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## Alternative Explanations of How the Capitalist Economy in Which We Live Operates

To understand why so many elite talking heads on TV and in the printed media did not see the global financial crisis coming, and why they can not readily explain policies that make prosperity an everlasting property of the economic system in which we live, the reader must first understand that there are two very different explanations (theories) of how the economic system that we call capitalism works. These are: (1) the classical theory and (2) the Keynes–Post Keynesian theory.

Unfortunately, to confuse matters, the classical theory has many sub classifications that go under different names although, as we will explain, all use the basic classical assumptions as their fundamental foundation. The classical theory sub classifications are

- (1a) the free market theory as championed by Nobel Prize economists [e.g. Milton Friedman, Robert Lucas] of the University of Chicago,
- (1b) Neoclassical Synthesis Keynesianism theory associated with Nobel Prize winning economists [e.g., Paul Samuelson, Robert Solow] of the Massachusetts Institute of Technology, and

- (1c) New Keynesianism theory associated with Nobel Prize winning economists [e.g., Paul Krugman of Princeton University and Joseph Stiglitz of Columbia University].

Advocates of subdivision (1b) and (1c) claim that their theory is developed from the general theory created by the English economist John Maynard Keynes in his 1936 book entitled “The General Theory of Employment Interest and Money”. The vast majority of economists who teach in academia and/or who are advisors to governments, central banks, and financial institutions have not read Keynes but still believe these classical subdivisions (1b) and (1c) are accurate representations of Keynes’s book. We will show, however, that these classical so called “Keynesian” theories’ are built upon assumed foundations that are actually incompatible with Keynes’s explanation of the operation of our money using, market oriented economic system.

The acceptance of these classical subdivisions as “Keynesian” theory—although they are not Keynes—have encouraged politicians and governments to adopt policies advocated by these so-called “Keynesians”, but these policies have brought about some bad economic outcomes, e.g., stagflation (i.e., price inflation while the economy suffers from high levels of unemployment), outsourcing of domestic jobs under the banner of free trade, and the growing inequality of income and wealth in developed capitalist economies. This increasing inequality has hollowed out the prosperous middle class that had developed since Second World War. As these unfortunate outcomes have been associated with classical “Keynesian” policy advice, consequentially these outcomes have created fear among politicians and ordinary citizens of any policies associated with the name of John Maynard Keynes. Today, almost all politicians are afraid of any policy labelled “Keynesian”.

The main purpose of this book is to explain (1) why the Keynes–Post Keynesian explanation of the operation of the monetary, market oriented economic system we call capitalism is more appropriate for understanding the operation of our economic system than either the free market classical theory or any of the aforementioned classical sub class “Keynesian” theories and then (2) to suggest Keynes–Post Keynesian economic policies to remove the flaws in the capitalist

system and thereby cure threats of financial crisis, of inflation, the loss of domestic jobs and the growing national inequality of income and wealth.

But first, let us provide a brief Keynes–Post Keynesian explanation of the global financial crisis of 2007–2008 to respond to the query of Queen Elizabeth what caused the financial crisis that apparently no economic advisors to governments saw developing.

The financial crisis that began in 2007–2008 started as a small default problem on some subprime mortgages that had been issued in the United States. These defaulting sub prime mortgages were part of the mix of created derivative securities that are known as mortgage backed derivatives. Holders of these derivative securities could neither easily discern how much of the mix of mortgages underlying their securities were sub prime mortgages nor who were the actual borrowers of all the mortgages or the value of the houses being mortgage financed that made up the mix underlying their particular derivative securities.

When the sub prime mortgage borrowers in the mix of some of these derivative securities began to default, the holders of all this complex derivative securities began to fear that the mortgages in their specific derivative security holdings might also soon fall into default. Consequently many derivative asset holders tried to sell their securities in order to make fast exits from the markets for these derivative assets as the fear of potential defaults spread. With derivative holders rushing to exit the derivative securities market while practically no one were willing to buy more of these derivative securities, the market prices of these derivatives crashed.

The accepted accounting rule required liquid assets held in one's portfolio be "marked to market", i.e., the balance sheet valuation of these securities are determined by their market price. When the market price of mortgage backed derivatives crashed, the result was to collapse the value of the asset side of balance sheets of all individuals and institutions that held these derivatives, threatening these holders with potential insolvency or even worse.

