

# The Iconoclastic Economist: John Maynard Keynes and the Bloomsbury Group

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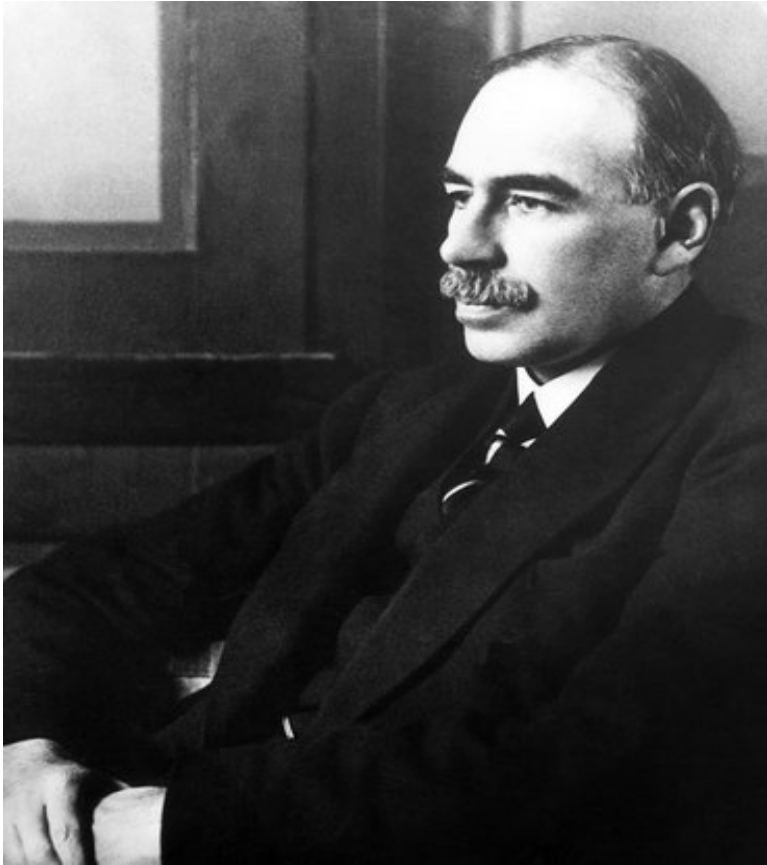
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# John Maynard Keynes (1883-1946)



- Biographical sketch
- Early career
- Civil service, WWI
- His seminal economic work
- His involvement with the Bloomsbury group
- Moral, economic, aesthetic

# Biographical sketch

- Born into an academic family in Cambridge, England
- Studied at Eton on scholarship
- Studied math at King's College, Cambridge
- Studied philosophy and economics informally
- Took Civil Service exams



# Attitude and culture, backward and forward

- Keynes was of the last generation when the British empire was at its most powerful
- He was also of the last generation in which culture, not expertise, entitled leaders to govern
- He had a lifelong faith in the ability of government officials to do good



# Civil Service, WWI

- 1906-1908: India Office
- 1909: returned to Cambridge
  - Studied probability theory
  - Studies and lectureship funded privately by 3 economists (one being his father!)
  - Wrote a book on Indian finance and currency
- 1915: Treasury post
  - Responsible primarily for credit

# Treaty of Versailles, Consequences of the Peace

- Financial representative of Britain at treaty negotiations in 1919
- Worked to keep German reparations from being excessive
- Worried about pushing Germany into political extremism
- Possible German influence: Melchior



# The Economic Consequences of the Peace (1919)

- One of his most influential works -- some say his best
- Assessment of the possible outcomes of the Treaty of Versailles and its high war reparations
- Objected on moral and economic grounds
- In hindsight, seen as prescient -- German hyperinflation, rise of National Socialism
- Led to Keynes being seen as anti-establishment

“The policy of reducing Germany to servitude for a generation, of degrading the lives of millions of human beings, and of depriving a whole nation of happiness should be abhorrent and detestable,--abhorrent and detestable, even if it were possible, even if it enriched ourselves, even if it did not sow the decay of the whole civilized life of Europe.”

