Howard J. Sherman, et al
Economics: An Introduction to Traditional and
Progressive Views. 7th ed. (M.E. Sharpe 2008).

CHAPTER 15

Keynesian Economics and the Great Depression

The previous chapter showed that there was very rapid growth in the United States in the 1920s followed by a spectacular decline and depression in the 1930s. What happened to reduce the output of goods and services so drastically? Natural resources were still as plentiful as ever. The nation still had as many factories, tools, and machines. The people had the same skills and wanted to put them to work. Yet millions of workers and their families begged, borrowed, stole, and lined up for a pittance from charity, while thousands of factories stood idle or operated far below capacity.

The explanation lay within the institutions of the capitalist market system. Factories could have been opened and people put to work, but they were not because it was not profitable for businessmen to do so. In a capitalist economy, production decisions are based primarily on the criterion of profits, not on people's needs. While the capitalist world was suffering what was perhaps its most severe depression, the Soviet economy—which claimed to be socialist—was experiencing rapid growth. As a result, the socialist cause gained many enthusiasts in the 1930s. When the Great Depression struck, it was a traumatic shock to many Americans who had come to believe their country was destined to achieve unparalleled and unending increases in material prosperity.

LEARNING OBJECTIVES

After reading this chapter, you should be able to:

- Describe Keynes' basic explanation of the boom and bust cycle of a capitalist market economy.
- Explain how the government can act to stabilize the economy.

HOW KEYNES DOUBLED THE SIZE OF ECONOMICS

The capitalist economic system seemed to be on the verge of total collapse. Drastic countermeasures were essential, but before the system could be saved, the problems had to be better understood. To that task came one of the most brilliant economists of the twentieth century: John Maynard Keynes (1883–1946). In his famous book, *The General Theory of Employment, Interest and Money* (1936), Keynes attempted to show what had happened to capitalism so that it could be reformed and thus preserved.

In order to understand the business cycle of boom and bust that causes depressions, Keynes invented a whole new area of economics. Before Keynes, economics students learned only microeconomics. After Keynes, students learned both micro- and macroeconomics. What is microeconomics and macroeconomics and why did Keynes have to invent macroeconomics? **Microeconomics** is *the study of individual firms, individual employees, and individual consumers.* **Macroeconomics** studies *the economy as a whole, the aggregate growth of the economy, and the aggregate amount of unemployment.* Before Keynes, economists considered it important only to teach the theory of individual consumers, employees, and firms.

Even in the midst of the Great Depression, they argued that aggregate economics was unnecessary because every good economist knew that there was automatically full employment and therefore growth at the highest possible rate. This remarkable view was based on Say's law written by Jean-Baptiste Say in 1800. **Say's law** claims that *any amount of output supplied to the market will always generate an equal amount of demand.* The reasoning is that output always generates income in terms of wages and profits. This income will then be used to buy other goods, since it is irrational for people to hoard money for no purpose. There may be a brief lack of demand in one industry until capital moves to another industry. There may also be a brief lack of demand in the aggregate economy if there is an external shock, such as a flood. But there can be no aggregate lack of demand for any considerable period. Economists argued that "in the long run" the economy as a whole must be in equilibrium at full employment. Keynes noted that "in the long run we are all dead!"

Keynes, in his famous book cited above, begins by an attack on Say's law that is systematic and detailed. Keynes's main point is that Say and the neoclassical economists speak as if the present economy is a real or barter economy, but the fact is that money is used for transactions. In fact, money is used not only as a **medium of exchange** or as *payment for goods and services;* money is also used to keep in reserve for emergencies or to hold back for speculative purposes. If the outlook for profit is poor, then firms and individuals have a rational reason for hoarding savings until there is a better opportunity to invest.

For more systematic analysis, Keynes divides spending into four great flows: consumer spending, business spending on plant and equipment, government spending, and spending on U.S. exports by foreigners. Keynes examined what income in the form of money is spent and goes back into the economy and what income "leaks out" of circulation or is kept in reserve and not spent.

In the purely private domestic economy (leaving out government and foreign trade) Keynes points out that people receiving income may spend it for consumption of goods and services or may save it. It appears that the savings must all leak out of circulation and not be part of demand. Actually, however, Keynes emphasizes that some of savings goes into business investment, that is, spending for plant and equipment. If all of the savings goes into this investment spending, then there is equality between the output supplied to the market at present prices and the output demanded (income spent) in the market at present prices.

If the saving out of income is much greater than the amount going into investment, then some income is not spent or is held for some rational reason, such as a reserve or worry about future possible losses. If this means insufficient money going into demand, then the lack of demand may cause a recession. In other words, at present prices the amount of consumer demand plus investment demand is less than output supplied, there are losses rather than profits. Business losses lead to production cutbacks and unemployment.

On the other hand, if the investment spending is greater than available savings out of income, this may cause price inflation. The reason for price inflation is that consumer spending plus busi-

ness investment spending create demand that is greater than the available supply at present prices. Therefore, prices will rise.

