Topic Page: Keynes, John Maynard (1883 - 1946)

Definition: **Keynes** from *Merriam-Webster's Collegiate(R) Dictionary*

pronunciation

John Maynard Keynes 1883–1946 1st Baron *Keynes of Tilton* Eng. econ.

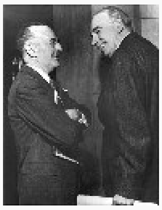

Image from: **John Maynard Keynes (right) meets with Harry...** in *Encyclopedia of Politics*

Summary Article: **JOHN MAYNARD KEYNES (1883—1946)**
From *Routledge Key Guides: Fifty Major Economists*

With Adam Smith and Karl Marx, John Maynard Keynes (pronounced CANES) stands as one of three giant figures in economics. Smith was the optimist of this trio, seeing higher living standards as the main consequence of capitalism. Marx was the pessimist of the three, believing that capitalism would self-destruct due to its many flaws. Keynes was a pragmatist seeking a middle road. He thought that intelligent government policy could save capitalism. This would allow us to reap its benefits without suffering its many problems.

Keynes is also the economist of economic slumps and recession. Writing in the middle of the Great Depression, he analyzed the causes of mass unemployment and set forth policies to help end the depression and to keep us from experiencing another one.

Keynes was born in Cambridge, England, in 1883 with the proverbial silver spoon in his mouth. His father, John Neville Keynes, was the registrar at Cambridge University and a distinguished economist and philosopher at the University. His mother was, for a time, the mayor of Cambridge. Keynes was educated at the best schools in England — Eton and King's College, Cambridge. At Cambridge, he studied philosophy with G.E. Moore, mathematics with Alfred North Whitehead and economics with Alfred Marshall. Keynes also became part of an exclusive club of Cambridge intellectuals that later became the Bloomsbury group. This group included major literary and artistic figures such as Virginia Woolf and E.M. Forster.

After graduating from Cambridge, Keynes sat for the British Civil Service exam. He received the second-highest score of those taking the test. This gave him the second choice among all open civil service positions. Although he craved a job at the Treasury, this position was taken by Otto Niemeyer, who had first choice by virtue of scoring highest in the exam. Ironically, Keynes received the highest scores in Logic, Psychology, Political Science, and Essays; but he scored second overall because of a relatively low score in Economics. Later in life, Keynes would often quip that he "knew more about Economics than my examiners" (Harrod 1951, p. 121).

Settling for a post in the India Office, Keynes helped organize and coordinate British interests involving India. "His first major job, lasting for several months, was ordering and arranging for the shipment to Bombay of ten young Ayrshire bulls" (Moggridge 1992, p. 168). Things did not get any more interesting after this and Keynes, understandably, became bored. After two years he returned to Cambridge to teach economics. Three years after that he became editor of the *Economic Journal*, at the time the most prestigious economics journal in the world.

Public acclaim first came to Keynes following publication of *The Economic Consequences of the Peace*, a book about the Versailles Peace Treaty ending World War I. During the war Keynes served in the British Treasury and was primarily responsible for obtaining external finance to support the British war effort. As the war drew to a close, Keynes was made a member of the British delegation at Versailles that was negotiating German war reparations. Besides containing biting portraits of the major participants at the peace conference (US President Wilson, French Chancellor Clemenceau, and British Prime Minister Lloyd George), Keynes (1971—89, vol. 2) provided an angry critique of the treaty itself. According to his calculations, Germany could not possibly make good on the British and French demands for reparations. The result would be the impoverishment of Germany, and rising German hostility towards France and England. The political consequence, which Keynes equally feared, would be the rise of an angry and militant Germany in the future.

