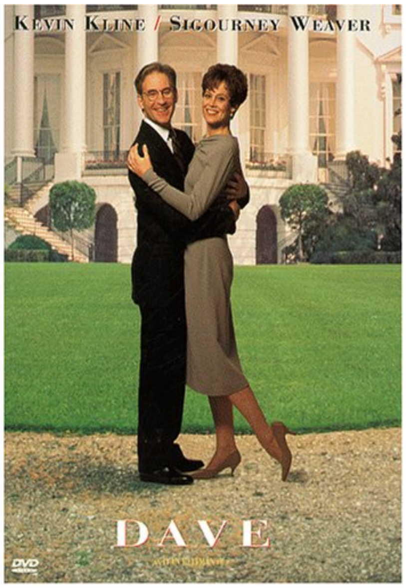

Keynesianism:

Saving Capitalism

By Professor Bernard Corry
new perspective Vol. 5, No. 1

Keynesianism derives from the work of John Maynard Keynes, perhaps the most famous economist of the twentieth century and one of the greatest figures in the whole history of economic inquiry. His book, *The General Theory of Employment, Interest and Money*, published in 1935, revolutionized economic thinking in the field of macroeconomic theory and policy; that is, the theory of the working of the overall economy and of the policy measures to maintain economic stability. Although developments in economic thinking since his day have modified considerably his theoretical ideas and the policy implications that seemed to flow from them, the gist of his reasoning can still find echoes in contemporary economic discussion.

The key propositions of Keynesianism

1. There is no natural tendency for capitalist market economies, which now dominate world economies, to correct economic shocks and maintain an equilibrium at full employment. Before Keynes it was well known that there was a regular pattern of boom and slump but it was assumed that economies quickly righted themselves without government intervention. Keynes denied this.

2. It followed from proposition 1 that capitalist economies would commonly experience general unemployment and that there would be no self generating economic forces to quickly correct the situation. So Keynes questioned the then prevailing views about the nature and cause of unemployment. He made a crucial distinction between what he called involuntary unemployment and voluntary unemployment. This distinction was one of the most controversial elements in Keynes's economics and was much disputed then and ever since. Involuntary unemployed were those seeking work at the going wage rate but unable to find it. Previously, economists had tended to argue that unemployment was due to rigidities in labour markets caused by factors like excessive wage claims, trade union activities and unemployment pay. Voluntarily unemployed workers who were, it was assumed, the majority of the unemployed, were those workers who chose not to work at the existing wage rates.

3. According to Keynes this failure to maintain the workforce in full employment was due to a lack of total spending. This view, again, was in vivid contrast to the pre-Keynesian idea that unemployment was largely due to wage rigidities. It is not

without interest to note that the current debates about the high unemployment rate in certain European countries hinges on this same issue.

4. These total spending failures were mainly due to a shortfall of private business domestic capital formation (that is, investment). Business decision takers were prone to swings of irrational optimism and pessimism about future profitability and this affected their investment plans. Adverse expectations would lead to a fall in investment expenditure, hence a fall in demand, output and employment and thus a rise in unemployment. These effects would be made worse through the fall in household incomes and the consequent reduction in household purchases.

5. From this diagnosis it followed that governments had a crucial role to play by economic stabilization policies. A shortfall of demand required government action to offset it. This could be either by using fiscal policies (taxation), increased government expenditure and/or tax reductions, or via monetary policy by lowering interest rates or increasing the money supply. (Keynes himself, however, was rather doubtful about the effectiveness of monetary policy.)

6. Politically, Keynesianism seemed to imply a large government sector as a necessary adjunct to rational macroeconomic stabilization policy.

The time of Keynes's greatest influence

Keynesianism, both as a theoretical doctrine and as actual economic policy, had greatest influence (in the non-Communist world) after 1945, following the Second World War, and remained the dominant influence until the late 1960s. In the 1960s several events seemed to cast doubt on the practical validity of Keynesiansim and, at the same time, its theoretical underpinnings were being questioned. The main attack came from monetarism, a doctrine spearheaded by Milton Friedman and fellow members of the Chicago School. These will be outlined in a later issue.

Dave	Return to AP MacroEconomics