



Keynesian economics

Franklin Roosevelt campaigned for the presidency in 1932 on a promise to balance the federal budget in order to end the Great Depression. In 1975, President Gerald Ford cut federal income taxes in order to end a recession, despite the fact that the projected federal deficits were the largest in history. What happened to change the course of economic events?

Classical economics held that the economy could only exist at equilibrium at the full employment level. This is because, as “Say’s Law” says, “supply creates its own demand.” That is, when a business hires factors of production [land, labor, capital, and entrepreneurship] it pays for those factors [rent, wages, interest, and profit, respectively] and those payments create purchasing power which, given the unlimited desire for stuff, results in consumers demanding goods and services. The assumption of this theory is that **GOODS ALWAYS EXCHANGE FOR GOODS**. That is, the value of the goods produced by a worker is always the same (approximately) as the value of the goods consumed by the same person. Another way of saying this is “**MONEY IS NEUTRAL**.” In other words, the introduction of money merely introduces a “medium of exchange” and does not affect the fact of the equality of exchange of goods produced for goods consumed. Consequently, it is impossible for there to be a long-lasting imbalance between supply and demand, since one creates the other.

This did not explain the Great Depression¹. A new theory was needed to explain the new reality.

The decadent international but individualistic capitalism in the hands of which we found ourselves after the war is not a success. It is not intelligent. It is not beautiful. It is not just. It is not virtuous. And it doesn’t deliver the goods.

- John Maynard Keynes (1883-1946).

John Maynard Keynes, in his famous treatise *The General Theory of Employment, Interest and Money* created an explanation for the Great Depression. He said that the economy could find an equilibrium at a level of less than full employment. Businesses would respond to lower demand by decreasing production, he said, rather than lowering prices and wage rates.² The decreased production required even fewer workers; fewer workers, in turn, consumed

¹ Great Depression, the severe U.S. economic crisis of the 1930s, supposedly precipitated by the 1929 stock market crash. Certain causative factors are generally accepted: overproduction of goods; a tariff and war-debt policy that curtailed foreign markets for American goods; and easy money policies that led to overexpansion of credit and fantastic speculation on the stock market. At the depth (1933) of the Depression, 16 million people—one third of the labor force—were unemployed. The effects were felt in Europe, and contributed to Adolf Hitler’s rise in Germany. The policies of the NEW DEAL relieved the situation, but complete recovery came only with the heavy defense spending of the 1940s.

² Especially, Keynes argued, wages are “sticky” in a recession; they don’t easily decline.

fewer goods. So the level of aggregate (total) demand in the economy could continue to decrease. The free enterprise system would not always, he said, rebound to a full employment equilibrium.³

It is ideas, not vested interests, which are dangerous for good or evil.

- John Maynard Keynes

Keynes rejected the notion that goods exchange for goods. The “law” of Jean Baptiste Say is false, Keynes asserted. Goods exchange for money. And money is not neutral. Recessions, Keynes said, were caused when the demand for goods and services decreased to a level which would not support full employment. The solution, he asserted, was simply to increase demand to the full employment level of GDP.

Since aggregate demand is composed of (1) spending on consumer goods, (2) spending on investment goods, and (3) spending by government, the role of government, Keynesians say, is to analyze consumption spending and investment spending and keep aggregate demand balanced by changing the level of government spending. Alternately, government could stimulate private demand.

$$C + I + G = GDP^4$$

Government could increase aggregate demand by

1. increasing the supply of money
2. decreasing the taxes on those who would spend money, or
3. increasing government spending.

