing the emphasis on the prefix *general*. The object of such a title is to contrast the character of my arguments and conclusions with those of the *classical** theory of the subject, upon which I was brought up and which dominates the economic thought, both practical and theoretical, of the governing and academic classes of this generation, as it has for a hundred years past. I shall argue that the postulates of the classical theory are applicable to a special case only and not to the general case, the situation which it assumes being a limiting point of the possible positions of equilibrium. Moreover, the characteristics of the special case assumed by the classical theory happen not to be those of the economic society in which we actually live, with the result that its teaching is misleading and disastrous if we attempt to apply it to the facts of experience”

KEY 2

Chapter 12, § 4 [The state of long-term expectation]

“In practice we have tacitly agreed, as a rule, to fall back on what is, in truth, a *convention*. The essence of this convention – though it does not, of course, work out quite so simply – lies in assuming that the existing state of affairs will continue indefinitely, except in so far as we have

specific reasons to expect a change. This does not mean that we really believe that the existing state of affairs will continue indefinitely. We know from extensive experience that this is most unlikely. (...) Nevertheless the above conventional method of calculation will be compatible with a considerable measure of continuity and stability in our affairs, *so long as we can rely on the maintenance of the convention.* (...)"

KEY 3

Chapter 14, [The classical theory of interest] Appendix, §2

"Ricardo offers us the supreme intellectual achievement, unattainable by weaker spirits, of adopting a hypothetical world remote from experience as though it were the world of experience and then living in it consistently. With most of his successors common sense cannot help breaking in – with injury to their logical consistency"

KEY 3 bis

Chapter 21, § 3 [The theory of prices]

"The object of our analysis is, not to provide a machine, or method of blind manipulation, which will furnish an infallible answer, but to provide ourselves with an organized and orderly method of thinking out particular problems; and, after we have reached a provisional conclusion by isolating the complicating factors one by one, we then have to go back on ourselves and allow, as well as we can, for the probable interactions of the factors amongst themselves. This is the nature of economic thinking. Any other way of applying our formal principles of thought (without which, however, we shall be lost in the wood) will lead us into error. It is a great fault of symbolic pseudo-mathematical methods of formalising a system of economic analysis (...) that they expressly assume strict independence between the factors involved and lose all their cogency and authority if this hypothesis is disallowed ; whereas, in ordinary discourse, where we are not blindly manipulating but know all the time what we are doing and what the words mean, we can keep 'at the back of our heads' the necessary reserves and qualifications and the adjustments which we shall have to make later on, in a way in which we cannot keep complicated partial differentials 'at the back' of several pages of algebra which assume that they all vanish. Too large a proportion of recent 'mathematical' economics are merely concoctions, as imprecise as the initial assumptions they rest on, which allow the author to lose sight of the complexities and interdependencies of the real world in a maze of pretentious and unhelpful symbols"

KEY 4

Chapter 24, § 5 [Concluding notes on the social philosophy towards which the general theory might lead]

"At the present moment, people are unusually expectant of a more fundamental diagnosis; more particularly ready to receive it; eager to try it out, if it should be even plausible. But apart from this contemporary mood, the ideas of economists and political philosopher, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed the world is ruled by little else. Practical men, who believed themselves to be quite exempt from any intellectual influences, are usually the slaves of some defunct economist. Madmen in authority, who hear voices

in the air, are distilling their frenzy from some academic scribbler of a few years back. I am sure that the power of vested interests is vastly exaggerated compared with the gradual encroachment of ideas. Not, indeed, immediately, but after a certain interval; for in the field of economic and political philosophy there are not many who are influenced by new theories after they are twenty-five or thirty years of age, so that the ideas which civil servants and politicians and even agitators apply to current events are not likely to be the newest. But, soon or late, it is ideas, not vested interests, which are dangerous for good or evil. »

1. FROM CONVENTIONAL ECONOMICS TO THE ECONOMICS OF CONVENTIONS, AND VICE-VERSA

PLAN

- 1.1. the dual use of « convention » in GT
- 1.2. the dual message of GT for 1929 crisis...
- 1.3. ... and what about 2008 crisis ?
- 1.4. Return to the history of writing GT
- 1.5. Keynes's « pragmatic project » as an unexpected stimulus for neo-classical economics
- 1.6. Why Keynes did not use the concept of « convention » to deal with « orthodoxy »