J.M. Keynes (1919)



# Money, unemployment, prices

- Keynes' seminal work: *The General Theory of Employment, Interest, and Money* (1936)
- Started his research in the 1920s
- Set out to provide a rigorous analysis of how an economy can be in an equilibrium and have unemployment -- why don't wages and prices adjust to employ all people who want jobs and all resources?

# What I' ll Cover

- Lynne and I agreed that she' d talk first for about 30 minutes and I would follow up for about 15 minutes
- I' m mainly going to talk about the contrast between Keynes and two other schools of thought in macroeconomics
  - Pre-Keynesian “Classical Macroeconomics” and Post-Keynesian “New Classical Macroeconomics”
- But First, Back to “Economic Consequences of the Peace”

# Keynes in 1919: The War Damage Was Beyond Germany's Ability to Pay

- “Even if every house and factory and cultivated field, every road and railway and canal, every mine and forest in the German Empire could be carried away and sold at a good price to a ready buyer, it would not pay for half the cost of the war and of reparation added together.”
- Keynes: “If we aim deliberately at the impoverishment of Central Europe, vengeance, I dare predict, will not limp.”

# But His Main Argument Involved Not Bolshevism but Self-interest

- For Keynes, the Victors (UK and France) were slitting their own throats with the Treaty of Versailles
- Germany could pay massive reparations only by running a large export surplus
  - Germany would have to devalue its currency to make its export goods cheap, thus destroying the competitiveness of UK and French exporters
- “Germany would be forced to flood the world’s markets with goods at ridiculously low prices”
- “If Germany could compass the vast export trade which the Paris proposals contemplate, it could only be by ousting some of the staple trades of Great Britain from the markets of the world.”



# In the End, Keynes Turned Out to be Wrong

- The Germans faced two burdens, the **internal** debt that the government owed to its own citizens as a result of wartime expenditures, and the **external** debt owed to the Allied victors.
- The Germans never achieved the massive export surplus that Keynes feared would be a result of the **external** debt. Their domestic inflation wiped out any advantage of depreciation
- The German hyperinflation wiped out the **internal** public debt created by the expenses of the war.
- The obligation to pay reparations (the **external** debt) was abrogated in 1931, after a decade of Germany dragging its heels and Allied failure to collect
- “What hyperinflation did for the internal German war debt, the Great Depression did for the external burden imposed by reparations.”

# Without the Great Depression . . .

- There would have been no Hitler and no WW II (at least in Europe)
- Keynes would not have climbed into the ranks of the three greatest economists of the twentieth century
- For the Great Depression revealed the intellectual bankruptcy of classical economics

# For the Classicals, the Full Economy Removes the Microscope

- Classicals started with the microscope of standard price theory, still taught everywhere
- If farmers produce too much wheat, the price will decline to lessen their incentive to produce and increase the customer's desire to purchase
- Similarly, if an economy produces more than consumers want to buy, the overall price level will drop. Firms will want to produce less, with lower wages workers will want to work less. *All will be well.*
- Classicals assumed: firms can sell all they want, workers can work as many hours as they want. There is *free choice* in sales and employment

# Keynes Overturned Flexible Prices as a Cure-all for Depressions

- Firms cannot afford to cut prices, because their costs are set by previous bargains with their workers and prices set by their suppliers
- When consumers want to purchase less or firms want to invest less or foreigners want to buy fewer exports, there is a decline in *aggregate demand*
  - *This is the total amount that the economy wants to purchase at today's price level*
- In this world there is no longer *free choice*

# Keynes' 1935 Book is still Alive in 2010

- Can firms *freely choose* how much to sell?
  - Not if customers stop coming into the restaurant or the auto show room as they did in 2008-09
  - Sales are less than production so production must be cut
- Can people *freely choose* how much to work?
  - Not if the restaurant or auto dealer tells them it no longer needs them, they are laid off as in 2008-09
  - Employment is less than the number of jobs people are seeking, so many are unemployed