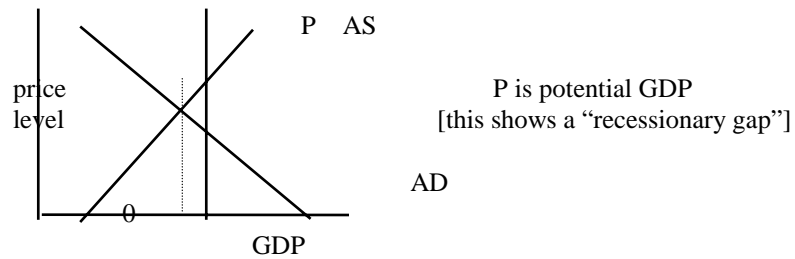
Any combination of these things might increase aggregate demand so that the level of demand would force business to fully utilize society’s resources to meet demand. This, he said, was the only condition justifiable in a capitalist economy, since it was always possible.

The first of these things might not always work, Keynes said, because people might not spend increases in the money supply. During a recession, people and business might not elect to spend or invest; the result would be that the money supply would not actually increase despite the best efforts of government.

The latter two methods call on the government to run a **deficit**. The society, Keynes said, would merely borrow against long term obligations to stimulate demand. Government, he said, could do this indefinitely. Whatever level of demand equated with full employment, Keynes believed, must be generated by government action.

³ Keynes argued that, contrary to previous doctrine, household savings do not always translate directly into increased business investment. This is because people prefer more liquid (spendable) resources than, for example, corporate stocks. So that, as uncertainty about the future increases during a recession, households may hold money in liquid forms such as savings accounts. Previous theory suggested that this increase in the "supply of loanable funds" would decrease the interest rate. This lower interest rate would spur more business investment. The increased investment demand would make up for a reduction in consumption demand and full employment equilibrium would be reestablished. However, Keynes argued that businesses will not invest when the prospects for consumer demand are low. [In technical terms, the demand for loanable funds becomes substantially less elastic in a recession.] Therefore, household income does not generate, inevitably, either consumption or investment. Instead, some income may “leak” out of the circular flow. This is a problem that Keynes called the “**liquidity trap**.”

⁴ GDP, or Gross Domestic Product, is the total value of goods and services produced in one year. A more full description of GDP is $C + I + G + (X - Im) = GDP$, where X stands for exports from the US and Im stands for imports to the US. We’ll discuss this later, as we consider international trade.



AN EXAMPLE:

Assume the economy is capable of producing \$10 trillion worth of goods and services per year. [This is called “**potential GDP**”.] If this is true, then to do so requires the use of all available resources, including people, -- full employment. If this were the case, then we would want aggregate demand to be exactly \$10 trillion. This is because the level of actual GDP (also called **aggregate supply**) is determined by the level of aggregate demand. Thus, if aggregate demand is less than \$10 trillion, GDP will fall short of the full-employment level and “cyclical unemployment” will occur (a recession in the business cycle). On the other hand, if aggregate demand is greater than \$10 trillion, the economy is not able to produce enough goods and services to fill the demand, shortages happen, and prices go up. This is demand-pull inflation. So the objective of fiscal policy to assure an aggregate demand of \$10 trillion.

FISCAL POLICY AND THE FEDERAL BUDGET

A simple formula, suggested by Keynes, is **that the government should run a deficit in a recession and a surplus in an expansion.** The deficit would stimulate the economy to full employment because it means that the government is either spending more--stimulating government demand--or taxing less--stimulating consumption/investment demand. The surplus would restrict an “**overheated**” economy (too much demand) because the government is either spending less--restricting government demand--or taxing more--restricting consumption/investment demand. Keynes said the deficit in recessionary periods would be offset by the surpluses in expansionary periods and the government would have a balanced budget over a period of several years.

The ideas of economists and political philosophers, 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 believe themselves to be quite exempt from any intellectual influence, are usually the slaves of some defunct economist. - John Maynard Keynes

PROBLEM #1⁵

The United States has not had a balanced budget since 1969; we have run a deficit in every year since. This illustrates the political problem with Keynesian theory. It is easy for politicians to promise more spending or less taxes--the correct Keynesian policy in years of recession, but it is very hard for them to cut spending or increase taxes--the correct Keynesian policy in years of inflation. Voters in a democracy always want more stuff for fewer tax dollars.