This effect quickly ballooned globally into the largest threat to economic prosperity since the Great Depression. What is rarely noted is that the origin of this latest global financial market crisis, like the New

York Stock exchange crash of 1929 that appears to have precipitated the Great Depression, is associated with the loss of market value of securities operation in free financial markets unhampered by government regulations.

In recent decades, many mainstream academic economists, central bankers such as Alan Greenspan, as well as most policy makers in government and their economic advisors have advocated freeing financial markets from government rules and regulators. These free market advocates insist that

1. government regulation of markets and large government spending policies are the cause of our economic problems,
2. market participants have their own self-interest in mind and therefore they “know” how to behave in these free markets to optimize their position and therefore
3. ending big government and freeing markets from regulatory controls are the solutions to our economic problems.

In an amazing “*mea culpa*” testimony before the House Committee on Oversight and Government Reform on October 23, 2008, Alan Greenspan, the former Chair of the Federal Reserve System and a strong advocate of unregulated free markets, admitted that he had overestimated the ability of free financial markets to self correct any problems that may occur. Greenspan indicated that he had entirely missed the possibility that deregulation could unleash a destructive force on the economy. In his testimony regarding the onset of the global financial crisis, Greenspan stated:

“This crisis, however, has turned out to be much broader than I could have imagined...those of us who had looked to the self interest of lending institutions to protect shareholders’ equity (myself especially) are in a state of shocked disbelief...In recent decades a vast risk management and pricing system has evolved, combining the best insights of mathematicians and finance experts supported by major advances in computer and communications technology. A Nobel Prize [in economics] was awarded for the discovery of the [free market] pricing model that underpins much

of the advance in [financial] derivatives markets. This modern risk management paradigm held sway for decades. The whole intellectual edifice, however, collapsed.”

Under questioning by members of the House Oversight and Government Reform Committee, Greenspan admitted “I found a flaw in the models that I perceive is the critical functioning structure that defines how the world works. That’s precisely the reason I was shocked... I still do not fully understand why it happened, and obviously to the extent that I figure it happened and why, I shall change my views”.

In other words, Greenspan has noted that free financial markets do not function as his classical theory says they should. We shall explain to Greenspan and other elites the flaw in their classical theory explaining the “functioning structure” of the world market economic and financial system works.

## Theory Provides Explanation

Since biblical times, humans have tried to understand the things they observe happening around them. In general, the human mind believes that there must be a cause for any event we observe. For most of the history of mankind, human belief attributed to the design of God or the Gods as the cause of anything that happened.

In the seventeenth century, philosophers began to argue that explanations of observed events could be developed on the basis of reasoning of the mind. In this intellectual movement that historians called the Age of Reason or Enlightenment, order and regularity was seen to come from human analysis of observed phenomena. The power of truth was not in the possession of truth but in its acquisition. The goal was to understand and explain observed processes occurring in our world.

To this end, it was essential to develop theories that would explain observed phenomena. Any understanding of the world we observe will be the creation of the human mind. Reasoning involves the mind creating a theory to explain what people observe happening. A theory is essentially the way humans attempt to explain observed phenomena on

the basis of a logical model that is built on the foundation of some fundamental axioms (presumptions). An axiom is an assumption that the theorist model builder accepts as a self evident universal truth that does not have to be proven. From this axiomatic assumptions foundation, the theorist uses the laws of logic to build a theory that reaches one or more conclusions.

In economics these conclusions are presented to the public as the explanation of economic events that are occurring, or will occur, in our world of experience. The theory is then used to suggest what can, or cannot be done, to affect future economic outcomes. If the facts of experience conflict with what are the logical conclusions of one's economic theory, as Greenspan admits happened in his theory of free financial markets, then one or more of the theory's fundamental axioms are flawed. The theory is unrealistic and should be discarded in order to permit a different—more realistic—theory to be built. The alternative to developing a better theory would be to change the facts—or even one's definition of the facts—to fit the unrealistic theory.<sup>1</sup>

No theory is ever accepted as the final explanation of observed events. Rather theories are accepted until they are supplanted by “better” theories. Typically the better theory requires fewer restrictive axioms for its foundation than the older theory it replaces.

