

1883

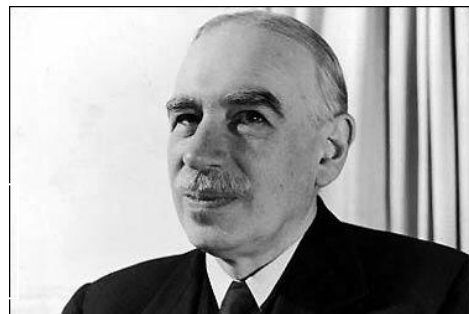
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1946

# John Maynard Keynes

*“The ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed, the world is ruled by little else.”*

– Keynes, *The General Theory of Employment, Interest and Money*



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## General Timeline

### Keynes

- **1883** – Born in Cambridge, England
- **1911** – Becomes editor of the *Economic Journal* at age 28
- **1918** – Becomes economic advisor to the British delegation at the Paris Peace Conference
- **1919** – Resigns position in opposition to peace settlement, writes *The Economic Consequences of the Peace*
- **1920s** – Focuses on monetary issues
- **1926** – Publishes *The End of Laissez-Faire*
- **1930** – Writes *Treatise on Money*
- **1930s** – As bursar of King’s College, increases endowment tenfold despite the Depression. In light of Great Depression, shifts focus from monetary issues to unemployment
- **1934** – Visits President Roosevelt in White House
- **1936** – Publishes *The General Theory of Employment, Interest and Money*
- **1940** – Rejoins the British Treasury, shifting focus to war finance and a postwar currency system
- **1942** – Accepts the title of Baron
- **1946** – Negotiates multibillion-dollar loan for Britain from the U.S., dies likely as a result of this stressful
- **1965** – Becomes only the second person to appear posthumously on the cover of Time magazine (after Freud)

### World

- **1914** – Archduke Franz Ferdinand of Austria assassinated, World War I begins
- **1918** – World War I ends, Paris Peace (Versailles) conference convenes
- **1929** – October 29<sup>th</sup>, Black Tuesday, Great Depression begins
- **1930s** – Persistent and widespread unemployment plagues Britain
- **1933** – Roosevelt implements New Deal economic programs in the U.S.
- **1938** – Keynesian fiscal policy begins being put into practice in U.S.
- **1939** – Hitler invades Poland, World War II begins
- **1940** – Bombing of London begins
- **1944** – Bretton Woods Conference held
- **1971** – President Nixon declares, “Now, I am a Keynesian”

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## **Biographical Information**

### **Childhood and Education:**

- Born in Cambridge in 1883, descended from a knight who had crossed the English Channel with William the Conqueror
- Father (John Neville Keynes) was an outstanding logician and noted Cambridge economist.
- Mother (Florence Ada Keynes) was a justice of the peace and mayor of Cambridge.
- Studied at Cambridge under the tutelage of Alfred Marshall and Arthur Pigou.
- Graduated from Cambridge in 1905 with a degree in mathematics.

### **Early Career:**

- Returned to Cambridge to work as a lecturer, and then chose to work for the British Treasury.
- In 1911, at the age of twenty-eight, became editor of Britain's *Economic Journal*.
- In 1918-19, served as the Treasury's principal representative at the peace conference at Versailles.
- In 1919, after withdrawing in disgust from the Paris Peace Conference, published his first book (*The Economic Consequences of the Peace*) as an objection to the punitive reparation payments imposed on Germany by the Allied countries after WWI.
- A leading member of the "Bloomsbury Group," a circle of brilliant artists, writers, critics, intellectuals and conversationalists lasting from 1907 to 1930.

### **Later Career and Important Contributions:**

- Throughout the 1920's, Keynes focused on monetary issues, acting as a spokesman for the Quantity Theory of Money. In his *The Economic Consequences of Mr. Churchill*, he ridiculed then-chancellor of the exchequer Winston Churchill for his decision to return to the gold standard.
- In 1923, published *Tract on Monetary Reform* and *Treatise on Money*, urging for the stabilization of price levels through interest rate manipulation.
- In 1926, published *The End of Laissez-Faire*, which focused on the evils of the day, specifically mentioning the fruits of risk, uncertainty, and ignorance.
- Throughout the 1930s, taught at King's College in Cambridge and amassed a respectable fortune speculating in commodities, currencies, and stocks in London. As bursar of King's College, he increased the endowment tenfold despite the economic climate of the Great Depression.
- In 1936, amidst the depths of the Great Depression, published *The General Theory of Employment, Interest, and Money*.
- In 1938, U.S. President Franklin D. Roosevelt embraced Keynes' idea of stimulating the United States' "buying power," which resulted in national output nearly doubling and unemployment plummeting from 17% to around 1% from 1939 to 1944.
- In 1946 (also the year Keynes died), the U.S. Federal Government passed America's Employment Act of 1946, which officially codified Keynes' wisdom.