By this point a figure of national prominence, Keynes turned his attention to more pressing economic issues. His *Tract on Monetary Reform* (Keynes 1971—89, vol. 4) warned of the dangers of inflation. It looked to central bank control of the money supply as a means of controlling inflation. This work also contained Keynes's famous and misunderstood dictum “in the long run we are all dead.” Many have taken this phrase to show that Keynes was willing to sacrifice long-term economic performance for short-term economic benefits. But this is not what he was driving at. He was actually criticizing others who believed that the problem of inflation would eventually remedy itself, without any active government involvement. Rather than waiting for inflationary problems to correct themselves in the distant future, when we all might be dead, Keynes thought it would be better to employ economic policy and improve things now. His point was that there was no reason to wait for elusive future gains when progress could be made in solving our economic problems by intelligently employing economic policies.

During the 1920s, as inflation receded and Britain experienced prolonged bouts of high unemployment, Keynes focused on this problem. *A Treatise on Money* (Keynes 1971—89, vols 5 and 6) examined the relationships between money, prices, and unemployment. It singled out the saving—investment relationship as the main cause of economic fluctuations. For Keynes, when people tried to save more than firms wanted to invest, businesses would soon find themselves with excess capacity to produce goods and too few buyers for what they produced. The result would be layoffs and high unemployment. On the other hand, when investment exceeded savings, there would be too much spending. Consumers would spend rather than save; businesses would want to hire more workers to produce goods and build plants and equipment. This would bid up wages as well as other costs of production, thereby increasing prices, or creating high inflation.

The problem, Keynes stressed, was that savings decisions and investment decisions were made by different groups of individuals. As a result, there was no guarantee the two would be equal. Keynes then argued that it was the responsibility of the central bank to keep these two variables equal to one another, and thus the responsibility of the central bank to prevent either inflation or recession. If savings exceeded investment, and unemployment was too high, the central bank would need to lower interest rates, thus both reducing savings and stimulating borrowing. On the other hand, if investment exceeded savings, and there was inflation, the central bank would need to raise interest rates, thus increasing savings and reducing borrowing for investment purposes.

As a slump became a Great Depression, Keynes sought to explain how such problems were possible. The *General Theory of Employment, Interest and Money* (Keynes 1971—89, vol. 7) is responsible for developing a new branch of economics (macroeconomics) and was the most referenced and debated work in economics during the twentieth century. It sets forth a theory explaining what determines the amount of production and employment in a country. Although the book says little about economic policy, it provides the theoretical foundation for government action to end economic contractions.

The General Theory begins by attacking Say's Law, the view that "supply creates its own demand." According to this dictum, unemployment was not possible because whatever the existing supply of workers (or the existing supply of goods in the economy), there will be a demand for these workers (or a demand for these goods). For Keynes, in contrast, total demand determined the supply of output and the level of employment. When spending was high, economies would prosper, businesses would expand and hire more workers, and unemployment would cease to be a problem. But when spending was low, firms could not sell their goods; they would be forced to cut back on production and hiring. If things got very bad, there would be mass layoffs, high unemployment, and a depression. For obvious reasons, Keynes next examined the determinants of total spending and what caused spending to change. Through this analysis, Keynes developed the modern theories of consumer spending and business investment (or business expansion by purchasing more plants and equipment).

Keynes identified two broad determinants of consumer spending — subjective factors and objective factors. The subjective or psychological factors affecting consumption were uncertainty regarding the future, the desire to bequeath a fortune, and a desire to enjoy independence and power. Greater fears about one's economic future, a greater desire to leave money to one's children, and a greater desire for independence, lead to more saving and less spending. Conversely, a secure economic future, no heirs, and indifference to one's economic independence reduce savings and increase spending.

Current income was the most important objective factor because most people habitually consumed a large fraction of their current income. As income rose, so did consumption; and during hard economic times, as income fell, consumption fell also.

Other objective factors were economic variables like interest rates, taxes, wealth, and the distribution of income. When interest rates rose, consumers would become reluctant to borrow money in order to buy homes, new cars, and other goods on credit. Conversely, with low interest rates, consumers would more freely incur debt and spend money. Likewise, greater wealth would lead people to spend more and save less. A stock market crash as occurred in 1929 would reduce wealth, leading people to spend less and save more. When income was distributed equally, more income would go to those likely to spend it, while greater income inequality would put a greater fraction of total income into the pockets of those likely to save it.

