The Locus of Keynes's Philosophical Thinking in The General Theory: The Concept of Convention

John B. Davis
Marquette University, john.davis@marquette.edu

I have argued elsewhere (Davis, 1989, 1991a, 1991b) that the criticisms addressed to Keynes's earlier philosophical thinking as initiated by Frank Ramsey, together with his own sense of the limitations of his earlier philosophy, led Keynes to reformulate his understanding of the central concept of his early philosophy, namely, the concept of intuition. This conclusion follows from Keynes's later philosophical statements and claims, first in his assessment of his early philosophy in 'My Early Beliefs', and second in his comments on economic method in letters to Harrod, where Keynes's earlier conception of the individual and society is extended and redeveloped to include a new emphasis on convention and a new understanding of intuition and judgement. On this new view, intuition and judgement are dependent upon and function within a system of interdependent belief expectations in which individuals find themselves embedded, so that it is no longer sufficient to explain the content and character of a particular individual's judgements and decisions in terms of a pure, unmediated intuition, but rather necessary to account for the manner in which a particular individual's judgements reflect different individuals' similar or like judgements in similar circumstances.

These conclusions flow directly from consideration of Keynes's philosophical development. Yet clearly what dominated Keynes's intellectual development in the years subsequent to his initial concern with philosophy was his struggle with the problems of economic theory and policy. This conceptual terrain was almost entirely removed from the language and interests of his early philosophy, and indeed philosophy in general, so that it cannot be said that Keynes's philosophical development was directly focused upon matters of philosophical significance, as would have been the case had his intellectual career taken the path upon which it had originally embarked. Keynes's philosophical development, thus, proceeded at two removes from the natural objects and preoccupations of philosophy. It did not make the traditional problems of philosophy its primary vehicle, and it also required translation from a different set of issues and a different way of thinking that occupied an increasing share of his intellectual activity. What this implies is that though one can trace the outlines of Keynes's later philosophical devel-
158  Method, competition, conflict and measurement

The task of those who seek to explain Keynes's philosophical thinking, therefore, is to demonstrate how Keynes resolved problems specifically in economics as a philosophically self-conscious thinker. Practically speaking, this is to explain the philosophical commitments of Keynes's later economics in a manner consistent with Keynes's own philosophical interests and history of philosophical thinking. Yet as a matter of emphasis, it is not to attach Keynes's later economics to his philosophy, as does the most recent literature that favours his early views (Carabelli, 1988; O'Donnell, 1989), but rather to find out how Keynes's philosophical commitments evolved with his economics and largely in their service.

To proceed on this score is to turn attention to The General Theory. Only after an examination of the philosophical dimensions of this work will it make sense to further discuss Keynes's later philosophical thinking. As preparation for that larger project, in what follows Keynes's conception of the workings of the economy in The General Theory will be set forth, with special attention to his emphasis upon the concept of convention. The concept of convention is both central to the argument of The General Theory regarding equilibrium unemployment, and was also singled out after the publication of The General Theory by Keynes in 'My Early Beliefs', as his chief later philosophical concern. Moreover, its elaboration in the locations in The General Theory in which the concept appears, bears strong connection to Keynes's comments to Harrod about economic method. The discussion below first summarizes Keynes's general argument in The General Theory, and then turns to an analysis of the role of convention in this argument.

The argument of The General Theory

In recent years there have been many good accounts of Keynes's argument in The General Theory (e.g., Chick, 1983; Kahn, 1984; Amadeo, 1989; Rogers, 1989; Asimakopulos, 1991). Keynes himself summarizes his argument in Chapter 18, 'The General Theory of Employment Re-stated'. He starts out by explicitly identifying the factors that are given, the independent variables, and the dependent variables. The 'ultimate independent variables' are:

(1) the three fundamental psychological factors, namely, the psychological propensity to consume, the psychological attitude to liquidity and the psychological expectation of future yield from capital assets, (2) the wage-unit as determined by the bargains reached between employers and employed, and (3) the quantity of money as determined by the action of the central bank (Keynes, VII, pp. 246-7).
These variables determine at any one time an economy's national income and its quantity of employment, the dependent variables whose explanation is the primary object of The General Theory. They are also variables that Keynes says are susceptible to influence and in some instances subject to deliberate control or management by central authorities to promote full employment levels of national income and output. Keynes summarizes his argument as follows (Keynes VII, pp. 247–9).

Focusing upon new investment as the crucial form of expenditure, Keynes notes that new investment proceeds to the point at which the supply price of each type of capital asset, taken together with its expected yield in the future earnings it is likely to generate, makes the marginal efficiency of capital equal to the rate of interest. This immediately presupposes states of activity for three of the independent variables noted above, the 'psychological expectation of future yield from capital assets', or as Keynes also describes it, the 'state of confidence' (Keynes VII, p. 248) concerning prospective yields, the psychological attitude to liquidity, and the quantity of money as determined by the actions of the central bank, which together thus determine the rate of new investment. New investment then brings forth new consumption, yet, according to the marginal propensity to consume, another of Keynes's independent variables, in an increment less than the increment to income stemming from the new investment. The ratio of new investment to additional income is termed the investment multiplier; by regarding it as equivalent to the associated employment multiplier, the increment to employment attendant upon the new investment can be established. Higher income then raises the schedule of liquidity preference by increasing the demand for money, which, given the quantity of money as determined by actions of the central bank, raises the rate of interest until new investment is halted.

