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Financial Crisis Through the Eyes of Keynes

Ever since the adoption of Keynesian policies during the onset of the Great Depression in the 1930s, it has been the go-to fiscal policy for governments around the world. It has become the standard for fundamental macroeconomic thinking and Keynes himself has built a legacy as one of the great philosophical, not just economic, thinkers of the twentieth century. From the Great Depression to the Great Recession, Keynesian theory has been an essential tool in the slowing down of financial catastrophe over the last century. However, even with all the success that Keynesian economics has been credited with, it has had its fair share of criticisms in recent years. The issue of increasing national debt in the United States has become a heated topic of debate over the past decade, prompting discussions about what new economic philosophies should take over for Keynesian ideas. Post-Keynesian theories, the Austrian School, and Modern Monetary Theory are all popular avenues that economists think the U.S could take soon. As mainstream government systems and relations have changed over time, so have the economic systems. Just as Keynesian theory took the world by storm in the twentieth century in a new era, it could soon be phased out by a new way of thinking for a new global economy.

To understand how John Maynard Keynes' ideas came to fruition, it is important to understand his upbringing, the world he grew up in, and his outlook on life. John Maynard Keynes grew up in a middle-class family in Cambridge, England during the late-nineteenth century as the son of a social worker mother and an economist father. His father was a big influence on his early economic ideals in that he instilled within him with the early laissez-faire ideas that were popular at the time. The industrial revolution had brought a vast amount of wealth to countries in Western Europe such as Great Britain, Germany, and France which was accompanied in large part by eighteenth century laissez-faire economics. During this time, state

intervention in economic matters in the private sector was very rare and out of the minds of most governments. This would all change, however, when an unprecedented war would shake up the world stage forever.

World War I was a colossal turning point for not just the political world, but also the economic world. As we know, World War I ended with an allied victory and the signing of the Treaty of Versailles which harshly punished the members of the Triple Alliance. As tensions grew between the European nations, the risks of maintaining the status quo grew. Keynes warned in his book, *The Economic Consequences of the Peace*, that the European powers failed the peace negotiations by punishing Germany and Austria-Hungary too harshly and not reintegrating them into the global economy. He believed this harsh action would lead to future economic crisis and war down the line (Pierson 264). His predictions would become reality when Hitler rose to power in Germany and began his fascist regime, further destabilizing Europe. Things would only get worse when the U.S stock market crashed in 1929 and plunged the world into a deep economic depression. The triumph of fascism in Germany and communism in Russia only made the sustainability of capitalism look worse, but John Maynard Keynes had already developed his models that would fundamentally change how people think about economics for decades to come.

John Maynard Keynes had published many works on the steps that should be taken during a recession. His ideas challenged the longstanding neoclassical economic beliefs in that he believed that in the new economic landscape of the twentieth century, people of wealthier nations were more likely to save their money en masse, thus causing a decline in consumer spending. His solution for this problem was for governments to pick up the slack and increase their own investment spending during these recessionary periods (Pierson 269). During the

height of the depression, he advised U.S government officials to take steps to integrate his theories into their policies which would result in Franklin D. Roosevelt's New Deal plan in the United States. Recovery would be a slow process in the United States during the 1930s but would be helped a great deal by Roosevelt's decision to enter the second world war in 1941. Increased demand for weapons and industrial output would pull the country out of the depression for good, proving that Keynes' theories of using expansionary fiscal policy to alleviate recession were valid.

Keynes would further back up his claims with the publication of his most famous work, *General Theory of Employment, Interest, and Money*, in 1936. This book would lay the groundwork for Keynesian principles backed up with mathematical models that were, at the time, hard for even economic experts to understand (Pierson 268). One of the major fundamentals of Keynesian theory was its rejection of Say's Law, which states that supply creates its own demand. If one were to believe this assumption, then the prospect of economic recession caused by an increase in consumer savings would not pose a risk to an economy. However, Keynes argued that this notion is false, and that demand is the driver of a nation's overall economic activity. This belief, combined with the ideas of the business cycle, provides an explanation for how an economy could have a period of low output during a time of mass unemployment (Pierson 269).

Keynesian law's core principles are that demand is the source of supply, savings do not necessarily equal investment, sustained unemployment is not always voluntary, and that there is no automatic tendency for a market to self-correct (Pierson 269). If one believes these rules that Keynes laid out, then one is to believe that a government has the responsibility and power to act when the national economy is in a slump because of increased consumer saving. A previous fear

of governments was the burden of deficit spending and carrying a large national debt. Keynes believed that the ideas of consumption, debt, and deficit spending should be destigmatized to save capitalism from further collapse (Pierson 270). Because of the adoption of these ideas by the United States in the postwar world, there has been a trend of increasing public budgets and debt as time has gone by. Keynesian economics would keep a low profile for the next few decades until another economic disaster would emerge at the turn of the twenty-first century to reinvigorate its founder's philosophy.