In contrast to the many factors affecting consumption, business investment depended on just two factors according to Keynes — the expected return on investment, and the rate of interest. The former constitutes the benefits from investing in new plant and equipment; the latter constitutes the cost of obtaining funds to purchase the plant and equipment. If the expected rate of return on investment exceeded the interest rate, firms will expand, building new plants and filling them with machinery to produce goods. However, if interest rates exceeded the expected rate of return on investment, that investment will not take place.

Changes in expectations and changes in interest rates lead to changes in investment. When business owners are optimistic about the economy (believing that they will be able to sell many goods in the future and get a good price from consumers for these goods), they will expect high rates of return on money used to build new plants and equipment. However, when pessimism sets in, business decision-makers expect fewer sales to consumers and think that only if they offer goods at low prices will consumers purchase these goods. In this case, expectations are for meager rates of return on new investment, and little new business expansion takes place.

Interest rates, according to Keynes, were determined in money markets where people and businesses demand money and where central banks control the money supply. The demand for money came from portfolio decisions made by people and businesses — the decisions to hold money or hold wealth in the form of stocks, bonds, and other assets.

A bond is merely a promise to pay the person who owns the bond a fixed sum of money at some point in the future. To keep things simple, consider a bond that promises to pay its owner $1,000 one year from today. If I were to purchase this bond for $800, my interest rate, or the rate of return on the money I lent to whoever printed the bond, will be 25 percent (a $200 gain on the $800 I paid for the bond). If the price for the bond were $909 rather than $800, I would be getting back around 10 percent on my money (a $91 gain on the $909 I paid for the bond). And had I bought the bond for $990, I would be making only around 1 percent on my money ($10 additional on the $990 I lay out now). Consequently, bond prices and interest rates are inversely related — as one goes up, the other goes down.

By necessity, the supply of money existing in the economy must be held by someone. Central banks create money by printing it up and then getting it out into the economy. By purchasing government bonds they are effectively lending the government money. The money can also be lent to banks (hence, central banks are generally regarded as banker's banks), which will then lend it to consumers and business firms.

When central banks buy bonds, this drives up the price of bonds and lowers the rate of return on these assets. On the other hand, when central banks want to reduce the money supply, they sell bonds. To get people to hold these bonds the central bank must offer them at a low price. Those buying the bonds will thus be receiving a good rate of return on their money; in other words, interest rates will rise.

After his critique of classical economic theory, and his presentation of the determinants of total demand for goods and services, surprisingly, Keynes had little to say about how to reduce unemployment and end depressions.

He supported both money creation *(monetary policy*) and tax cuts as well as more government spending (*fiscal policy*). In a much-quoted passage, he writes about more government spending to fill the need for more houses, hospitals, schools, and roads. But he notes that many people are likely to object to such “wasteful” spending. Another approach was needed.

> *If the Treasury were to fill old bottles with banknotes, bury them at suitable depths in disused coal mines which are then filled up to the surface with town rubbish ... private enterprise [would] dig the notes up and there need be no more unemployment.*
>
> *(Keynes 1971—89, vol. 7, p. 129)*

And in a much maligned passage, Keynes (1971—89, vol. 7, p. 378) calls for “a somewhat comprehensive socialization of investment.” While many have taken him to be advocating government control of all business investment decisions, Keynes only wanted government spending to stabilize the aggregate level of investment in the national economy (Pressman 1987). He believed that consumer spending was relatively stable, changing little from year to year. Investment, however, was driven by fickle expectations or what he called "animal spirits." Changes in business confidence or expectations about the future of the economy would change the level of investment and have a large impact on the economy. Moreover, self-fulfilling prophesies were likely to be at work. When businesses were confident, they would invest more and the economy would expand. This boom would reinforce expectations about profits, and lead to even greater optimism and investment. On the other hand, expectations about a poorly performing economy in the future would lower investment, slow economic activity, and reinforce and strengthen business pessimism about future profits. When optimism prevailed the economy would boom, but when pessimism set in there would be dramatic declines in investment and massive unemployment.

