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Keynes's *General Theory*

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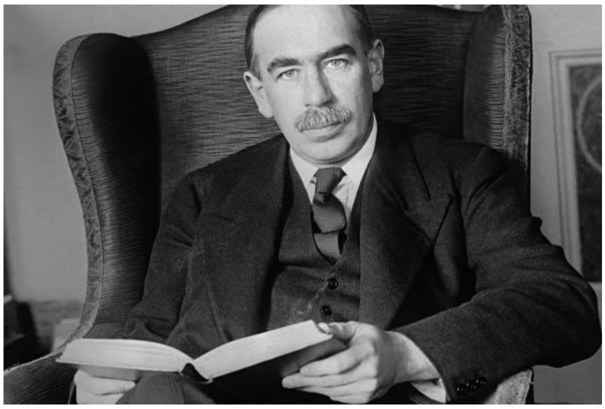
ECONOMICS is a term derived from the Greek word 'Oikonomia', meaning household management. Economics as a social science gradually extended the management beyond the household to the society as a whole. By the late 18th century, Adam Smith (1723-90) had defined it as "the science that enquires into the nature and causes of the wealth of nations" (1776).



The weaknesses of this Classical school led in the late 19th century to the growth of neoclassical economics (first coined in 1900). It gave demand a more important role and indeed initially it was the basic factor in the works of the Englishman William Jevons (1835-1882) and the Austrian Carl Menger (1840-1921). Both separately formulated a marginal utility theory, in which 'value' depends entirely on utility or satisfaction.

Smith, the father of modern Economics, is also regarded as the founder of the classical school, which championed the free market. His ideas were developed by others including Jean-Baptiste Say (1767-1832) and David Ricardo (1772-1823), and later refined by neoclassical economists in the late 19th and early 20th centuries.

It might be thought that a free market would lead to chaos and eventually the law of the jungle. But Smith suggests that although each producer pursues his own self-interest, he is led as if by an 'invisible hand' to maximise social welfare. The hand in question was the competitive price mechanism of demand and supply. The producer wants to charge as high a price as possible but, being in competition with others producers, he is forced to keep his prices down and improve quality, otherwise they will undercut him and his sales will collapse. Competition therefore keeps prices low and quality high. Smith did not explain his metaphor of the 'invisible hand' in exactly this way (the relevant passage is obscure) but it is effectively the gist of his argument.

Smith, in common with these other economists, nevertheless played down the influence of demand on price, believing in a modification of the labour theory of value — the price of a good is determined by the total amount of labour required to produce it — which added other costs of production. Jean-Baptiste Say was a French economist best known for Say's Law which, in Keynes's formulation, states that supply creates its own demand. Again, supply is seen as the crucial factor in the market. Since resources are scarce relative to people's needs, there can be no shortage of demand. According to Ricardo, "demand is only limited by production". People will buy what they produce because every activity generates incomes in the form of wages, profits, rents etc equivalent to the value of its output.

It was the Frenchman Léon Walras (1834-1910) and the Englishman Alfred Marshall (1842-1924) in his *Principles of Economics*, first published in 1890, who claimed that both demand and supply determine price. Rational buyers maximising utility and rational sellers maximising profits barter their way towards a balance or 'equilibrium'. Marshall argued that demand is more important in the short run because supply is slower to react to changing conditions, but it becomes more important in the long run when investment can be changed.

Although there were differences, all of these economists, both classical and neoclassical, agreed that competition in the market produces a socially beneficial outcome, not least because the market is self-regulating. There may be occasional disturbances and temporary unemployment but, if left alone, it will quickly revert to a general full employment equilibrium. Consequently, government interferences in the free market were condemned not only as unnecessary but also as barriers to efficiency.

Then came the Great Depression. Between 1929 and 1933 the American economy suffered a GDP decline of nearly 30% (real disposable income fell by nearly 40%). The unemployment rate soared from 3% in 1929 to 25% in 1933 and 85,000 businesses failed. In the UK the unemployment rate rose to about 22% and in Germany by 1933 it was nearly 30%. Neoclassical economists, whose ideas dominated government thinking in both America and the UK, regarded this slump as a temporary aberration, but it lasted for more than a decade.

At first, neoclassical economists such as Lionel Robbins – who thought in terms of a zero-sum game – called for wage reductions to increase profits and employment, and cuts in state spending, which was seen as a rival to the private sector for resources. Yet when implemented, —>

they produced the opposite result: unemployment rose and output fell. In some countries different policies were eventually applied. In America under Roosevelt's New Deal and in Hitler's Germany, a policy of increased spending by governments was operated. This was done without a proper theoretical framework. That was provided by John Maynard Keynes in 1936 in *The General Theory of Employment, Interest and Money.*

A year earlier, Keynes had written to George Bernard Shaw: "I believe myself to be writing a book on economic theory which will largely revolutionise – not, I suppose, at once but in the course of the next ten years – the way the world thinks about its economic problems". He was not exaggerating, for he basically invented macroeconomics, the study of the whole economy, based on the assumption that what is good for individuals and single markets is not necessarily good for the general society.