The position of equilibrium, with values for national income and employment, need not of course be a full employment equilibrium. Indeed, in Keynes's view, the capitalist economic system is 'capable of remaining in a chronic condition of sub-normal activity for a considerable period without any marked tendency either towards recovery or towards complete collapse' (Keynes VII, p. 249). This state of affairs derives from the levels achieved by the independent variables Keynes isolates, or more specifically, from the state of activity exhibited by the psychological propensities or attitudes he believes of central importance. But what does it mean to say that a particular psychological propensity or attitude, for example, the psychological attitude toward liquidity, exhibits a particular state of activity? In determining equilibrium income and employment this question does not arise, since the levels of the independent variables, and the state of activity of each psychological propensity, are taken as given for that purpose. Yet The General Theory does more than demonstrate that unemployment may exist in equilibrium; it also
considers how this state of affairs is tied to the development of a monetary economy that has made the psychological propensities Keynes isolates the chief determinants of income and employment. From this historical perspective, the question of how the psychological propensities isolated achieve their respective states of activity becomes important. Indeed, Keynes asserted that his selection of independent variables was in part motivated by a conviction that these particular psychological propensities and attitudes were potentially subject to influence by central authorities. More needs to be said, then, about the nature of the psychological propensities and attitudes that underlie the argument of *The General Theory*, and more in particular about Keynes's philosophical understanding of the concept of a psychological propensity.

To begin, it helps to emphasize that Keynes's summary view of his argument, with its focus upon new investment expenditure, gives primary attention to two of the three 'fundamental' factors he identifies, the psychological attitude toward liquidity and psychological attitude toward or state of confidence concerning the future yields from capital assets. These attitudes, it should be noted, are also the subject of Keynes's most emphatic statements in *The General Theory* about the conventional character of economic behaviour. In his discussion of the incentives to liquidity Keynes asserts, '[i]t might be more accurate, perhaps, to say that the rate of interest is a highly conventional, rather than a highly psychological, phenomenon. For its actual value is largely governed by the prevailing view as to what its value is expected to be' (Keynes VII, p. 203). In discussing long-term investment expectations, Keynes states that the valuation of investments cannot be accomplished solely through mathematical calculation, but depends upon a convention in organized investment markets that 'the existing state of affairs will continue indefinitely, except in so far as we have specific reasons to expect a change' (Keynes VII, p. 152). The chief psychological propensities at issue in Keynes's view of the economy, then, are thought to require explanation in terms of the notion of a convention. Keynes's (Chapter 18 summary) view of the operation of the capitalist market economy, accordingly, itself needs to be understood in this way. How is this to be done?

In *Macroeconomics After Keynes*, Victoria Chick asserts that at an important point in the transition from his thinking in the *Treatise on Money* to that in *The General Theory* Keynes came 'to the astonishing conclusion that the chief cause of unemployment is not so much that the real wage is too high, but that the rate of interest is too high' (Chick, 1983, p. 10). That the rate of interest could be too high meant for Keynes that the array of empirical, psychological, and institutional factors (such as bank policy, lenders' and borrowers' attitudes toward risk and liquidity, etc.) which determined the rate of interest possessed a configuration relative to the configuration of those empirical, psychological, and institutional factors (such as employers' and...
employees' bargaining strengths, relative wages, etc.) which determined the wage-unit that left income and output below full employment levels. Put differently, that there existed unemployment was ultimately to be explained by the inertial evolution of conventional attitudes and predispositions regarding finance and the labour market that locked the interest rate and the real wage in non-market clearing relations to one another. As emphasized by Colin Rogers (1989), for Keynes the Wicksellian notion that there exists a real or natural, long rate of interest that constitutes the ultimate anchor to which all other variables ultimately freely adjust is without foundation and intellectually naïve. It is market forces, rather, which the historical evidence demonstrates are constrained to adjust to conventional non-market, historically and socially determined institutional arrangements, and it is these, in fact, that thus constitute the centre of gravitation for the economic system as a whole. Should, then, the demand for liquidity as determined by such forces be especially high, it is because of institutional and psychological developments in the historical evolution of financial markets that, given long-standing, conventionally established levels for real and relative wages, leave the interest rate too high to justify the new investment needed for full employment.

Income and employment are then determined by the level of effective demand this state of affairs permits. Here Keynes's argument and its view of market forces in the labour market is familiar.

The propensity to consume and the rate of new investment determine between them the volume of employment, and the volume of employment is uniquely related to a given level of real wages—not the other way round. If the propensity to consume and the rate of new investment result in a deficient effective demand, the actual level of employment will fall short of the supply of labor potentially available at the existing real wage, and the equilibrium real wage will be greater than the marginal disutility of the equilibrium level of employment (Keynes VII, p. 30).

The principle of effective demand, by way of the dependence of investment upon conventional attitudes toward liquidity and prospective yield, is thus in significant degree detached from the logic of market forces. Indeed, when entrepreneurs determine their offers of employment in light of their (short-term) expectations of sales and earnings, they put aside concern with the effects of possible wage changes on desired output, and focus their primary concern simply upon the level of expected sales. Relatedly, from the perspective of the economy as a whole, Keynes often emphasized that any economy-wide wage deflation might well negatively affect effective demand. In combination, then, the attitude toward liquidity, with its effect on the interest rate, and the attitude toward prospective yields, with its impact on long-term
expectations, jointly serve to determine income and employment, and both
behaviours, clearly, are for Keynes pre-eminently conventional in nature.
That Keynes's argument in *The General Theory* takes this form is not
always well appreciated. No doubt this is partly due to the fact that the short-
period equilibrium focus of the book makes investigation of the further
determinants of the argument's independent variables, or what might explain
the states of activity the different psychological propensities and attitudes
exhibit, a less immediate objective. But surely also important is the fact that
this latter investigation is largely an historical-social one that lacks the well-
defined, formal character of the income determination argument. As Keynes
emphasized to Harrod, economics is an art or way of thinking that makes
unusual demands upon the economist, and 'good economists are scarce,
because the gift for using "vigilant observation" to choose good models,
although it does not require a highly specialised intellectual technique, ap­
ppears to be a very rare one' (Keynes XIV, p. 297). Here, the successful
exercise of this 'art or way of thinking' is taken to require a deeper under­
standing of the psychological attitudes and propensities Keynes believes
central to the determination of income and employment, and 'vigilant obser­
vation' in choosing such models to depend upon grasping the precise role
that conventions play in establishing the state of activity of these attitudes
and propensities. More can be understood about Keynes's own thinking in
this regard by turning to own analysis of average expectation and the struc­
ture of convention.