1.1. The dual use of « convention » in GT

- Key 1 introduces « classical analysis » (i.e. « orthodox » economics*) as a new concept for economic analysis of the world of economists (indeed of the academic economists' community) [*Pref. to the french edition]
 - Key 2 introduces « convention » as a new concept for economic analysis of the real world (e.g. regulating the financial community)
- the notion of *conventional economics* (↔ « orthodoxy » is a sort of convention) seems to be the logical counterpart of the *economics of conventions*, as founded by Keynes

1.2. The dual message of GT for 1929 crisis...

To understand why there is mass involuntary unemployment (1929), we need to introduce **two conventions**

- **About economy** : there is a « bad » convention around the level of the interest rate : the financial community is too greedy (too pessimistic about future)
- **About economics** : there is another « bad » convention, in the way of doing economics [= 'presuppositions, atmosphere, method' * Pref to the french edition, p.xxxi] : the (mainstream component) of the academic community modelizes the 'economic system' with too optimistic assumptions about its 'inherent tendency towards self-adjustment'

The GT tries (and succeeds) to *displace* once for all the 2nd convention, by devising a new model of the economy, suggesting macro-economic tools to *circumvent* the 1st convention (which may happen again)

1.3.... And what about 2008 crisis ?

The same two conventions seem to be as relevant for 2008 as for 1929

With **two differences** :

- **One about economy** : the financial community has also been demanding too much but a long time before (cf 15% ROE) (with then rather positive consequences upon the rate of growth) : at that time then it was not due to excessive pessimism

- **Another one about economics** : between 1929/1936 and 2007/?, there were two decades of triumphant ...keynesianism. So it must have played a role, *at least if ideas are as important as he thought*. Therefore, it looks as if the regression of keynesianism during the years of neo-liberalism was (at least partly, at least indirectly) a consequence of Keynesianism itself !

Could we find some help from the Past ?

1.4. Return to the history of the writing of GT

- My hypothesis :There was a fundamental change in theoretical strategy of Keynes, when writing GT (1930-1935) :
- at the mid 1933, he renounced his initial « **radical** » project of creating a *new* theoretical language (centered on uncertainty – i.e. interpretive rationality and coordination failures) for a ‘monetary theory of production’
- ...and converted himself to a « **pragmatic** » project of inserting into the standard language the *minimal* changes necessary to be sure that what is called « unemployment » in the model (when it is not excluded by construction) corresponds to actual involuntary unemployment, according to its (common sense) ordinary meaning

1.5. Keynes’pragmatic project as an unexpected stimulus for neo-classical economics (a)

The pragmatic project had such a success – in economy, as in economics – that it paved the way (partly, indirectly, unintentionally) to the neo-liberal era (>1970), subsequent to the social-democrat, ‘fordist’, era (>1945)

- **In economy** : macro-economics reveals itself more and more difficult to be governed from the state : revenge of the long-term (growth of the public sector; public debt). Decoupling of national macro-economic performance and micro-econ performance of the globalized firms
- **In economics** : Keynes played an important, albeit involuntary, role in the strengthening of the two ‘pillars’ (Arrow) of neo-classical economics
 - individual rationality : TP (1921)→ Ramsey (1926) and the birth of subjective probability → axiomatization by Savage (1954). An unfortunate experience of a 1st attempt at a radical project ?

- market coordination : according to Clower, Hicks was comforted in his own project of commuting from the Marshallian branch of neo-classical economics to the Walrasian one – by the success of his translation of GT in applied general equilibrium terms (IS/LM)→ axiomatization by Arrow & Debreu (> 1954)

1.5. Keynes' pragmatic project as an unexpected stimulus for neo-classical economics (b)

- The '**neo-classical**' **synthesis** gave a very weak and fragile view of the intellectual content of GT, as soon as it leads to disappointing macro results, especially when taking into account the axiomatization of the two pillars of neo-classical economics. The subsequent resurgence of methodological individualism, exemplified by non-walrasian equilibria, made it possible to switch from GE to contract theory, on one side, and DGSE, on another side.
- So we are now confronted to the same two « bad » conventions as in the times of Keynes, indeed more toxic now
 - the **economy** is even more dominated by finance, and the globalization has discounted the importance of national macroeconomics for the question of employment
 - the **orthodoxy** is technically (and ideologically) much more powerful
- Therefore, Keynes' s heirs have no other solution than developing the « radical » project ... but without Keynes.