The result of this political problem is that Keynesianism has meant that the level of government spending has increased from about 3% of GDP in the 1930s to about 30% of GDP today. When a recession ends, the government does not pull back in spending. So the economy suffers a period of inflation until the economy expands to the point where aggregate supply (GDP) catches up with aggregate demand. This new equilibrium exists at a higher level of

⁵ Keynes’ biographers have identified his assumptions as including the assumption that an intellectual elite of aristocratic leaders would always be able to convince ordinary voters to do the “right” thing. These assumptions have been called “the presuppositions of #6 Harvey Road,” Keynes’ birthplace.

government expenditures. When a new recession occurs, the government stimulates again and the cycle repeats itself. The problem is that, over time, this means that about 30% of what we produce goes to the government in the form of taxes. Furthermore, it means that inflation is not cured and, eventually, further stimulus is very difficult.⁶

Keynes would not recognize our current economy. Until recently, the federal budget has been in deficit and, even in deficit years, the economy has occasionally slid into recession. In Keynesian theory, the deficits of the 1970s and 1980s were wildly stimulatory. But we were once again fighting a recession. So further stimulation would have required even higher levels of deficit spending. What would this level of government borrowing have done to the capital markets and the ability of consumers and businesses to borrow money?

PROBLEM #2

The monetarists believe that Keynes' theory worked only by accident. They say that Keynesianism makes no sense. In a recession, the Keynesians argue that the government should run a deficit. But that deficit is financed by the Treasury borrowing money from the capital pool. So the Keynesians are stimulating the economy with money removed from the economy. The net result, monetarists say, is that nothing changes. The only reason Keynesian policies have produced recovery from recession is because the FED has reacted to government borrowing by increasing the money supply to compensate for the loss of loanable funds ("**monetizing the debt**"). So the real reason, monetarists argue, for economic recovery has been an increase in the money supply.

PROBLEM #3

The economy has not always behaved as Keynes predicted. In the late 1960s and early 1970s, the United States was beset by "**stagflation**." This means that we had economic stagnation (recession) and inflation at the same time. According to Keynes, this is impossible because recession is caused by too little aggregate demand while inflation is caused by too great aggregate demand. But stagflation was what confronted Richard Nixon when he assumed the presidency in 1969, and it lasted through the administration of Jimmy Carter. Clearly the time had come for a new economic theory to explain new realities, just as Keynes theory explained the reality of the Great Depression.

KEYNESIANISM IN THE MODERN ERA

Today there are at least two different "schools" of economics based on Keynes' insights: the post-Keynesian school and the neo-classical/Keynesian synthesis school. The former adheres strongly to Keynes' original ideas and supports drastically increased budget deficits combined with wage-price controls ("**incomes policy**") as proper governmental policy. The latter school attempts to integrate Keynes' beliefs into the classical tradition. These economists believe that the economy reaches full employment equilibrium "in the long run" but may need Keynesian stimulus in the short run of time. More on this latter!

A Personal Note from your teacher

I do not consider myself a "Keynesian." However, Richard Nixon famously said in 1969 that "We are all Keynesians now." And, in a certain sense, President Nixon was correct. It is certainly true that the "theory of aggregate demand" influenced everyone, including me. I accept, for example, the notion that the current economy would be benefited by a "demand side" stimulus such as tax cuts.

However, I also think that Keynesian analysis is seriously flawed. The reasons for that are not important now. I present this explanation of Keynesianism merely to allow you to analyze current programs and policy proposals according to the underlying assumptions – Keynesian all – that under gird those proposals.

⁶ Of course, there are many other reasons which may result in politicians increasing the budget. Many of these reasons are political, rather than economic. Keynes should not be blamed for this spending. Nevertheless, his arguments often are used to support an initial increase in government spending. This increase is never then eliminated. Inertia persists!!