**Convention and average expectation in Keynes's argument**

For Keynes, conventions are responsible for determining the general level or
state of activity displayed by the psychological propensities and attitudes at
work in the economy. Yet psychological propensities and attitudes manifest
themselves in varying degrees in different individuals, and thus it is more
useful and more informative to say that Keynes's interest in conventions was
ultimately directed toward explaining how conventions act to structure differ­
et individuals' psychological propensities and attitudes in relation to one
another – alternatively how conventions relate the degrees to which psycho­
logical propensities and attitudes operate across different individuals. This is
borne out most clearly in Keynes's often-cited Chapter 12 explanation of the
role convention assumes in determining long-term investment expectations.
It can readily be seen, however, that Keynes's analysis there is quite general,
and as such, applies in similar fashion to his treatments of the differences
between individuals regarding the attitude toward liquidity, the propensity to
consume, relative wages, and entrepreneurial behaviour in the short-period.
How, then, does Keynes understand convention in his account of long-term
expectations?
Perhaps this question is best approached by first asking why it should be the case that the convention governing investment valuation – 'that the existing state of affairs will continue indefinitely, except in so far as we have specific reasons to expect a change' (Keynes VII, p. 152) – assumes the form that Keynes says it does. Why is it the case, that is, that organized investment markets tend to preserve the status quo – 'the existing state of affairs' – rather than, say, constantly challenge it? Keynes's characterization of the convention that operates in investment markets has as its background a number of important statements he makes regarding the origins of speculative activity in equity markets and stock exchanges. Chief among these is his statement that at the end of the nineteenth century, capital markets were not nearly so highly developed as they came to be in the first decades of the twentieth century when there emerged a significant separation between ownership and management in the typical business firm. Prior to that separation – when 'enterprises were mainly owned by those who undertook them or by their friends and associates' (Keynes VII, p. 150) – close involvement with the affairs of a business, and with the fundamentals of its operations, typically meant a steady commitment to that firm's growth. 'Decisions to invest in private business of the old-fashioned type were [...] decisions largely irrevocable, not only for the community as a whole, but also for the individual' (Keynes VII, p. 150). This decentralized, atomistic world of business, in which individuals had little interaction with one another in regard to decisions to invest and grow, was largely displaced by the emergence of a more mobile and versatile form of capital ownership, which permitted the daily transfer of wealth from one investment to another, and which threw investors together on centralized stock exchanges in their common pursuit of speculative gains. In this change in the site and character of investment activity, investors lost both their former isolation from one another, and their former hands-on knowledge of the operations of business. They gained the opportunity to daily compare their judgements and those of others, so that the modern investment process made investors far more interdependent, though at the same time less well acquainted by past standards with those considerations specific to particular firms' investment strategies.

In these circumstances, Keynes tells us, what constituted a good or bad investment came to be 'governed by the average expectation of those who deal on the Stock Exchange as revealed by the price of shares, rather than by the genuine expectations of the professional entrepreneur' (Keynes VII, p. 151). While one might be tempted to think that the reference to good or bad investment implies that the 'energies and skill of the professional investor and speculator' are to be largely devoted to acquiring a better knowledge than widely available, so as to permit 'superior long-term forecasts of the probable yield of an investment over its whole life', in Keynes's view the
investor’s ‘energies and skill’ are rather almost entirely devoted to ‘foresee­
ing changes in the conventional basis of valuation a short time ahead of the
general public’ (Keynes VII, p. 154). Thus, while ‘the social object of skilled
investment should be to defeat the dark forces of time and ignorance which
envelop our future […] the actual, private object of the most skilled invest­
ment to-day is “to beat the gun'', as the Americans so well express it, to
outwit the crowd, and to pass the bad, or depreciating, half-crown to the other
fellow’ (Keynes VII, p. 155). Average expectation regarding the worth of
various investments is thus not only removed from an informed acquaintance
with the underlying facts relevant to those investments, but really represents
no more than an average opinion of their worth – or, more accurately, Keynes
asserts, an opinion of ‘what average opinion expects average opinion to be’
(Keynes VII, p. 156).

Nonetheless, in such circumstance, or ‘under the influence of a mass
psychology’ as not surprisingly develops when average opinion seeks to
determine average opinion, the professional investor’s ‘behaviour is not the
outcome of a wrong-headed propensity’, but rather the inevitable ‘result of
an investment market organised along the lines described’ (Keynes VII, p.
155). This average expectation of an investment’s prospective yield, of course,
subsumes different individual expectations of prospective yields both above
and below that average. Different individuals accordingly have different
views of the value of any given investment, and their taking action in regard
to any particular investment opportunity depends upon their recognizing how
their particular expectations differ from the average. Different individuals
might thus be said to position themselves in investment markets relative to
average opinion in those markets, though, despite the importance of this
distribution for the daily play of trade between different investors, in the final
analysis it is average expectation – and end-of-the-day mean result of any
given distribution of individual investors acting upon their different, particu­
lar expectations – that is always visible to investors *en masse* in the form of
the final price that clears the market.

The historical background to Keynes’s treatment of convention, then, em­
phasizes the role of average expectation as a force in determining long-term
expectations. How are the ‘daily, even hourly, revaluations of existing invest­
ments carried out in practice? In practice, we have tacitly agreed, as a rule, to
fall back on what is, in truth a *convention*. The essence of this convention
[...] lies in assuming that the existing state of affairs will continue indefi­
nitely, except in so far as we have specific reasons to expect a change’
(Keynes VII, p. 151–2). More accurately, the convention in place regarding
investment behaviour is that average expectation is fairly taken to be correct,
extcept in so far as particular individuals find their own special circumstances
give them reason to think otherwise. Alternatively, any standing or broadly
accepted interpretation of the existing state of affairs is correct as representing the best, general knowledge or understanding available, and incorrect to the extent that particular individuals have special knowledge associated with their own individual circumstances which justifies their thinking otherwise. Put in these terms, a convention effectively combines two different forms of knowledge – general and individual – both of which individuals utilize to plan their different courses of action.