1.6. Why Keynes did not use the concept of convention to deal with orthodoxy ?

Type of project	Economy	Economics
PRAGMATIC	The level of the rate of interest is the result of a « convention » – which may be « bad »	« Orthodoxy » is a major concept, but not explicitly linked to the twin concept of convention → displace it by minimal changes (It amounts to devise a new model/theory, without breaking with the econ. Language)
RADICAL	The level of the rate of interest is the result of a « convention » – which may be « bad »	« Orthodoxy » is a major concept, and explicitly linked to the concept of convention – it becomes a «bad » convention → replace it (but how ? It amounts to creating, alone, a new language)

2. THE 'WITTGENSTEIN HYPOTHESIS' AND KEYNES'S VIEW OF ECONOMIC THEORY AS A SOCIAL PRACTICE

PLAN

- 2.1. The pervasive question of language in GT
- 2.2. Wittgenstein 1 & Wittgenstein 2 :
 - (a) the connexion of language and the world ...
 - (b) ... is reversed ...
 - (c) ... and likewise the relation between ordinary and formal languages
- 2.3. Economic theory as a special language-game implying ordinary & formal languages
- 2.4. Lucas 1980 meets Keynes on key 3...
- 2.5. ...but not on key 3 bis
- 2.6. The emergence of orthodoxy as a convention

2.1. (a) The pervasive question of language in GT: keys 3 & 3 bis

Keys 3 and 3 bis deals with Keynes' view of what is doing economic theory (= the practice of the academic economists' community)

- Key 3 : economic theory consist in building models which are artificial (but consistent) worlds

- Key 3 bis : models are interpreted through an interplay between formal language and 'ordinary discourse'

→The question of language, thus formulated, introduces my hypothesis of a possible influence of Wittgenstein on Keynes, during the critical years 1929/35, when W was turning from his 1st to his 2nd philosophy of language, and Keynes from TM to GT

'Wittgenstein hypothesis' : { K1→K2 // W1→W2 }

2.1. (b) The pervasive question of language in GT: key 4

Key 4 introduces the concept of « ideas », as more important than vested interests

→ « Ideas » are obviously expressed in ordinary language, and models in a formal language; So we seem to have a methodological apparatus with at least 2 terms : ideas (ordinary language), models (formal language). But there is another term, candidate to play a role: « orthodoxy » (key 1), since it is clearly linked to « ideas » (and theories), and also to « convention » (key 2) . So we are eventually left with a 4-term framework.

Our hope is that the Wittgenstein hypothesis (*in its strong form*) will help us to go deeper in the understanding of the strange 4-term methodological apparatus of GT.

2.2. W1 & W2 : (a) the connexion of language and the world ...

Cf Hintikka, M.B. & J., *Investigating Wittgenstein*, Basil Blackwell, 1986

W1 :« In *Tractatus*, the naming relations are absolutely simple. The only thing you can say of the relation of a name to its object is that the name stands for the object.» (p.187)

W2: « W's crucial doctrine that language-games serve as links between language and reality makes its 1st full-scale appearance in the *Brown Book* [1934/35]. (...)It is remarkable to find the contrast between the idea of words as mere labels and the idea of words receiving their meanings from their use in practice (and not merely their use in language) clearly expressed as early as in the *Blue Book* [1933/34]. » (pp.194-5)

→ In one sentence : the « role of connecting language and the world » is assigned to language-games

2.2. W1 & W2 : (b) ...is reversed...

J.Searle interviewed by B.Magee , *The great philosophers*, BBC, 1987, p.326

« in his later work, [Wittgenstein] abandoned the picture theory of meaning in favour of a use or tool conception of meaning. (...) To get a correct conception of language we need simply to look at how it functions in real life, we need to look at what people do with words. (...)

His early view had the consequence that the structure of the real world determines the structure of language. But in his later work, it is, in a sense, the other way round. (...) the structure of our language determines the way we think of the real world. It determines what we count as one object or two objects; it determines what we count as an object at all »

2.2. W1 & W2 : (c) ...and likewise the relation between ordinary and formal languages

W1 (*Tractatus*) : The ordinary language has to be purified (→ with the help of formal language – ‘invented’ by Russell-Whitehead, *Principia mathematica*, to which Keynes referred, in his TP)

W2 (*Philosophical Investigations*) : there is nothing « above » ordinary language (« A main source of our failure to understand is that we do not *command a clear view* of the use of our words » PI, § 122)

2.3. economic theory as a special language-game, implying ordinary & formal languages

/1/ Economic theorizing is a ‘language-game’ consisting in translating « ideas » from ordinary language into self-contained and mathematically coherent « models » expressed in a formal language....