One can consider the builder of any economic theory as if he/she is a magician. Theorists rarely make logical errors in moving from axioms to conclusions any more than a professional prestidigitator drops the deck of cards while performing a card trick. Most economics theorists are proficient at creating the illusion of pulling policy conclusion rabbits out of their black hat model of the operation of the economy. Often the policy rabbits pulled from the black hat model generates some audience enjoyment and applause.

A careful examination of the [axiomatic] rabbits the magician [economic theorist] put initially into the black hat back stage is required to evaluate the relevance of the policy rabbits pulled from the black hat on stage. Before accepting the logical conclusions of any economic theory as correct and therefore applicable to our money using, market oriented economic system, central bankers such as Alan Greenspan, government

officials, business executives, politicians and the general public should examine and be prepared to question the fundamental assumptions of any theory. If these assumptions are not applicable to our economic world, then the policy conclusions of this theory must be rejected as irrelevant and even possibly harmful.

## Alternative Theories

There are two fundamental economic theories that attempt to explain the operation of the market oriented, money using, capitalist economy in which we live-classical theory and Keynes-Post Keynesian theory. The classical economic theory that has tended to reign supreme in mainstream economic circles since the latter part of the eighteenth century. There are many versions of this classical theory that go under different names but all are based on some of the same fundamental assumption foundation. The labels for these versions include efficient market theory, Walrasian theory, general equilibrium theory, dynamic general equilibrium theory, Austrian theory *and* mainstream “Keynesian” theories including the neoclassical synthesis Keynesian theory developed by Nobel Prize winner Paul Samuelson and the New Keynesian theory developed by students of the Samuelson neoclassical synthesis Keynesian approach. The proponents of these variants of the classical axiomatic analysis may differ on the details of their analysis but the mantra of all these approaches is that, in the long run, if markets possess freely flexible wages and product prices, then these markets will ultimately assure a fully employed economy that provides as much prosperity as its resources can produce. The basic axiomatic foundation of all these theories is the assumption that all market participants can “know” the economic future market outcomes from here to eternity<sup>2</sup> if not with perfect certainty, at least with knowledge of the objective probability risks involved and therefore with actuarial certainty. Accordingly all decision makers in these assumed “certain future” model can foresee any crisis coming and, in their own self interest, take any action necessary to avoid such a crisis from harming their own self-interest. Thus the classical system basic “known future” assumption led Greenspan to state in his congressional

testimony, this classical theory told him that the function of managers of lending institutions would know the “self-interest of lending institutions to protect shareholders’ equity” and therefore these managers would prevent their lending intuitions from taking the mistaken purchasing and holding securities action in the mortgage backed derivatives market. The theory indicated it was the function of the managers to “know” that at a specific future date the defaults of the subprime portion of the derivative securities will result in the market price collapse which destroyed much of the equity of shareholders. If the managers knew the future they would protect equity by selling these securities before the price collapse.

The Keynes–Post Keynesian liquidity theory of a market oriented economy, on the other hand, presumes business managers make important production decisions while realizing they do not know with certainty what is going to happen in the future. The fundamental assumption basis of Keynes’ theory is (1) time is a device that prevents everything from happening at once, so that decisions made today will have their pay-out result at some future date days, weeks, months or even years in the future and (2) the economic future is uncertain and not readily predictable. Clearly there is a major difference between the classical view of a known predictable future and the Keynes’ assumption that the economic future is uncertain and cannot be reliably predicted today.

In the Keynes theory, managers have to make decisions today regarding the level of production, employment, pricing, etc. without knowing for certain what the future results will be of these decisions. Accordingly, the development of legal forward money contracts for market transactions commits both parties to a contractual action at a specific future date. The buyer on the contract can meet his/her commitment by the payment of a contractual specified sum of money. The seller can produce the item being sold at the specified contract date, or, if for any reason, the seller cannot deliver the item, he/she can meet this contractual commitment by paying the buyer a sum of money sufficient to cover the costs that the buyer experiences when the delivery is not made. Accordingly, the possession of liquidity, i.e., the ability to meet all legal money contractual obligations becomes an important aspect of all economic actions of all decision makers in the market economy.



The government has the duty to ensure enforcement of all these legal money contractual obligations. This permits decision makers to be relatively certain about contractual cash inflows and outflows over the otherwise uncertain future.