These two sorts of knowledge conventions deserve further comment. The general sort of knowledge or understanding that average expectation represents acquires its credibility from the fact that, because investors are less and less able to interpret the fundamentals of firms' operations, a knowledge of these firms' average performance gains in relative importance. The weakness of this sort of knowledge or understanding is that, as but a summary form of thinking, average expectation naturally subsumes a variety of individual opinions, some of which, no doubt, represent a more accurate estimation of the value of various investments. In contrast, the sort of understanding the special knowledge particular individuals often possess has as its strength the greater possibility of being better founded on the true determinants of an investment's value. The weakness of this sort of knowledge or understanding derives from the fact that, with the separation of ownership and management, this sort of individual knowledge or understanding is still deficient by comparison with the standard of close, in-house acquaintance with firm operations that explained individual knowledge before the modern separation of ownership and management.

Despite their comparative disadvantages – or better, precisely because of them – these two sets of counterbalancing considerations together dictate the way in which the conventional valuation of investments is established. Thus, on the one hand, we recognize that average expectation is ever-changing, and accordingly do not 'really believe that the existing state of affairs will continue indefinitely. We know from extensive experience that this is most unlikely' (Keynes VII, p. 152), and this reminds us that average expectation at best approximates a good knowledge of an investment's worth. At the same time, nonetheless,

We are assuming, in effect, that the existing market valuation, however arrived at, is uniquely correct in relation to our existing knowledge of the facts which will influence the yield of investment, and that it will only change in proportion to changes in this knowledge; though, philosophically speaking, it cannot be uniquely correct, since our existing knowledge does not provide a sufficient basis for a calculated mathematical expectation. (Keynes VII, p. 152)

That is, average expectation is still fairly taken to be 'correct' – despite its evident deficiency – on account of the fact that that standard by which it
might be discounted, namely, 'calculated mathematical expectation', is not typically available to us on 'our existing knowledge'. Indeed, a 'calculated mathematical expectation', were it to be possible or appropriate, would at the very least reflect an individual knowledge of the specific facts surrounding a particular investment. Yet since the separation of ownership and management, the in-house acquaintance with firm operations necessary for this knowledge and such a calculation rarely exists for most investors. Ironically, with this separation, the method of mathematical expectation gains in reputation with investors who, now distant from particular facts in their firm-specific contexts, seek a technique of judging the significance of collections of the various facts available to them that will improve on average expectation. As a result of this overall state of affairs, investment valuation becomes the product of an uneasy balance between an average expectation that is invariably wrong yet accepted and each individual's specific judgements which lack firm foundation yet offer at least the promise of doing better than average thinking. It is this combination that makes it necessary to regard a convention as a structure of expectations, a structure, it should still be emphasized, that is always rooted in a specific historical setting.

A conventional valuation of investments – indeed convention generally in The General Theory it can be argued – is thus constituted out of a structure of diverse opinion that bears a complex relationship to average opinion as its central reference. In this structure, it is the significance of average expectation as a central reference that explains why conventions favour the status quo. More will be said about the nature of the complex relationship between average and individual expectation that produces this result in the following section in regard to investment valuation. Here it should be emphasized that a convention in the sense set out here is a form of practical interaction that exercises a regulative effect on individuals via their recognition of the significance of average opinion, while at the same time accommodating action that departs from this central reference. Such a structure is normative in the most general sense in that it imposes an orientation upon individual behaviour without at the same time making that orientation binding. This is reflected in the fact that the content of ruling conventions typically change over time. What a particular investment is worth may generally be agreed upon to be one thing on one occasion, and yet generally agreed upon on another occasion to be something quite different. Convention seen from this perspective is a dynamic structure; in essence, the competing rationales that average and individual expectation offer guarantee regular change in the content of any convention, and this places a considerable premium upon 'vigilant observation' as central to the economist's craft.

Keynes of course addressed the important topic of the dynamics conventions exhibit in regard to the issue of their stability and precariousness.
Fundamental in this is his emphasis on the role played by the state of confidence, which, with the decline in 'the element of real knowledge in the valuation of investments' attendant upon the separation of ownership and management (Keynes VII, p. 153), emerges as a factor 'to which practical men always pay the closest and most anxious attention' (Keynes VII, p. 148). In these circumstances, ephemeral and insignificant matters often disturb an investment community's attachment to the notion that average opinion genuinely represents a reasonable valuation of a particular investment. That is, confidence emerges as significant with the very emergence of average expectation as a central reference in investment valuation. Thus, as it is increasingly average opinion seeking average opinion that characterizes such markets, a 'conventional valuation [...] established as the outcome of the mass psychology of a large number of ignorant individuals is liable to change violently as the result of a sudden fluctuation of opinion due to factors which do not really make much difference to the prospective yield' (Keynes VII, p. 154). In this ever more insubstantial world, even the more skilled individual, 'who, unperturbed by the prevailing pastime, continues to purchase investments on the best genuine long-term expectations he can frame' (Keynes VII, p. 156), is likely to be a casualty of the general change in character of the modern investment process, which more and more makes for the outsider 'investment based on genuine long-term expectation [...] so difficult to-day as to be scarcely practicable' (Keynes VII, p. 157).