/2/ ...but with a final step consisting in returning to the ordinary language, to check whether the economic variables have not lost their ordinary meaning, for ordinary men.

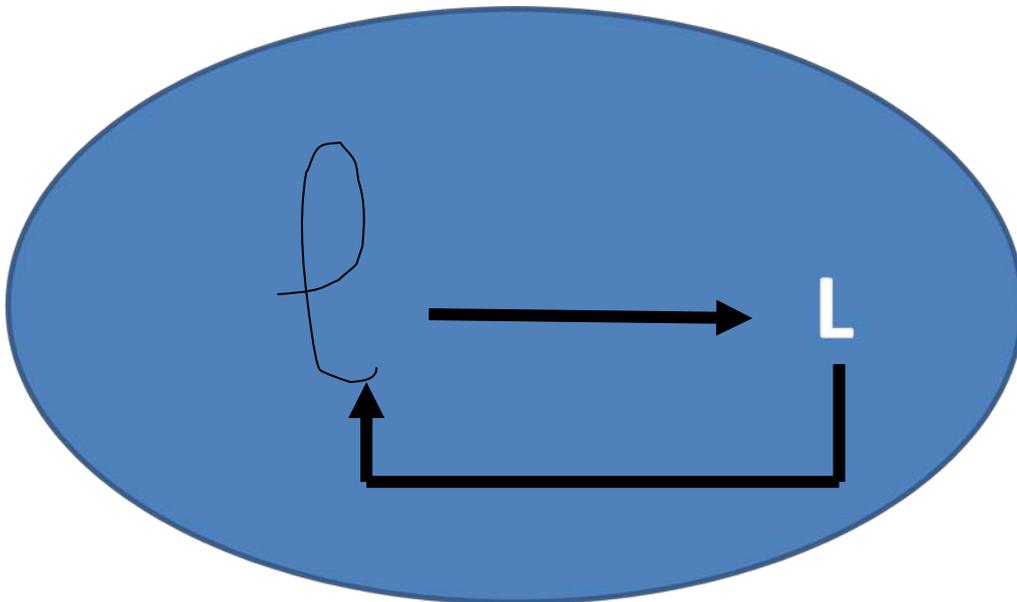
Short of this last step, the danger is to confuse the model and the reality, the map and the territory, and to institute a truncated view of reality, deaf and blind to all the objections issued from the ordinary world.

This confusion may give birth to « **orthodoxy** »...

ECONOMIC THEORY AS A LANGUAGE-GAME:

A SCHEME (WITHOUT ORTHODOXY)

e



LEGEND

e : ordinary language [linguistic vehicle : words / semantic content : IDEAS]
L : formal language [linguistic vehicle : variables in a model / semantic content : THEORIES]
→ = Construction (transfer)
← = Deconstruction (translation)

2.4. Lucas 1980 meets Keynes on key 3 ...

R.E. Lucas, « Methods and problems in business cycle theory », *JMCB*, november 1980

« One of the functions of theoretical economics is to provide fully articulated, artificial economic systems that can serve as laboratories in which policies that would be prohibitively expensive to experiment with in actual economies can be tested out at much lower cost. To serve this function well, it is essential that the artificial 'model' economy be distinguished as sharply as possible in discussion from actual economies. (...) This is the sense in which insistence on the 'realism' of an economic model subverts its potential usefulness in thinking about reality. Any model that is well enough articulated to give clear answers to the question we put to it will necessarily be artificial, abstarct, patently 'unreal'. (...)

At the same time, not all well-articulated models will be equally useful. (...) we need to test them as useful imitations of reality by subjecting them to shocks for which we are fairly certain how actual economies, or parts of economies, would react. The more dimensions on which the model mimics the answers actual economies give to simple questions, the more we trust its answers to harder questions. This is the sense in which more 'realism' in a model is clearly preferred to less » pp.696-7

« progress in economic thinking means getting better and better abstract, analogue economic models, not better verbal observations about the world » (p.700)

2.5. ...but not on key 3 bis

The PROBLEM : consider for instance the variable (name) « u » in the model : *what allows Lucas to say that it refers to the object « unemployment » in the real world ?*

Lucas : mimic the statistical behavior of the « real » economy

Keynes (key 3 bis)

- it is in the progressive and methodic alleviating of the restrictive assumptions (which requires the use of ordinary language) that we begin to fix the reference in the real world of the name « u » [in that sense we institute the reality]

