Can Keynesian Economics Reduce Boom-Bust Cycles?

by Brent Radcliffe (Contact Author | Biography)

Why do economic downturns, such as the Great Depression, occur? How does an economy find itself in the perfect storm of high unemployment, a liquidity crisis and rapidly declining consumption? How can the effects of recessions and depressions be mitigated? For years economists struggled with these problems, but a British economist's ideas in the early twentieth century offered a possible solution. Read on to find out how John Maynard Keynes' theories changed the course of modern economics.

Keynesian Economics

John Maynard Keynes (1883-1946) was a British economist educated in economics at the University of Cambridge. He was fascinated by mathematics and history, but eventually took interest in economics at the prompting of one of his professors, famed economist Alfred Marshall (1842-1924). After leaving Cambridge, he took up a variety of government positions, focusing on the application of economics to real world problems. He rose in importance during the World War I, and served as an advisor at conferences leading to the Treaty of Versailles. It was his 1936 book, "General Theory on Unemployment, Interest and Money", however, which would lay the foundations for his legacy: Keynesian economics.

The field of economics studied by Keynes at Cambridge focused on classical economics, whose founders included Adam Smith, the author of "An Inquiry into the Nature and Causes of the Wealth of Nations" (1776). Classical economics focused on a laissez-faire approach to market corrections, and in some ways was still a relatively primitive approach to the field. Prior to classical economics, much of the world was still emerging from a feudal economic system, and industrialization had yet to fully take hold. Keynes' book essentially created the field of modern macroeconomics by looking at the role aggregate demand plays. (Find out how five ground-breaking thinkers laid our financial foundations in *How Influential Economists Changed Our History*.)

The Keynesian theory attributes the emergence of a depression to several factors:

- The circular relationship between spending and earning (aggregate demand)
- Savings
- Unemployment

Aggregate Demand

Aggregate demand is the total demand for goods and services in an economy, and is often considered to be the gross domestic product (GDP) of an economy at a given point in time. It has four key components:

- Consumption (by consumers who buy goods and services) - C
- Investment (by businesses in order to produce more goods and services) - I

- Government spending - G
- Net exports (value of exports minus imports) - NX

Together, these components become C + I + G +NX, the formula for aggregate demand.

If one of the components decreases, another one of the components will have to increase in order to keep GDP at the same level. (To learn more, check out our related article *Understanding Supply-Side Economics*.)

Savings
Savings is was viewed by Keynes to have an adverse effect on the economy, especially if the savings rate is high or excessive. Because a major factor in the aggregate demand model is consumption, if individuals put money in the bank rather than buying goods or services, the GDP will fall. In addition, a decline in consumption leads businesses to produce less and require fewer workers, which increases unemployment. Businesses also are less willing to invest in new factories.

Unemployment
One of the groundbreaking aspects of the Keynesian theory was its treatment of employment. Classical economics focused on the idea that markets settle at full employment. Keynes theorized, however, that wages and prices are flexible, and that full employment is not necessarily attainable or optimal. This means that the economy seeks to find a balance between the wages that workers demand and the wages that businesses can supply. If the unemployment rate falls, fewer workers are available to businesses looking to expand, which means that workers can demand higher wages. A point exists at which the business will no longer hire.

Wages can be expressed in both "real" and "nominal" terms. Real wages take into account the effect of inflation, while nominal wages do not. To Keynes, businesses would have a hard time forcing workers to cut their nominal wage rates, and it was only after other wages fell across the economy or the price of goods fell (deflation) that workers would be willing to accept lower wages. In order to increase employment levels the real, inflation-adjusted wage rate would have to fall. This, however, could result in a deepening depression, lower sentiment and a decrease in aggregate demand. Additionally, Keynes theorized that wages and prices responded slowly (were "sticky") to changes in supply and demand. One possible solution was direct government intervention. (Take a deeper look into how employment is measured and perceived by certain markets in *Surveying The Employment Report*.)

The Role of Governments
One of the primary players in the economy is the central government. It can influence the direction of the economy through its control of the money supply; both by its ability to alter interest rates or by buying back or selling government-issued bonds. In Keynesian economics the government takes an interventionist approach – it does not wait for market forces to improve GDP and employment. This results in the use of deficit spending.

As one of the components of aggregate demand function mentioned earlier, government spending can create demand for goods and services if individuals are less willing to consume and businesses less willing to build more factories. Government spending can use up the extra production capacity. Keynes also theorized that the overall effect of government spending would be "multiplied" if the businesses employed hire more people, and if the employees spend money through consumption.

It is important to understand that the role of the government in the economy is not solely to dampen the effects of recessions or pull a country out of a depression - it also must keep the economy from heating up too quickly. Keynesian economics suggests that the interaction between the government and the overall economy move in the opposite direction of the business cycle: more spending in a downturn, less spending in an upturn. If an economic boom creates high rates of inflation, the government could cut back its spending or increase taxes. This is referred to as fiscal policy. (Find out how current financial policies may effect your portfolio's future returns, in *How Much Influence Does The Fed Have?*)

Use of the Keynesian Theory

The Great Depression served as the catalyst that shot John Maynard Keynes into the spotlight, though it should be noted that he wrote his book several years after the Great Depression. During the early years of the Depression, many key figures, including then President Franklin D. Roosevelt, felt that the notion of the government "spending the economy to health" seemed too simple a solution. It was by placing the economy in terms of the demand for goods and services that made the theory stick. In his New Deal, Roosevelt employed workers in public projects, both providing jobs and creating demand for goods and services offered by businesses. Government spending also rapidly increased during the World War II, as the government poured billions of dollars into companies manufacturing military equipment.

The Keynesian theory was used in the development of the Phillips curve, which examines unemployment, and the ISLM Model.

Criticisms of Keynesian Theory

One of the more outspoken critics of Keynes and his approach was economist Milton Friedman. Friedman helped develop the monetarist school of thought (monetarism), which shifted its focus toward the role money supply has on inflation rather than the role of aggregate demand. Government spending can push out spending by private businesses because less money is available in the market for private borrowing, and monetarists suggested this be alleviated through monetary policy: the government can increase interest rates (making borrowing money more expensive) or sell Treasury securities (decreasing the amount of available funds for lending) to beat inflation. (For more on this, read *Monetarism: Printing Money To Curb Inflation.*)

Another criticism of the theory is that it leans toward a centrally planned economy. If the government is expected to spend funds to thwart depressions, it is implied that the government knows what is best for the economy as a whole. This eliminates the effects of market forces on

decision-making. This critique was popularized by economist Friedrich Hayek in his 1944 work, "The Road to Serfdom". In the forward to a German edition of Keynes' book, it is indicated that his approach might work best in a "totalitarian state".

Conclusion

While the Keynesian theory in its original form is rarely used today, its radical approach to business cycles and solutions to depressions had a profound impact on the field of economics. Today, many governments use portions of this theory to smooth out the boom-and-bust cycles of their economies, and economists combine Keynesian principles with macroeconomics and monetary policy to determine what course of action to take.

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