The build up to the Great Recession of 2008 was a surprise to most but had some precursors that should have raised alarms in the United States. One of the things that enabled the crisis to happen in the first place was the vast amount of deregulation in the United States banking system. This would allow banks to shadily give mortgages to people who more than likely couldn't afford to pay for the houses they were trying to buy. The banks believed nothing could go wrong because, to this point, the housing market was so stable, and a crash was not on the mind of anyone taking part in what was going on. Little did they know, the housing market would in fact crash and put the economy into a tailspin in a way that had not been seen since the Great Depression. A new economic disaster was threatening the global economy and like in the 1930s, a new liberal administration was prepared to use the theories of John Maynard Keynes to get on the road to recovery.

When Barack Obama was inaugurated as the 44th president of the United States, he immediately had a tough task ahead of him. According to World Bank, the total world economy contracted by 2.1% in 2009 alone. The WTO (World Trade Organization) stated the volume of world trade fell by 12% in the same year. On top of that, the unemployment rate would rise to a postwar record 8.7% (Keely 12). The United States was once again in a severe rut where

consumers were saving more than they were consuming. The Obama administration decided that the best course of action in this dire situation was to revisit the policies used to combat the Great Depression in the 1930s. The idea was to create an over $800 billion stimulus plan that would create job growth and invest in the nation as whole. The American Recovery and Reinvestment Act of 2009 would be signed into law, but its value would decrease to $787 billion because of concerns over how it would impact the national debt. In fact, the national debt would increase by 30 percentage points during the crisis, but most economists agree that the government burdens were justified (Keely 45). Recovery would be slower than it was during the Great Depression and some believe this would be because Keynesian policies were getting weaker. This along with increasing political debates over the implications of a larger national debt as a percentage of the GDP, have brought economists to propose new theories that governments can use to fight recessions.

In the event of another global economic meltdown, it is unsure of how effective Keynesian policy would be, as there have been times where it has had its limits. An example of this very scenario happened in the U.S during the 1970s when the country went through a terrible bout of stagflation, which is the combination of high unemployment and high inflation rates. Keynesian theorists had no answer for how this could have happened, as they believed that unemployment and inflation had a strict inverse relationship that could be explained by the Phillips Curve (“Stagflation”). This has led some economists to look to the past for new ideas along with modifying existing Keynesian theory to preserve capitalism in the 21st century economy. Those theories included post-Keynesian ideas, Austrian economics, and Modern Monetary Theory all of which criticize standard Keynesian economics for either going too far, or not going far enough in its philosophy of government intervention.

Post-Keynesian theory is a more recent interpretation of the original Keynesian beliefs pioneered by John Maynard Keynes in his *General Theory of Employment, Interest, and Money.* These Post-Keynesians mix the ideas of Keynes and more contemporary beliefs in their philosophy and conclude that market economies are stopped from reaching full employment because of existing imperfections within the system. They argue that these imperfections are minimal enough that the issue of less-than-full employment is a problem confined to the short run. This idea deviates away from what Keynes originally believed as it was in his theory that he saw that less-than-full employment was something to be concerned with in the short and long run ("Distribution"). The Austrian School of economics is another philosophy that's gaining some popularity in mainstream economic circles. It's core arguments are contrary to clear majority of the ideas found in Keynesian economics. One of the main differences between the two theories is Austrian beliefs in supply-side economics, which emphasizes lower taxes on consumers and decreased regulation on industry. One last interesting alternative to Keynesian ideology is the more left-wing Modern Monetary Theory. This recently developed economic theory's core principles expand on the idea of national debt and deficit spending. Followers of Modern Monetary Theory believe that a country that can produce its own currency shouldn't have to worry about the implications of a high national debt. This would allow a government to spend as much money as it wanted on any program without having to worry about cutting spending on other necessary programs. This was a very brief explanation of these three alternative philosophies, but more information can be found on my website and on my podcast under the media section.

Keynesian theory developed because of a changing global economic landscape and will likely be replaced by a new way of thinking within the next few decades to adjust for a new

global economy. It is tough to tell, but some economists believe capitalism may currently be going through a stage of upheaval. Increasing income inequality and technological advancements lowering the need for labor is making it tougher for the average person to take part in the consumerism that made capitalism so successful in past centuries. Keynes himself argued his theory was the middle path between free market capitalism and socialism, so only time will tell if that is the route economies will take in the future. Whatever happens, however, it cannot be argued the influence John Maynard Keynes has had on the current economic norms of the capitalistic world and beyond.

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