- in the end, it remains a ultimate step, which should be to confront the meaning of the variable (the determination of which has just been elucidated with all the relevant complexity) with the meaning it has in ordinary language for the ordinary man (cf « what the word means »)

→ Two examples, one from Keynes, another one from one of his heir :

Example 1 : Pigou's *Theory of unemployment*

Letter to Robertson, 5 september 1933

« Moreover on p.102 (§4), he is assuming that all money income is necessarily spent on the purchase of current output. This is consistent with his previous assumptions, which are, between them, a sufficient condition for unemployment to be impossible. Thus his *Theory of unemployment* is only valid in conditions which ensure that there is no unemployment »

Cf Appendix, chap.19

« His title the 'Theory of unemployment' is, therefore, something of a misnomer. His book is not really concerned with this subject »

Example 2: Solow on the explanation of unemployment by Lucas

« On theories of unemployment », *AER*, march 1980 , p.7

« When they [the modern classical school] try to explain how the equilibrium volume of employment can fluctuate as widely as actual employment does in business cycles, their only substitute for Pigou's high elasticity of demand is a high elasticity of supply (of labor) in the face of perceived temporary opportunity for unusual gains (...). People who give the vague impression of being unemployed are actually engaged in voluntary leisure. (...) It is astonishing that believers have made essentially no effort to verify this central hypothesis. (...) It is hardly plausible on its face. (...) It is thus legitimate to wonder why the unemployed do not feel themselves to be engaged in voluntary intertemporal substitution, and why they queue up in such numbers when legitimate jobs of their usual kind are offered during a recession* »

* « I have tried to phrase that carefully. For some direct evidence, see 'Jobs and want ads: a look behind the evidence,' *Fortune*, Nov. 20, 1978 »

To give the last word to 'ordinary discourse' is just to give it to 'understanding' ?

« La preuve du social, elle, ne peut être que mentale. Autrement dit, nous ne pouvons jamais être sûrs d'avoir atteint le sens et la fonction d'une institution, si nous ne sommes pas en mesure de revivre son incidence sur une conscience individuelle. »

C.Levi-Strauss, *Introduction à l'œuvre de Marcel Mauss*, PUF, 1950

2.6. (a) The emergence of orthodoxy as a convention: 1st phasis

If the return to **ordinary language** is partial and defective, the initial **ideas** are protected from falsifications, then artificially vindicated, in spite of their narrowness. The connexion between ℓ and L becomes more and more **conventional** among economists (like a colonial army isolated from the indigenous population), at the level of the most basic assumptions – but (we admit) not at any other level, where competition may be fierce and creative (but within the limits of this restricted view of the **reality**).

2.6. (b) The emergence of orthodoxy as a convention: last phasis

Economists tend to live in a more and more conventional world, distinct of the ordinary world. At some time, this process may produce a situation where economists speak a theoretical language (mix of ℓ and L) which is unable to speak of some object belonging to the ordinary language (e.g. u), although it has a name for this object, the same name than in ℓ - but it has created a new reality, « better » than the ordinary one (expurgated from its non-rational elements according to the theoretical model). It looks as if, instead of ℓ revising L, it's L which settles an allied ℓ , ignoring the indigenous ℓ . Here is the emergence of **orthodoxy** – a **convention** about what deserves to count as Reality, for the scientists, and what has no such right (→ therefore its religious connotation ?)

2.6. (c) The emergence of orthodoxy as a convention: results for nowadays

Orthodoxy ≠ Paradigm

- A **paradigm** is defined by the objects which *must* be dealt with, and the way in which they must be dealt with. It is compatible with a significant degree of reflexivity

- **Orthodoxy** is organized around objects that *cannot* be dealt with (in spite of the sameness of vocabulary) and/or the methods which cannot be used. It is contradictory with a significant degree of reflexivity : indeed it's defined by a minimal degree of reflexivity about the most fundamental, or 1st order assumptions (and a maximal degree about 2nd, 3rd order, etc., assumptions)

→The problem for heterodoxy is not (only) to devise a new theory, nor to launch a new paradigm, but to invent a new theoretical language – and that difficulty is one more element protecting orthodoxy....