The state of confidence regarding any given investment option, then, is not impressive by comparison with the full play and expression of animal spirits that characterized the past era of enterprise. Though entrepreneurs in the past undoubtedly also acted on the assumption that what obtained in the past was an important guide for their decisions about the future, this was 'business as a way of life' (Keynes VII, p. 150), where life in business was embedded in lifelong commitments to particular firms. Average expectation lacked meaning in this historical context, so that the state of confidence also lacked significance. In short, investment markets assume a different complexion as speculation and the pursuit of short-term gain come to dominate both enterprise and the long-term project of forecasting the prospective yields of assets. Perhaps this is nowhere more sharply expressed by Keynes than in his comparison of the investment process and a newspaper beauty contest.

[Professional investment may be likened to those newspaper competitions in which the competitors have to pick out the six prettiest faces from a hundred photographs, the prize being awarded to the competitor whose choice most nearly corresponds to the average preferences of the competitors as a whole; so that each competitor has to pick, not those faces which he himself finds prettiest, but those which he himself thinks likeliest to catch the fancy of the other competitors, all of whom are looking at the problem from the same point of view. It is not a case of]
choosing those which, to the best of one’s judgment, are really the prettiest, nor even those which average opinion genuinely thinks the prettiest. We have reached the third degree where we devote our intelligences to anticipating what average opinion expects average opinion to be. And there are some, I believe, who practice the fourth, fifth and higher degrees. (Keynes VII, p. 156)

The professional investor neither asks what might be intrinsically the ‘prettiest’ or best investment, nor even what average opinion will take to be the ‘prettiest’ or best investment, but rather what other investors believe other investors believe to be the ‘prettiest’ or best investment. In these circumstances, investors’ expectations display a flimsy attachment to their central reference in average expectation – the necessary, though hardly all-dominating moment in a structure of interdependent beliefs regarding good investments. In such circumstances, the state of confidence is inevitably a changing phenomenon, and long-term investment commitments are often and easily abandoned, with the result that the level of investment is generally lower than would likely be the case were the spirit of enterprise more dominant.

Given, then, that ‘[t]hese tendencies are a scarcely avoidable outcome of our having successfully organised ‘liquid’ investment markets’ (Keynes VII, p. 159), Keynes concludes that the modern world faces a dilemma.

The spectacle of modern investment markets has sometimes moved me towards the conclusion that to make the purchase of an investment permanent and indissoluble, like marriage, except by reason of death or other grave cause, might be a useful remedy for our contemporary evils [...] But a little consideration of this expedient brings us up against a dilemma, and shows us how the liquidity of investment markets often facilitates, though it sometimes impedes, the course of new investment. For the fact that each individual investor flatters himself that his commitment is ‘liquid’ ... calms his nerves and makes him much more willing to run a risk. If individual purchases of investments were rendered illiquid, this might seriously impede new investment, so long as alternative ways in which to hold his savings are available. This is the dilemma. So long as it is open to the individual to employ his wealth in hoarding or lending money, the alternative of purchasing actual capital assets cannot be rendered sufficiently attractive. (Keynes VII, p. 160)

The liquid character of investment markets enhances investment activity, while the availability of money investments that are comparatively attractive hampers it. It is true, as Richard Kahn has noted (1984), that Keynes’s account here does not clearly distinguish between decisions regarding real capital formation and decisions taken on stock exchanges, so that there is some ambiguity in his thinking concerning just how decisions made in the latter case come to affect decisions made in the former. Keynes’s general view, nonetheless, is clear. The increasing importance of speculative activity pursuant upon the historic separation of ownership and management had, and
was likely to continue to have, decidedly negative effects on the level of investment expenditure.

This could well be seen as being a matter of the diminished role remaining in economic life for the full play and exercise of ‘animal spirits’, that ‘spontaneous urge to action rather than inaction’ (Keynes VII, p. 161) that was more fully in evidence in that earlier period when business enterprise was more dominant. Speculation, in contrast, with its greater emphasis upon the immediate, foreseeable return, places heavy weight upon the estimation of probable gain. Yet because the consequences of so many of the long-term projects business contemplates are fundamentally uncertain – as Keynes puts it, really no clearer at the outset in their ultimate upshot than ‘an expedition to the South Pole’ (Keynes VII, p. 162) – the occasions available for ‘calculated mathematical expectation’ are rare, so that the increasing role for speculation changes the character of the investment process for the worse. Long-term investment, where uncertainty about the future is inescapable, makes it clear that ‘individual initiative will only be adequate when reasonable calculation is supplemented and supported by animal spirits’ (Keynes VII, p. 162) and the ‘spontaneous optimism’ (Keynes VII, p. 161) they manifest.

From this perspective, chronic unemployment results from the interest rate being too high, because the short-term gains available to those whose wealth is ready and liquid sustains a demand for money that keeps interest rates high relative to the marginal efficiency of capital and investor animal spirits. In this conception, interdependent expectations are formed around both long-term investment and around the long rate of interest. Clearly in Keynes’s thinking these two sets of expectations are related, since individuals with investible wealth may substitute between financial and real investment. Keynes nonetheless treats the two underlying psychological attitudes involved, that toward liquidity and that toward prospective yield, as separate independent variables, and consequently founds his equilibrium income determination analysis upon the interaction of these two sets of interdependent expectations through the income adjustment process. This must be regarded as a concession to the need to define the income model in determinate terms, since any collapsing of these two independent variables would render Keynes’s insight regarding the too-high level of the interest rate difficult to explain. Yet from the deeper perspective involved in investigating the social-historical determinants of these independent variables – that investigation which has been initiated here in an explication of the levels of activity of these psychological attitudes via their constitution in conventional structures of interdependent activity – it will ultimately not be possible to avoid treating the linkage between financial and real investment and their associated systems of interdependent expectation.