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**The General Theory of Employment, Interest and Money (1936)**  
**Book IV, Chapters 11-18**

**Key Concepts:**

**Liquidity Preference Theory:**

Liquidity preference depends on 3 motives:

- 1) *Transactions Motive*- the need of individuals and businesses to have cash to pay for current expenses and purchases. To distinguish between the two, Keynes further broke transaction motive into Income Motive and Business Motive
- 2) *Precautionary Motive*- keeping cash to cover any unforeseen liabilities
- 3) *Speculative Motive*- Individuals or businesses find it more advantageous to have cash in anticipation of higher interest rates, lower bond prices, or the general price level to fall

It is possible that people (i) will always prefer liquidity to interest (a liquidity trap) (ii) will not want to hold money (hyperinflation)

- 1) People's preferences are determined by future expectations, open market operations, and the velocity of money.
- 2) "It is evident, then, that the rate of interest is a highly psychological phenomenon." (202)

**Marginal Efficiency of Capital**

Definition: The expected rate of return above the cost of new investment.

- 1) Investment will occur in a society until the marginal efficiency of capital is equal to the rate of interest.
- 2) The marginal efficiency of capital fluctuates with every change in expectations of future profits on investments

**Active Monetary Policy:**

As a solution to a liquidity trap, the government should keep printing money to keep the interest rate at a level corresponding to full employment. The printing of money results in lowering interest rates to the point where investment in capital, even with small-expected yields, becomes profitable.

**Against Laissez-Faire:**

"The position of equilibrium, under conditions of *laissez-faire*, will be one in which employment is low enough and the standard of life sufficiently miserable to bring savings to zero." (218)

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## **Key Contributions:**

### **Contribution # 1: Keynes developed an analytical framework to explain the determinants of aggregate demand and investment spending.**

He argued that investment spending is determined by both (1) interest rates and (2) the marginal efficiency of capital.

(1) *Interest rates* are determined by (a) money supply and (b) liquidity preference.

People have a liquidity preference based on their (a) precautionary motive, (b) transactions motive, and (c) speculative motive.

When the interest rate falls below a certain point, there is little incentive to switch from holding cash to holding bank deposits.

(2) *Marginal Efficiency of Capital*: The expected rate of return above the cost of new investment. The marginal efficiency of capital is determined by (a) expectations of future profits, and (b) supply price of capital. By describing investment decisions as such, he introduces the notion of future confidence in the economy as a major determinant of business-driven spending.

“The state of confidence is relevant because it is one of the major factors determining [the rate of investment], which is the same thing as the investment demand schedule” (149).

### **Historical importance:**

- His breakdown of the determinants of investment highlights the fact that future profit expectations will affect the demand for investments.
- It also offers a potential explanation for America’s business pessimism and economic woes.
- Classical economists in the past had accepted models that were based on long-run assumptions, models that did not allow for the existence of unemployment.
- Keynes rejected these models because they were out of touch with reality.
- Americans experienced double-digit unemployment for roughly ten years in a row.
- In response, Keynes tried to create an economic model that could explain the current reality and offer insight to policy makers trying to save the country.

### **Key Contribution # 2: Keynes used his explanation of aggregate demand and investment spending to recommend that the United States engage in expansionary fiscal policy.**

-After formulating his theory of savings, investment spending, and liquidity preference, Keynes discusses various government measures aimed at increasing national output. He said that the government could use (a) monetary or (b) fiscal policy measures. While the first would adjust the money supply to influence interest rates and investment, fiscal policy could influence aggregate demand more directly.

-In addition, Keynes argued that the US was in a position where monetary policy was ineffective (i.e. (a) liquidity trap and (b) weak aggregate demand).

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-Keynes developed the foundations of the IS-LM model that is used in macroeconomic classrooms today. This framework offered a potential explanation for the government's monetary impotence.

-In the context of the liquidity trap theory, Keynes notes the ineffectiveness of monetary policy at increasing real money demand when economic prospects are low. This can translate to a horizontal LM curve where increases in the real money supply have no effect on the demand for money.

-But the weak monetary policy can also be explained by a vertical IS curve that is unresponsive to interest rate changes. If investors have a pessimistic view of the future, their expectations of future profits decline as well. This reduces the marginal efficiency of capital, and can result in a situation where the marginal efficiency of capital < interest rate.

**Historical Importance:** Relevance to Solving Economic Issues in the Great Depression.

The monetary impotence during the Great Depression could be explained by:

- (a) A vertical IS curve, or
- (b) A horizontal LM curve.

-Consider first the possibility of a steep IS curve: Note that the real money supply increased substantially (32%) from 1929-1936 when Keynes published his major work. In response, the real interest rate declined by roughly 1%. Despite the lower real interest rate, during this same time period the real fixed investment declined by roughly 40%. This shows evidence of a steep IS curve where aggregate demand fails to respond to lower interest rates.

-The second possible explanation for monetary impotence during the Great Depression could lie in a horizontal LM curve where the interest rate remains relatively stable in response to increases in the real money supply. This does not appear to be the sole cause for monetary impotence, as the long-term interest rate declines in response to higher real money supply.

“Nevertheless, circumstances can develop in which even a large increase in the quantity of money may exert a comparatively small influence on the rate of interest” (172).

To combat the potentially steep IS curve or flat LM curve, Keynes supports the use of fiscal policy to bolster aggregate demand. Proper fiscal policy could reduce taxes (raising take-home income for consumers and businesses → increased aggregate demand), or could increase spending on government projects (directly contributing to aggregate demand by inducing increased consumption expenditures).

“Only experience, however, can show how far management of the rate of interest is capable of continuously stimulating the appropriate volume of investment” (164).

**Ultimately, Keynes was able to (a) explain the existence of unemployment during the Great Depression and (b) offer a solution to combat the country's economic problems.**

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