Thus, in the world in which we live, the government provides the institutions of money and money contracting *for all market transactions* whether they be for immediate (spot) transaction or for a forward specific transaction at a future date. *The sanctity of the money contract is the essence of the capitalist economic system* and the basic axiom of the Keynes theory.

All variants of classical theory, on the other hand, ignore money contracts by presuming all market transactions are made in terms of “real contracts” where, in essence, goods trade for goods between the transactors—as it would be in a barter economy. In other words, the classical explanation presumes the economy operates “as if” it is a barter economy.

Moreover since classical theory assumes that all decision makers can know the future, it follows that when a “real contract” is made in a free market system, both self-interested parties to the real contract “know” they will have the necessary real resources to meet their real contractual commitment. There can never be an honest market default in the theoretical classical system. Hence there is no need for government interference in the market place.

The conclusion of the Keynes–Post Keynesian system, however, is that the government, as the developer and enforcer of the money contracting system, can cure, with the cooperation of private industry and households, some major economic flaws that can occur in the operation of a capitalist market-oriented, money using economy when, in the absence of government action, unfettered greed and/or fear is permitted to dominate economic market transaction decisions.

Keynes produced a theory that would explain why there could be massive unemployment even in a competitive market economy that possesses perfectly flexible wages and prices but also uses money contracts for all market transactions. Accordingly, liquidity can be an important factor in making market decisions.

As Keynes stated:

“The classical theorists resemble Euclidean geometers in a non-Euclidean world who, discovering that in experience straight lines apparently parallel often meet, rebuke the lines for not keeping straight -as the only remedy for the unfortunate collisions which are occurring. Yet, in truth, there is no remedy except to overthrow the axiom of parallels and to work out a non-Euclidean geometry. Something similar is required today in economics.”<sup>3</sup>

By overthrowing restrictive classical axioms Keynes developed a general theory that was equivalent to his call for a non-Euclidean type of economic theory. Keynes argued these classical axioms are not applicable to the monetary economy in which we live where entrepreneurs organize the production process by hiring workers to produce goods and services to be profitably sold for money in the market place.

The collision of apparent straight lines in a non-Euclidean world was the equivalent of classical economists observing massive unemployment in their world while their theory suggested that the competitive market economy should provide full employment for all who want to work. To the extent these classical theory economists observed the existence of unemployment, they explained that the unemployed workers were at fault for not being willing to accept a job at a lower market wage—a wage where all could be fully employed. In other words, the victims (unemployed workers) were blamed for their unemployment!

Keynes suggested that it was not the refusal of workers to accept a lower wage for getting employment that was the problem. Classical economic theory which professes that if workers would only accept lower wages all who wanted to work would be employed was not applicable to our economic system. Keynes argued that classical theory was a theory whose “teaching is misleading and disastrous if we attempt to apply it to the facts of experience”.<sup>4</sup>

Unfortunately even in our time many so-called experts in economics—including Nobel Prize winners—continue to develop sophisticated models that still possess the fundamental axioms of classical economic theory that Keynes argued had to be discarded. Since these classical axioms lie below a mountain of mathematical and statistical computer analysis, they are difficult for the average person or even many trained

economists to recognize. Nevertheless, the result of using these very technical classical axiomatic models have encouraged decisions by policy makers and regulators that are often misleading and disastrous—as Alan Greenspan admitted in his Congressional testimony.

## Notes

1. I must admit that sometimes such changes of the facts happen in academia. For example Milton Friedman changed the definition of savings in his Permanent Income Theory to get the redefined facts to support his classical analysis. Keynes and most people would define savings as that portion of current income that is not used to purchase any producible goods. Friedman defines savings out of current income as equal to the purchase price of a newly produced durable goods, e.g., a new automobile. Since the automobile was expected to last for years, only the depreciation of the automobile in the current period is defined as consumption. The rest of the purchase price is defined as savings, where the utility (usefulness) of the auto was saved to be consumed as depreciation in each future period over the auto's useful life.
2. Nobel Prize winner Paul Samuelson wrote a book entitled *Foundations of Economic Analysis* (1947) *Harvard University Press* which insists that any valid economic theory must have “Walrasian microfoundations” so that every decision maker in the system knows the market prices of everything not only today but for every day in the future.
3. *Op. cit.*, p. 16.
4. *Op. cit.*, p. 3.

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