2.6. (d) The emergence of orthodoxy as a convention: an example to-day

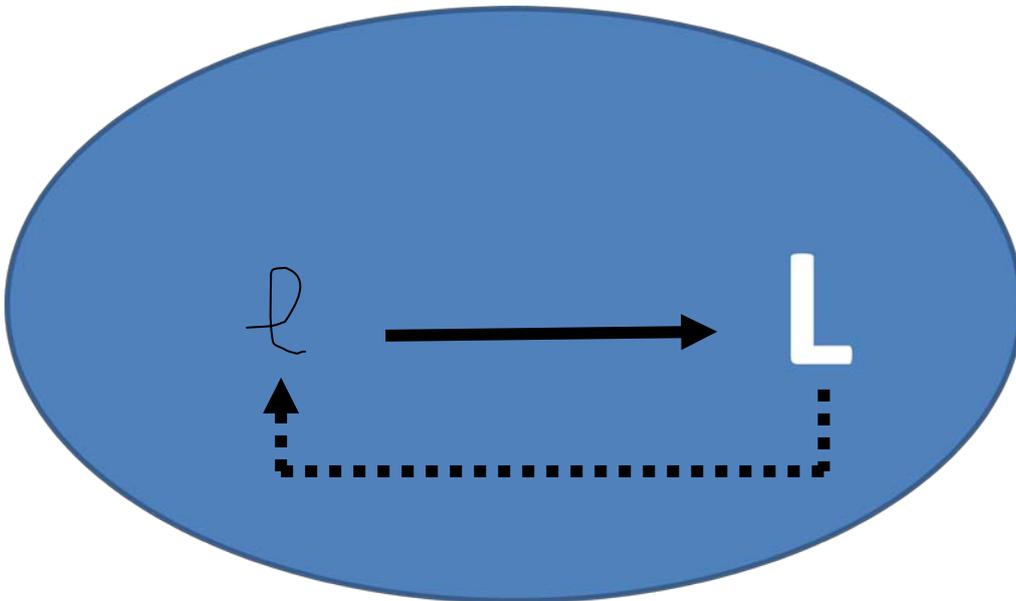
MODELS Of the Labor Market	THEORIES (« espoused » theoretical ideas)	IDEAS (implicit but deductible from the models)	IDEAS (more deeply hidden)
Search models	Unemployed people are rational	U due to too high reservation wages	To illuminate ...
Implicit contracts	Firms as an insurance company	U due to rigid wages in bad times	...(in) voluntary nemployment...
Trade-Unions	Bargaining on wages and employment	U due to too high an agreed wage	...It is not necessary...
Efficiency wage / Principal Agent	Wage as a management tool	U due to too high a wage (independent of the market)	...to look outside ...
Insider Outsider	Recruitment costs as a lever for incumbent workers	U due to too high a wage , imposed by employed people	...the labor market (isn't it a market, after all! ?)

ECONOMIC THEORY AS A “LANGUAGE–GAME” :

A SCHEME (WITH ORTHODOXY)

*« But, soon or late, it is ideas,
not vested interests,
which are dangerous
for good or evil »*

e



LEGEND

- e** : ordinary language [linguistic vehicle = words / semantic content = IDEAS]
L : formal language [linguistic vehicle = variables in a model / semantic content = THEORIES]
→ = Construction (transfer)
← = Deconstruction (translation)

CONCLUSION

1. Reactions from orthodoxy

- Keynes, *GT Preface*, 1936,p.XXI
« Those who are strongly wedded to what I shall call ‘the classical theory’, will fluctuate, I expect, between a belief that I am quite wrong, and a belief that I am saying nothing new »
- Akerlof, *Explorations in pragmatic economics*, OUP, 2005, pp.3-4
« I wrote ‘the market for lemons’ in 1966/67 (...) and submitted it (...) to the AER, which in short order rejected it. The editor returned it without any referee reports (perhaps a case of asymmetric information). His letter said that AER did not publish articles so trivial. I spent the academic year 1967/68 in India, where I revised the paper (...). I sent the new version , first to the RESd, and then to the JPE. They also both rejected it. These editors indicated that if this was economics, then *economics* would be something very different. Only on a 4th try, in 1968, did I finally obtain acceptance of the article, at the QJE »

2. Reactions to orthodoxy

- **Keynes** : « I was wanting to convince my own environment and did not address myself with sufficient directness to outside opinion. Now three years later, having grown accustomed to my new skin and having almost forgotten the smell of my old one, I should, if I were writing afresh, endeavour to free myself and state my own position in a more clear-cut manner »
Preface to the French edition, feb.1939
- **Wittgenstein** : « Once the new mode of thought is established, the old problems disappear; indeed, it becomes difficult to to grasp them again. For they have their locus in the mode of expression. And if it is replaced by a new one, then the old problems fall with the old garment » , *Remarques mêlées*, date : 1945 [my translation from german/french]

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