Giants Of Finance: John Maynard Keynes

by Andrew Beattie (Contact Author | Biography)

If ever there was a rock star of economics, it would be John Maynard Keynes. Keynes shares his birthday, June 5th, with Adam Smith and he was born in 1883, the year communist founder Karl Marx died. With these auspicious signs, Keynes seemed to be destined to become a powerful free market force when the world was facing a serious choice between communism or capitalism. Instead, he offered a third way, which turned the world of economics upside down. In this article, we'll examine Keynes' doctrine and its impact. (To read about Adam Smith, be sure to check out *Adam Smith: The Father Of Economics*.)

The Cambridge Seer

Keynes grew up in a privileged home in England. He was the son of a Cambridge economics professor and studied math at university. After two years in the civil service, Keynes joined the staff at Cambridge in 1909. He was never formally trained in economics, but over the following decades he quickly became a central figure. His fame initially grew from accurately predicting the effects of political and economic events.

His first prediction was a critique of the reparation payments that were levied against the defeated Germany after WWI. Keynes rightly pointed out that having to pay out the cost of the entire war would force Germany into hyperinflation and have negative consequences all over Europe. He followed this up by predicting that a return to the prewar fixed exchange rate sought by the chancellor of the exchequer, Winston Churchill, would choke off economic growth and reduce real wages. The prewar exchange rate was overvalued in the postwar damage of 1925, and the attempt to lock it in did more damage than good. On both counts, Keynes was proved right. (For related reading, see *War's Influence On Wall Street*.)

A Big Miss, But a Great Rebound

Keynes was not a theoretical economist: he was an active trader in stocks and futures. He benefited hugely from the Roaring '20s and was well on his way to becoming the richest economist in history when the crash of 1929 wiped out three-quarters of his wealth. Keynes hadn't predicted this crash, and was among those who believed a negative economic event was impossible with the Federal Reserve watching over the U.S. economy. Although blindsided by the crash, the adaptable Keynes did manage to rebuild his fortune by buying up stocks in the fire sale following the crash. His contrarian investing left him with a fortune of around $30 million at his death, making him the second richest economist in history. (For more on this period in economic history, check out *What Caused The Great Depression?* and *Crashes: The Great Depression*.)

The General Theory

Many others fared far worse in the crash and the resulting depression, however, and this is where Keynes' economic contributions began. Keynes believed that free market capitalism was inherently unstable and that it needed to be reformulated both to fight off Marxism and the Great Depression. His ideas were summed up in his 1936 book, "The General Theory of Employment, Interest and Money". Among other things, Keynes claimed that classical economics - the invisible hand of Adam Smith - only applied in cases of full employment. In all other cases, his "General Theory" held sway. (Read *Can Keynesian Economics Reduce Boom-Bust Cycles?* to learn more.)

Inside the General Theory
Keynes' "General Theory" will forever be remembered for giving governments a central role in economics. Although ostensibly written to save capitalism from sliding into the central planning of Marxism, Keynes opened the door for government to become the principal agent in the economy. Simply put, Keynes saw deficit financing, public expenditures, taxation and consumption as more important than saving, private investment, balanced government budgets and low taxes (classical economic virtues). Keynes believed that an interventionist government could fix a depression by spending its way out and forcing its citizens to do the same, while smoothing futures cycles with various macroeconomic techniques.

Holes in the Ground
Keynes backed up his theory by adding government expenditures to the overall national output. This was controversial from the start because the government doesn't actually save or invest as business and private business do, but raises money through mandatory taxes or debt issues (that are paid back by tax revenues). Still, by adding government to the equation, Keynes showed that government spending - even digging holes and filling them in - would stimulate the economy when businesses and individual were tightening budgets. His ideas heavily influenced the New Deal and the welfare state that grew up in the postwar era. (To learn the differences between supply-side and Keynesian economics, read *Understanding Supply-Side Economics*.)

The War on Saving and Private Investing
Keynes believed that consumption was the key to recovery and savings were the chains holding the economy down. In his models, private savings are subtracted from the private investment part of the national output equation, making government investment appear to be the better solution. Only a big government that was spending on behalf of the people would be able to guarantee full employment and economic prosperity. Even when forced to rework his model to allow for some private investment, he argued that it wasn't as efficient as government spending because private investors would be less likely to undertake/overpay for unnecessary works in hard economic times.

Macroeconomics: Magnifying and Simplifying
It is easy to see why governments were so quick to adopt Keynesian thinking. It gave politicians unlimited funds for pet projects and deficit spending that was very useful in buying votes. Government contracts quickly became synonymous with free money for any company that landed it, regardless of whether the project was brought in on time and on budget. The problem was that Keynesian thinking made huge assumptions that weren't backed by any real world evidence.

For example, Keynes assumed interest rates would be constant no matter how much or how little capital was available for private lending. This allowed him to show that savings hurt economic growth - even though empirical evidence pointed to the opposite effect. To make this more obvious, he applied a multiplier to government spending but neglected to add a similar one to private savings. Oversimplification can be a useful tool in economics, but the more simplifying assumptions are used, the less real-world application a theory will have.

The Theory Hits a Rut
Keynes died in 1946. In addition to "The General Theory", he was part of a panel that worked on the Bretton Woods Agreement and the International Monetary Fund (IMF). His theory continued to grow in popularity and caught on with the public. After his death, however, critics began attacking both the macroeconomic view and the short-term aims of Keynesian thinking. Forcing spending, they argued, might keep a worker employed for another week, but what happens after that? Eventually the money runs out and the government must print more, leading to inflation.

This is exactly what happened in the stagflation of the 1970s. Stagflation was impossible within Keynes' theory, but it happened nonetheless. With government spending crowding out private investment and inflation reducing real wages, Keynes' critics gained more ears. It ultimately fell upon Milton Friedman to reverse the Keynesian formulation of capitalism and reestablish free market principles in the U.S. (Find out what factors contribute to a slowing economy, in *Examining Stagflation* and *Stagflation, 1970s Style*.)

Keynes for the Ages
Although no longer held in the esteem that it once was, Keynesian economics is far from dead. When you see consumer spending or confidence figures, you are seeing an outgrowth of Keynesian economics. The stimulus checks the U.S. government handed out to citizens in 2008 also represent the idea that consumers can buy flat-screen TVs or otherwise spend the economy out of trouble. Keynesian thinking will never completely leave the media or the government. For the media, many of the simplifications are easy to grasp and work into a short segment. For the government, the Keynesian assertion that it knows how to spend taxpayer money better than the taxpayers is a bonus. (To learn more about the stimulus checks, read *How do government issued stimulus checks improve the economy?*)

Conclusion
Despite these undesirable consequences, Keynes' work is useful. It helps strengthen the free market theory by opposition, as we can see in the work of Milton Friedman and the Chicago School economists that followed Keynes. Blind adherence to the gospel of Adam Smith is dangerous in its own way. The Keynesian formulation forced free market economics to become a more comprehensive theory, and the persistent and popular echoes of Keynesian thinking in every economic crisis caused free market economics to develop in response.

Friedman once said, "We are all Keynesians now." But the full quote was, "In one sense we are all Keynesians now; in another, no one is a Keynesian any longer. We all use the Keynesian language and apparatus; none of us any longer accepts the initial Keynesian conclusions."

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