For example, a fall in the wages of workers in a particular firm might indeed lead to an increase in the demand for workers in that particular firm (law of demand), but a fall in wages in general might reduce consumption (aggregate demand), followed by a fall in production, and so cause the economy to settle for a prolonged period at an equilibrium level of output well below the full employment level. The neoclassical approach in a depression of supply side policies thus leads to the opposite result of what was intended. Similarly, an increase in savings may lead to a fall in aggregate demand and thus a decrease in total output and income which will in turn reduce total saving. This paradox of thrift, first noted by Bernard Mandeville in his *Fable of the Bees* (1714) – that thrift may be good for the individual but bad for the collective and instead that prosperity may be increased by spending rather than saving – is a cornerstone of Keynesian economics.

The General Theory shifted the thrust of economics from the concept of aggregate supply stressed by economists from Ricardo onwards to the concept of aggregate demand. In a sense, Keynes was able to alter the perspective because he was not a professional economist and therefore not encumbered by the weight of tradition which caused orthodox economists to fail to see the wood for the trees. He also believed that allowing people to suffer unemployment and poverty while waiting for the free market to bring the economy back into equilibrium was morally and socially unacceptable. As he famously wrote: "this long run is a misleading guide to current affairs. In the long run we are all dead. Economists set themselves too easy, too useless a task if in tempestuous seasons they can only tell us that when the storm is long past the sea is flat again". Focusing only on the long run was ignoring the current plight of victims of the depression, and that had to be quickly addressed.

On the basis of the circular flow of income and the identity between total income, output and expenditure, we can say that Y (income) or AD (Aggregate Demand) or GDP (Gross Domestic Product) = C (consumer expenditure) + I (investment expenditure) + G (government expenditure) + X-M (exports - imports). In the short run, an economy does not consume all that it produces. The difference, savings, needs to be invested if total production is to be sold and if all productive factors are to be full employed. But savings may not be matched by investment, which is volatile and depends on investors' expectations about the future, which is uncertain. Suppose that investors become pessimistic and reduce their investments. Keynes dismissed the idea that a fall in interest rates would then act to make investment more attractive. Instead, as investment falls, so overall spending falls, followed by income and savings. The economy spirals downwards, as occurred during the Depression.

If I and/or C falls then G needs to increase to plug the deflationary gap, a situation where the level of total expenditure is less than the capacity of the economy to produce, leading to unemployment and idle capital equipment. Here, then, is an active role for government: to facilitate injections (J) into the circular flow. It can do it by increasing its own spending and introducing measures to boost investment and exports. Alternatively, or in addition, it can help to reduce withdrawals (W) from the flow, namely savings, taxes and imports. Moreover, there is a multiplier effect (k) as an increase in J will be multiplied as it goes through the economy. The size of the multiplier in a two sector economy (Y=C+I) depends on the proportion of any extra injection that is consumed rather than saved. If fact, it is the reciprocal of the marginal propensity to save (MPS). If the MPS is 0.25, then k is 4. So, if the government spends, say, an extra £1bn, then the final increase in expenditure will be £4bn. In practice, it is not as high because there are actually three leakages, not one: as well as saving, there are taxes and imports to consider. In fact, the IMF estimates that the multiplier for most developed economies is about 1.5.

The Keynesian solution of increased government expenditures and lower taxes to stimulate demand and pull the economy out of a depression was not implemented in his own country until the 1940s. After the war the 'Keynesian consensus' dominated western economic policies until the 1970s. The combination of high inflation and unemployment in the mid-1970s contributed to a return to neoclassicism under Reagan and Thatcher which lasted into the latest recession that began in 2008. Keynesianism was a dirty word for 30 years. As Paul Krugman notes, "in 2005 the right-wing magazine *Human Events* listed listed Keynes's *General Theory* among the ten most harmful books of the nineteenth and twentieth centuries, right up there with *Mein Kampf* and *Das Kapital*" (*End this Depression Now!* Norton, 2013, p94).

Part of the reason is that conservatives have always seen it as the thin end of the wedge: concede that governments can play a useful role in fighting slumps, and the next thing you know we'll be living under socialism. Yet Keynes himself was not a socialist. He described his book as 'moderately conservative in its implications'. Indeed, what he was saying was really obvious when you think about it. Believing in an invisible hand guiding a social system is no different from believing in a hidden god. It's as silly as saying that a ship doesn't need a crew to steer it. Without human guidance it will almost certainly end up on the rocks. Keynes believed that capitalism needed to be wisely managed. In the recent recession, so too did many governments and, without openly admitting it, they adopted Keynesian policies once again. At least the wiser ones did. The UK government has proved, not for the first time, to be a late convert to its own countryman's ideas, announcing the end of austerity in 2018. ❑