What role, then, does convention play in Keynes’s income and employment analysis? We have seen that investors’ attitudes toward prospective
yields are structured around average expectation so as to tend to sustain the past valuation of investments, albeit given the forces for change embodied in individual expectations. The level and volume of this investment, however, is influenced by the level of the rate of interest, which is also conventionally determined for Keynes. Attitudes toward liquidity should also be seen to be structured around an average expectation of the interest rate, much as attitudes toward prospective yields on investments are structured around their average expectation. In the case of the interest rate, 'its actual value is largely governed by the prevailing view as to what its value is expected to be. Any level of interest which is accepted with sufficient conviction as likely to be durable will be durable; subject, of course, in a changing society to fluctuations for all kinds of reasons round the expected normal' (Keynes VII, p. 203). Any particular interest rate, that is, reveals a balance of expectations across individuals with different views of the value of money, a balance which manifests itself in an average, central reference value in terms of which individuals form their respective expectations regarding the value of money. The reigning interest rate, accordingly, is conventional in that it is expected to obtain unless there are reasons to expect otherwise. And like investment expectations, the average expectation of the interest rate 'is not rooted in secure knowledge', is not rooted in any objective understanding of the true value of money, and thus 'may fluctuate for decades about a level which is chronically too high for full employment' (Keynes VII, p. 204).

Keynes's general conception of the economy, thus, is one in which these two fundamental sets of psychological attitudes, the attitude toward prospective yields and the attitude toward liquidity, are structured as dynamic, interactive systems of interdependent belief. In each case, an average expectation, though changeable in content, reigns as a conventional, central reference for the range of particular expectations different individuals form regarding prospective yields or future interest rates respectively. The state of average expectation in the money market relative to the state of average expectation regarding future yields determines the interest rate relative to the determination of firms' investment demand schedules, and jointly they determine the level of effective demand, income, and employment. Should the actual contents of these two conventions change relative to one another, then demand, income, and employment will change. A condition of chronic unemployment, further, is the result of a particular balance between these two, key sets of psychological attitudes in particular circumstances at a particular point in history. Specifically, the manner in which individuals' psychological attitudes are structured in recent experience is such that the desire for liquidity is strong relative to the confidence in prospective yields. A full explanation of the existence of chronic unemployment, therefore, incorporates an historical-institutional analysis of the structuring of these two, key sets of psychologi-
Keynes’s philosophical thinking

Keynes's philosophical thinking 171

cal attitudes to account for the particular balance these two, conventional systems of interdependent beliefs have attained in modern economies.

Keynes's underlying vision in *The General Theory*, then, partakes of both insights into the social–psychological dimensions of the economy and sensitivity to the evolving historical framework of the economy. In the first connection he develops an analysis of those psychological attitudes central to the understanding of monetary economies that explains economic outcomes in terms of a systematic organization of the beliefs and choices that derive from these attitudes. In his attention to the structure of interdependence these beliefs assume, he further characterizes a formal connection between these beliefs and attitudes that has the specific advantage of being determinate yet open-ended. That a convention reigns is explained by the significance a perceived average expectation possesses. Yet that average expectation can assume any content means that the logic of average expectation can accommodate an historically diverse experience. Convention, for Keynes, is thus a formal yet instantiable concept, and this is crucial to the incorporation of his historical insights, the latter dimension to his particular vision. On this score, it cannot be too much emphasized that Keynes's historical diagnosis regarding the shift from enterprise to speculation is crucial to his overall project of explaining unemployment. It is crucial in that, on the one hand, it enables him to say how chronic unemployment came about, and on the other hand, it creates opportunities for investigating unemployment's potential remedies.

**Convention as a structure of interdependent expectations**

More needs to be said, however, about Keynes's emphasis upon the nature of interdependent expectations to explain his later philosophical thinking, and here the attention needs to be directed to the issue of just how individuals come to form their particular expectations. Recall that when writing to Harrod about the nature of economics as a moral science after completing *The General Theory*, Keynes had also emphasized that the subject matter of economics is neither 'constant' nor 'homogeneous', and that this is due to the fact that it dealt with individuals' 'motives, expectations, [and] psychological uncertainties' (Keynes XIV, p. 300). We now see that he might well have added that individuals' 'motives, expectations, [and] psychological uncertainties' are variegated and diverse, and that this stems from the fact that individuals invariably find themselves in very different circumstances when it comes to such things as their respective views regarding the prospective yields on various investments and perceptions of the relative desirability of holding money. It is interesting that this point did receive special attention in *The General Theory* discussion of 'bulls' and 'bears' in the money market (a treatment which recalled a similar analysis in the *Treatise on Money*), and
that Keynes thought this analogous to his account of long-term expectations and the marginal efficiency of capital.

Just as we found that the marginal efficiency of capital is fixed, not by the ‘best’ opinion, but by the market valuation as determined by mass psychology, so also expectations as to the future of the rate of interest as fixed by mass psychology have their reactions on liquidity-preference; – but with this addition that the individual, who believes that future rates of interest will be above the rates assumed by the market, has a reason for keeping actual liquid cash [...] whilst the individual who differs from the market in the other direction will have a motive for borrowing money for short periods in order to purchase debts of longer term. The market price will be fixed at the point at which the sales of the ‘bears’ and the purchases of the ‘bulls’ are balanced (Keynes XIV, p. 170).

A structure of individual expectations, then, not only has average expectation as its central reference, but also, as this passage emphasizes, somehow achieves a balance between divergent individual expectations. This particular emphasis, which gives less weight to the gravitational aspects of average expectation as a central reference, invites us to further investigate the principles that govern the distribution of individual expectations about the mean. Clearly, in a market system these principles will go beyond the simple arithmetical concept of a mean, since average expectation, as a reigning value in a single price market, emerges from a non-arithmetical market logic of offers and counter-offers. This proposition is perhaps best examined by thus taking a closer look at individual expectation in relation to average expectation.