When the whole economy is considered, behavior of government must be included. Federal, state, and local governments spend money, which is part of aggregate demand for output. On the other hand, there is some leakage out of circulation into taxes. Taxes take away money that might otherwise have been spent.

Finally, a complete analysis of the economy must include foreign trade. Exports bring in money from foreigners so exports also boost demand. On the other hand, imports mean the payment of money by our citizens to foreigners, so imports reduce aggregate demand.

Keynes considers how these four flows—consumption, investment, government, and exports—may fluctuate, focusing first on consumer demand. His most important finding is that consumer demand rises as income rises, but usually rises more slowly. The reason is that at low levels of income, people are forced to spend their whole income on necessities. As income rises, however, people increase their spending above the bare minimum, but they also have the freedom to save more money. In an expansion, excessive saving may cause lack of demand. Lack of demand is one very important factor affecting profit and profit behavior affects investment. A falling percentage of consumption out of income may tend to depress the economy through its influence on investment.

From Keynes' analysis, it follows that private sector behavior may lead to a recession as there is insufficient demand for aggregate output. He therefore advocates an active government policy to prevent recessions. The government may spend more money on projects such as schools or hospitals, which put people to work and generate more income.

Keynes makes the point that constructive government expenditures, such as health and education, are the preferable type of expenditure. However, wasteful expenditures such as for war may also expand demand. He makes the point in an amusing and dramatic way:

> Ancient Egypt was doubly fortunate, and doubtless owed to this its fabled wealth, in that it possessed two activities, namely, pyramid building as well as the search for precious metals, the fruits of which, since they could not serve the needs of many by being consumed, did not stale with abundance. The Middle Ages built cathedrals and sang dirges. Two pyramids, two masses for the dead, are twice as good as one; but not so two railways from London to York (Keynes, p. 131).

Keynes also shows how private enterprise may be added to the policy picture if that is politically necessary:

> If the Treasury were to fill old bottles with banknotes, bury them at suitable depths in disused coalmines which are then filled up to the surface with town rubbish, and leave it to private enterprise on well tried principles of laissezfaire to dig the notes up again . . . there need be no unemployment. . . . It would indeed be more sensible to build houses and the like; but if there are political and practical difficulties in the way of this, the above would be better than nothing" (ibid., p. 129).

Keynes further considers the possibility that the government may lower taxes on the middle class and the poor, who have incentive to spend all of their remaining money to demand goods and services. Moreover, Keynes considers the possibility that the government may use monetary policy to encourage investment through low interest rates.

The Great Depression dragged on for ten years. It ended only when the government began to spend enormous amounts of money on the military during World War II. The fact that government spending could end a severe depression impressed economists. Most economists declared themselves to be Keynesians and some sort of Keynesian policies were dominant in the United States for at least two decades. Keynes set the framework for modern macroeconomics. This brief chapter merely introduced his ideas. Many of Keynes' ideas as well as those of other contributors to macroeconomics will be discussed in detail in Part III.

SUMMARY

The severity of the Great Depression of the 1930s caused many economists to become dissatisfied with the orthodox neoclassical economists' view that unemployment was merely a short run adjustment to a temporary disequilibrium situation. Keynes's new idea that there is a real problem requiring real remedies was rapidly accepted by most important economists. Keynesian economists thought that World War II proved that massive government intervention in the market economy could create full employment.

Keynes rejected Say's law that demand always adjusts to supply. He showed that there is no automatic adjustment after a shock to immediate equilibrium. He showed that there can be long-lasting unemployment under certain conditions. He explained how aggregate demand can be insufficient to buy aggregate supply at present prices.

The new area of macroeconomics, invented by Keynes, was taught all over the globe. National income accounts also made use of Keynes' division of spending into consumer spending, investment spending, government spending, and net export spending. Keynesian economics was dominant in the United States after World War II for about twenty-five years. Then a more conservative macroeconomics based on neoclassical economics came back into dominance. All of this will be investigated in detail in Part III of this book.

SUGGESTED READING

An excellent book giving Keynes in clear language in the spirit of that day is Alvin Hansen, *A Guide to Keynes* (1953).

KEY TERMS

macroeconomics	microeconomics
medium of exchange	Say's law

REVIEW QUESTIONS

Describe Keynes's basic explanation of the boom and bust cycle of a capitalist market economy.

1. What is macroeconomics?
2. State Say's law and then explain what it means in your own words.
3. How does the use of money in the economy create the possibility that Say's law may not hold?
4. What are the two main things people can do with their income (money)?

5. What are the components of spending?
6. How does income (money) "leak" out of circulation? In what way do savings enter back into circulation?
7. What happens when there is not enough demand for the amount of goods produced?

Explain how the government can act to stabilize the economy.

8. How can the government offset a lack of private demand? How does this help prevent a recession?
9. How could lower taxes, especially for middle and low income households, help the economy?