The solution to such volatility was to have government stabilize the level of investment. When private investment was low, the government should borrow money (i.e. run a budget deficit) and engage in public investments such as building new roads and bridges as well as spending more money on schools and better education. This would expand the economy as well as improve expectations. In contrast, when business investment was high due to great optimism, government should stop borrowing, repay past loans and cut back on public investment.

Keynes did better when it came to preventing slumps. His concern was to control the speculation that contributed to asset bubbles (like the stock market bubble of the 1920s and the housing bubble of the early 2000s). When these bubbles burst, lower wealth would reduce consumption and greater pessimism would lower both consumption and investment. The result would be a prolonged slump. He was also worried that during economic expansions there would be a tendency to focus on speculative activities rather than productive ones. To prevent this Keynes proposed high (brokerage) fees and transaction taxes on speculative activities (Pressman 1989).

In the 1940s Keynes was again working for the British government, and also returned to policy issues surrounding the war effort. He helped negotiate British loans from the US to help fight World War II. When the war ended, Keynes helped develop the new international monetary arrangements being worked out by the victorious governments. He believed that one cause of the Great Depression was that every country tried to export unemployment to its trading partners. By running a trade surplus, each country could produce more and create more jobs; its trading partners would import goods instead of producing them, leading to higher unemployment there.

Many countries attempted to generate trade surpluses in the 1930s through devaluing their currencies. In making foreign money and foreign goods more expensive, governments knew that their citizens would buy fewer foreign goods and buy more goods produced by domestic firms with domestic workers. Similarly, by making domestic money and domestic goods cheaper for people in other countries, devaluation would increase exports. The problem was that when one country devalued its currency, attempting to create exports and employment for its citizens, other countries would follow suit. The result was a series of currency devaluations that in the end did not benefit any country.

To prevent competitive currency devaluations, Keynes proposed a system of relatively fixed exchange rates throughout the developed world. This system was agreed to by the Allied victors at Bretton Woods, New Hampshire, in 1944, and came to be known as the Bretton Woods system. Each country pegged its currency to an ounce of gold and kept it there. With every currency tied to gold, the value of every currency was tied to every other currency. If the US government said each dollar was worth 0.1

ounces of gold, and if the British government decreed that each pound was worth 0.2 ounces of gold, then $2 had to equal £1 since both were equal to 0.2 of an ounce of gold. Currencies would not vary from this rate because both countries will exchange their money for gold at this rate, and everyone can buy and sell at this rate.

Bretton Woods operated for around twenty-five years. During this time the world economy grew at unprecedented rates; unemployment in developed countries reached their lowest levels ever recorded. But problems simmered below the surface. At the agreed exchange rates gold was rapidly leaving the US, and the US feared it would soon run out of gold. Something had to be done to stop this. Bretton Woods died in August 1971, when President Nixon ended the convertibility of dollars into gold and let the dollar float relative to an ounce of gold. The current system of flexible exchange rates was born.

A second way countries sought to export their unemployment was through protectionism. Countries sought ways to exclude foreign goods. If that failed, they would impose a tariff or a tax on imported goods, making them more expensive than goods made within the country. This, too, had a deflationary impact because every country experienced reduced foreign demand for their goods.

The solution to the problem of each country attempting to run a trade surplus via protectionism was to establish an international system that would lend money to nations running trade deficits and penalize nations that persistently ran trade surpluses. This would encourage countries running trade surpluses to buy more foreign goods, and would counter any tendencies towards another depression. The clearing mechanism and the lending facility Keynes wanted were also established at Bretton Woods — the International Monetary Fund and the World Bank.