Following the treatment above, it will be helpful to retain the focus upon investors’ attitudes toward prospective yields. In the equity market, the average expectation of a particular stock’s value emerges from a trading process between buyers and sellers of that stock. Different traders’ initial offers to buy and sell a stock range over a variety of values, and bargaining between them each day brings about a market-clearing exchange at a single value that involves adjustment in asking price on the part of some and entry to and exit from the market on the part of others. The average expectation of a particular stock’s value in this sense subsumes a variety of individual views regarding that stock’s potential value on the part of the market’s participants. As the quoted price or reigning value, it constitutes a central reference for buyers and sellers, both because, as already noted, it reflects the collective wisdom of the market regarding the value of any particular stock, yet also because it represents a point of departure for offers to buy and sell at the start of each successive trading day. On this analysis, average expectation is more than simply a mean value of individual offers, since it represents the outcome of individuals’ dealings with one another in light of the daily re-determination of a reigning value.
The convention that 'the existing state of affairs will continue indefinitely, except in so far as we have specific reasons to expect a change' thus means different things to different individuals according to their different perspectives on how they believe average expectation is likely to change. When individuals have 'specific reasons to expect a change' in average expectation based on their own particular circumstances, views, and information, they act upon those 'reasons' in making offers to buy and sell stocks, and in the process help to determine a new average expectation of these stocks' values. In this, individuals most definitely hope that it will not be the case that 'the existing state of affairs will continue indefinitely', since they optimistically believe that their particular, special perspective on the market will put them in a position 'to outwit the crowd, and to pass the bad, or depreciating, half-crown to the other fellow' (Keynes XIV, p. 155). Individuals, that is, are principally interested in changes in average expectation, just because they believe that the individual insight embodied in their individual expectations is superior to the collective wisdom represented by average expectation.

How is it the case, however, that individual traders judge as justified offers that depart from average expectation which they and others make, when the collective wisdom average expectation embodies must always weigh against an individual buyer or seller entertaining an expectation different from the average? That an individual hopes 'to outwit the crowd' hardly implies he or she can do so. Yet individual traders invariably look upon the reigning price produced by average expectation as a point of departure in the pursuit of gain. Individual expectation must, then, have its own ground of legitimacy. Of course, entertaining the expectation of a stock's value different from its reigning value generally depends upon being in the possession of some special information or view not widely distributed among those in the market. The distribution of individual expectations about the average is thus in the first instance a function of the differential possession of information or knowledge about the market on the part of different individuals. Being in such possession, while nonetheless necessary, is not sufficient to explain how individuals judge offers departing from average expectation as justified, since information or views not widely distributed must for that very reason also appear suspect relative to the consensus understanding represented by average expectation. Indeed, since average expectation already comprehends differential or unevenly distributed information and views, being in the possession of special information cannot by itself provide sufficient incentive for making offers that depart from average expectation.

Keynes, however, provides an additional explanation for the distribution of individual expectations around average expectation. In his account of the development of speculation and the decline of enterprise, he argues that the professional investor comes less and less to be concerned with the underlying
fundamentals of an investment, and more and more with anticipating the psychology of the market surrounding that investment. Indeed in his metaphor of the newspaper beauty contest, the goal of the professional investor is not merely to estimate average opinion, but rather to estimate 'what average opinion expects the average opinion to be' (Keynes XIV, p. 156). From this perspective, investors judge the desirability of offers to buy and sell that depart from average expectation according to their views of the psychology of the market regarding average opinion. In the context of the discussion here, transactions between particular traders turn upon these individuals' mutual opinions of each other's individual expectations – in effect, their opinions of each other's psychology – since it is these individual expectations that embody views of what average opinion is likely to be. This implies that when individual traders actually go ahead to complete transactions with one another at prices that depart from reigning values, they share a confidence in the justifiability of such transactions that itself adds to their prior reasons for effecting it based on special information or knowledge. Confidence, then, specifically a confidence distributed and shared differentially across potential traders, is Keynes's additional condition for explaining observed trading behaviour.

This notion of a shared confidence, it should be noted, is linked to Keynes's discussion of introspection and value judgements as methods employed in economics understood as a moral science. Previously (1991b) I have argued that these methods Keynes believes important for economic science are equally at the disposal of individuals in the economy. Transposing Keynes's views on economic method to the behavior of economic agents implies that individuals form interdependent beliefs expectations when they reciprocally consult their own cases to judge the likely opinions of others by analogy with their own. In The General Theory, Keynes's reference to 'what average opinion expects the average opinion to be' displays a preoccupation with essentially just this same sort of interdependence. Professional investors consider offers to buy and sell that depart from quoted prices, and in important degree determine the desirability of acting upon those offers according to the perceived interest and willingness of those with whom they transact to do so as well. From the moral science emphasis on introspection and analogical reasoning process, each individual trader attempts to ascertain the motives of those with whom he or she would transact by a consideration of what his or her own motives would be in a like situation. If the imputed motives and reasoning appear defensible, trade at a price away from the reigning or quoted price begins to acquire a plausibility that supplements a trader's own original rationale for considering such a price based on differential information. That this process of evaluation occurs reciprocally adds further potential support to possible transactions between traders, both in that two traders
rather than one may compare initial own reasoning with the reasoning of another, and in that each may also take the other’s opinion of his or her own reasoning as further validation of that initial reasoning. This sort of interdependent reasoning and formation of individual expectations, therefore, allows for the possibility that individual traders may supplement their differential possession of information with a sufficient degree of shared confidence that enables them to resist the pull of average expectation.