# Unique Keynesian 1935 Insights

- Consumer Demand depends not just on price of goods, but on consumer income
- Demand for workers depends not just on their wage but on the quantity of goods and services produced – that tells firms how many workers are needed
- Interaction: People lose their jobs and buy less. Firms sell less, cut production, and lay off more workers
- *The Multiplier Effect.* Each round of sales decline and job cuts creates another round.
- This was the US economy in 2008-09

# But Why Does Demand Decrease?

- Business Investment is Inherently Unstable
- Why?
  - *Time to Build.* It takes a long time to build a condo or office building
  - Planned in 2004, approved in 2005, construction starts 2006 and ends 2007
  - *Coordination Failure.* Only 2,000 condo units are needed by 6,000 are built
- Result: 2008 2009 2010 2011 market is flooded with unsold condo units, construction falls from 6,000 to zero and the multiplier effect kicks in

# Overbuilding Augmented by Asset Bubbles

- *Herd Instinct* creates asset bubbles.
  - Investors believe prices will always go up, no danger of loss
  - Borrow as much as possible, multiplies profit *IF* price continues to go up, but wipes out your equity if price goes down even a small percentage
  - Investors do not learn from history
- Examples. Stock market 1927-29, stock market 1995-2000, housing market 2000-2006
- When markets collapse and consumer wealth declines, so do sales of consumer goods



# What to Do? Keynesian Prescription of Fiscal Policy

- The **problem**, consumers and business firms are not spending enough to create sufficient jobs for those who want to work
- The **solution**, government must spend more when the private sector spends less
- Keynes is the direct intellectual grandparent of the Obama stimulus program

# What Would He Think?

## Keynes Reincarnated from 1945

- He'd Immediately Cite Yogi Berra:
- *It's déjà vu all over again*
- He would immediately recognize the causes of the demand decline of 2008-09
  - The stock market decline would remind him of the stock market bubble and collapse of 1927-29
  - The housing bubble would remind him of the Florida land boom of the mid 1920s
  - He would even recognize the role of the guilty mortgage brokers and Wall St. hustlers that brought the economy down in a binge of overborrowing (“leverage and securitization”) with their analogies in the late 1920s (“the investment trusts”)

# And If We Invited JMK Over to a Northwestern Graduate Macroeconomics Seminar?

- He might briefly marvel at the projector and Powerpoint slides, the cinema hall of the 1930s brought into the classroom
- After recoiling from the layers of math and the inarticulate mumblings of the modern generation, he would recognize immediately the failing of their theories as a replay of the classical economists who came before him
- Their models assume that consumers *freely chose* the amount they want to buy and people *freely chose* the amount they want to work
- He would be startled to hear nothing of the involuntary constraints faced by firms and workers

# Perhaps Keynes Would Walk Out of the Seminar in Disgust

- . . . When he heard a list of sources of business cycles including “technology shocks”
  - Surely they’ re not suggesting that the Great Depression was caused by forgetfulness?
- . . . When he heard a list of sources of business cycles including “preference shocks”
  - Surely they’ re not suggesting that the Great Depression was caused by a sudden desire to eat fish instead of beef?

# In 2009 the Media Speculated Whether We Would Need a New Keynes to Explain the Crisis

- While the details of the housing bubble and Wall St amplification of that bubble are new, the old idea of unbridled greed was familiar from the 1920s
- Once housing prices began to decline, the Wall Street superstructure of exotic securities collapsed like a house of cards, as in the early 1930s
- 1930s Keynesian Theory fits the current crisis like a glove

# Why Was 2008-09 a Big Recession Instead of a 2<sup>nd</sup> Great Depression?

- We Had Learned from Keynes:
- Monetary policy did not sit back passively as in 1930-32
- Fiscal policy went immediately into action (think if March 1930 had been like March 2009)
- Our situation is bad, only slowly getting better, but without the ideas of John Maynard Keynes it would be a lot worse