Unfortunately, these institutions did not fill the role that Keynes hoped they would. The US expected it would run trade surpluses because its manufacturing capacity was not destroyed during the war; so it opposed penalizing countries with persistent trade surpluses. Keynes pushed hard for such a policy, but the US had all the bargaining chips because of all the money it had lent to Britain during World War II (see Block 1977). Ironically, such a policy would have been a great benefit to the US in the late twentieth and early twenty-first centuries, when it ran enormous trade deficits. It would also have helped with some of the economic problems facing Europe in the early 2010s (see **Robinson**).

Keynes suffered a series of heart attacks while negotiating the final details of the new international financial institutions and arrangements. He died at his country home in Tilton, East Sussex, in 1946.

Without doubt, no twentieth-century economist has had a greater impact than Keynes. At the theoretical level, he developed macro-economic analysis. Macroeconomics, as taught in colleges and universities today, still relies on the concepts and modes of analysis developed by Keynes. Even those opposed to Keynesian economics (see **Friedman** and **Lucas**) find it necessary to start with Keynes and then explain the limitations and problems with his theory.

But it is at the policy level that Keynes had the greatest impact. The tools used by central banks and central governments to control the business cycle are primarily due to Keynes. There is no better example of his influence than the policy reaction to the economic slump of the late 2000s. Keynesian policies were enacted worldwide. Interest rates were cut to near zero. Governments increased spending and cut taxes to stimulate spending. While these policies did not return economies to full employment, and while fiscal policy too quickly returned to a focus on reducing budget deficits, these actions did keep unemployment from rising to Great Depression levels in most developed countries.

For this we have Keynes to thank.

Works by Keynes

- The Collected Writings of John Maynard Keynes, ed. Moggridge, D. 30 vols, Macmillan London, 1971—89. Paperback editions of Essays in Biography and Essays in Persuasion are published by Norton. Harcourt, Brace & World publishes a paperback edition of The General Theory of Employment, Interest and Money. Dover has a paperback edition of The Economic Consequences of the Peace and Prometheus Books a paperback edition of A Tract on Monetary Reform.

Works about Keynes

- Dillard, Dudley The Economics of J. M. Keynes, Prentice Hall New York, 1948.
- Hansen, Alvin A Guide to Keynes, McGraw Hill New York, 1953.
- Harrod, Roy The Life of John Maynard Keynes, Norton New York, 1951.
- Moggeridge, Donald Maynard Keynes: An Economist's Biography, Routledge London and New York, 1992.
- Pressman, Steven “The Policy Relevance of The General Theory,” Journal of Economic Studies, 14 (1987), pp. 13-23.
- Pressman, Steven “Keynes on Speculation,” in Perspectives on the History of Economic Thought, Vol. II, edited by Donald Walker; Hants, Edward Elgar 1989, pp. 97-120.
- Skidelsky, Robert Keynes: Return of the Master, Penguin Books London and New York, 2009.

Other references

- Block, Fred L. Origins of the International Economic Order, University of California Press Berkeley California, 1977.

© 1999, 2006, 2014 Steven Pressman

APA

John Maynard Keynes (1883--1946). (2014). In S. Pressman, *Routledge Key Guides: Fifty major economists* (3rd ed.). London, UK: Routledge. Retrieved from https://search.credoreference.com/content/topic/keynes_john_1883_1946

Chicago

"John Maynard Keynes (1883 1946)." In *Routledge Key Guides: Fifty Major Economists*, by Steven Pressman. 3rd ed. Routledge, 2014. https://search.credoreference.com/content/topic/keynes_john_1883_1946

Harvard

John Maynard Keynes (1883--1946). (2014). In S. Pressman, *Routledge Key Guides: Fifty major economists*. (3rd ed.). [Online]. London: Routledge. Available from: https://search.credoreference.com/content/topic/keynes_john_1883_1946 [Accessed 16 October 2019].

MLA

"John Maynard Keynes (1883 1946)." *Routledge Key Guides: Fifty Major Economists*, Steven Pressman, Routledge, 3rd edition, 2014. *Credo Reference*, https://search.credoreference.com/content/topic/keynes_john_1883_1946. Accessed 16 Oct. 2019.