How, then, does this reciprocal interaction of judgements actually occur? Each individual attempts to understand the thinking of the other by reference to what he or she imagines would be his or her own thinking in the other’s place. Yet each trader is also aware that just as he or she is attempting to replicate the reasoning of another, so the other is simultaneously attempting to do the same. This means that to properly understand the thinking of the other each must also attempt to replicate the other’s attempt at replication, so that, in addition to estimating the other’s reasoning, each must also estimate how his or her own reasoning appears to the other. Higher-order replications may be imagined, but they do not add materially to the basic conception of interdependence at hand. On this conception, interdependent decision-making contexts are essentially much like what a more recent literature explains as game-theoretic coordination problems (e.g., Lewis, 1969). In this framework individuals making independent yet interdependent decisions are said to be capable of co-ordinating their separate and conflicting objectives (here, traders’ different goals in buying and selling to one another) by arriving at a system of concordant mutual expectations of first and higher orders regarding each other’s aims and thinking. They are, however, only potentially able to do so, since the dominance of individual interest and perspective implicit in the notion of an interaction between separate individuals makes co-ordination failures the general premise of the analysis. As for Keynes, then, the principal issue that confronts this more modern literature concerns specification of those conditions that make such co-ordination possible.

In the game theoretic literature, this issue is sometimes characterized in terms of the idea of salient solutions (Schelling, 1960). If difficulty in communication constitutes an obstacle forestalling co-ordination of independent plans, individuals may avail themselves of co-ordination equilibria that stand out from other courses of action in virtue of their conspicuousness. The salient or conspicuous solution need not be uniquely good or have any other particularly remarkable characteristics. It need only be something that enables interacting individuals to expect each other to expect each other to detect some particular solution to their coordination problem. Precedent, in particular, counts as an important source of salience and means of achieving co-ordination. Individuals possessing a similar experience with some particular regularity similarly extrapolate this regularity into the future to hit upon a
means of co-ordinating their respective actions and separate intentions. In the broadest sense, a precedent is only some past, commonly recognized pattern, external to the immediate interaction of individuals, that guides their individual expectations. Precedents may thus be institutionally embedded or merely shared perceptions.

Put in this light, the special attention Keynes devotes in *The General Theory* to the state of confidence indicates less a concern that investors lacked the will or the needed quantity of animal spirits to commit themselves to long-term investments in the age of speculation, and more a conviction that investors are less and less able to discover sufficient precedents for co-ordinating their individual investment plans. In these circumstances, average expectation gains in significance at the expense of individual expectation, and investors accordingly reduce the extent of their commitments demanding prolonged neglect of average expectation. In effect, the historical development of the investment process produces a structure or distribution of individual expectations that is increasingly compact around average expectation. Yet note that because the possibility of profit (and loss) derives from pursuing offers to buy and sell that depart from reigning prices, an investment activity increasingly compact around average expectation must as a whole become less profitable. This produces a chronic stagnation of investment expenditure which itself depresses aggregate demand. Put in terms of Keynes's important emphasis upon uncertainty, the increasing difficulty investors find in establishing a shared confidence regarding potential transactions reflects an increasing uncertainty regarding their expectations of one another. It is, therefore, not so much the essential indeterminacy of the future that explains uncertainty (which, it should be emphasized, is no less a reality in times when investment is extensive), but rather the changed state of confidence within the community of investors, who find it increasingly difficult to establish concordant expectations regarding transactions that depart from average expectation, that explains uncertainty. In this respect, it would be misleading to say that for Keynes uncertainty is an inescapable, existential dilemma. More appropriately, for Keynes uncertainty is chiefly a social relation; a social relation, moreover, that is tied to a specific history to which we must turn if we are to explain the state of activity of animal spirits, as reflected in Keynes’s independent variables.

**Concluding comments**

The historical transition from the era of enterprise to the age of speculation, it might finally be noted, produces an ironic reversal in the relationships between individuals involved in the investment process. When business was a ‘way of life’, individuals worked for extended periods for one firm. They were close to the fundamentals of firm operations, and detached from any
mass market psychology regarding long-term investment. This enabled them to disregard average expectation (to the extent that it was at all tangible in such an era), and project individual expectations regarding the firm’s expansion that had clear precedent for outside investors in lengthy involvement with firm operations. Moreover, the decision in a firm to offer equity shares or sell bonds was also the product of discussions between firm owners and managers that addressed just these fundamentals. Thus, though firms acted atomistically in investment markets in virtue of the unique character of their respective underlying fundamentals, they did so by establishing an internal shared confidence among themselves regarding their firm’s individual investment expectations that constituted a precondition for the shared confidence established between the firm and its outside investors.

In contrast, the separation of ownership and management that gave speculative activity a predominant role in investment markets produces precisely the opposite state of affairs. When investors found that they must attend to the psychology of the market rather than to the underlying fundamentals of firm operations, they lost that atomistic relation to one another as buyers and sellers of investments that prevailed when ownership was united with management. At the same time, however, their detachment from firm fundamentals made it increasingly difficult for investors to achieve a shared confidence over transactions at prices departing from average expectation. Removed from the setting of the firm, investors thus found themselves cast together in their common concern with average opinion, yet at the same time less able to reach agreements with one another that would potentially earn them profits. This changed horizon is important for understanding Keynes’s long-term policy perspectives regarding investment, since these depend upon restoring the lost past balance between the private and public aspects of character in the investment process.

In this reversal, then, we see Keynes’s ultimate philosophical concern with the broad categories of individuality and sociality. *The General Theory* takes us beyond this framework as previously advanced in its incorporation of an understanding of the historical development in capital markets and the economy. On the broad philosophical level, Keynes’s thinking requires a general explanation of the interrelated nature of individuality and sociality. On the historical plane, the way in which interdependent expectations link individuals together depends upon the institutions that exist in the economy. Keynes came to recognize this when he discovered the importance of convention. In his early philosophical thinking, in contrast, individuality had been balanced by a commonality of human nature. However, Keynes came to believe this inadequate on account of his difficulties in explaining the play of intuition, and thus, as he insists in ‘My Early Beliefs’, determined that individuality was balanced by convention. The treatment of convention in
Method, competition, conflict and measurement

The General Theory, as a structure of interdependent individual expectations having average expectation as a point of reference, gives concrete expression to this balance.

References