Keynes's Interpretation and Response to the Great Depression: An Evolutionary Stage for Capitalism

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1. Introduction

The Great Depression was an unrivaled economic catastrophe. In February 1931, British economist John Maynard Keynes declared "the foundations of Capitalist society are being shaken" (Keynes 1981a, 480). With the collapse of the U.S. stock market, unprecedented levels of unemployment, and persistent fear among consumers, the economic machine was broken. Keynes further explained, "For these foundations of Capitalist society are the expectation of normal profit to the individual as an incentive to enterprise and the sacredness of contract" (Keynes 1981a, 480). Businesses lacked profit, and workers lacked jobs. Neither side of the socioeconomic spectrum was capable of reaching its full potential in the market. Capitalism's ability was being tested, and to many people, it did not appear likely to succeed.

During the Great Depression, many newspaper firms and academics wanted Keynes's input on the problems of unemployment and the persistent fear that distressed both governments and the general public. Keynes visited the United States, Russia, and various locations in Europe during this time to observe how the economic system was unfolding (Keynes Papers 1931-1934, AV/1-2).[1] He saw the Great Depression not only as a functional failure, with people experiencing high levels of unemployment and businesses experiencing low profits, but also as a moral failure because the system and the prevailing economic thought at the time did not support the means and well-being of the people. This essay examines Keynes's perceptions and interpretation of the events of the early 1930s to explain what led him to the conclusion that government intervention was necessary for the recovery of the economic system. Overall, I hope to show how Keynes's holistic understanding of the economic system aided capitalism by putting the "broken machine" (Keynes Papers 1930, A/30/242) into a new working order that was practical for both businesses and workers. Keynes helped reframe capitalism to apply not just to the self-interested, profit-seeking entrepreneurs, but also to the everyday consumers desperately in need of work.

2. System Failure

From the beginning of the slump, Keynes understood the deeper significance of the events that were unfolding. While it was clear to most that society was facing a severe unemployment problem as well as a lack of confidence in the system, Keynes saw these problems as evidence that traditional capitalism was failing. The Great Depression was an expression of failure; the doctrine of classical economics did not support the needs of society. Keynes believed the economic system was headed toward radical change.

The functional problem during the Great Depression was the perpetuating cycle of declining employment and business profits. In the United States, the unemployment rate grew from

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8.7 percent in 1930 to 24.9 percent in 1933. In Great Britain, unemployment began at 16 percent in 1930 and reached a height of 22.1 percent in 1932.[2] In February 1930, Keynes spoke on BBC Radio with Sir Josiah Stamp, director of the Bank of England at the time, about the unemployment problem of the previous few months. Keynes explained the severity of the situation to Stamp calling it a "vicious cycle" (1981b, 323). This cycle began with a fall in prices, which meant entrepreneurs' revenue fell and therefore, so did their profit. Although costs had also fallen, the decrease in prices was much more severe, so the lower costs did not offset lower prices. With their profits shrinking, businesses had less and less incentive to produce and therefore less need for labor. However, as Keynes pointed out, "one man's expenditure is another man's income," (Keynes 1982, 53). Consequently, consumers had less money to spend on products. Therefore, demand fell, prices fell further, and business profits continued to shrink as more people were simultaneously put out of work.

The world was not only experiencing severe unemployment with this vicious cycle, but also enduring the negative psychology that stemmed from a lack of confidence and fear of uncertainty. In June 1930, Keynes opened a lecture in Spain by stating, "We are suffering just now from a bad attack of economic pessimism" (Keynes 1978, 321). Many people were uncertain about what the slump would bring and whether it would end in the near future. This uncertainty and fear led people to save more of their income as they sought greater economic security. Consumption halted, business investment declined, and savings increased. The economic machine was not running as classical economic theory predicted, and it was clear to Keynes that this was a functional failure. Businesses and workers were not reaching their full potential in the system, and Keynes believed something needed to be done to break the cycle of increasing unemployment and declining business profits.

Furthermore, Keynes argued the existence of prolonged unemployment showed that the system was not only a functional failure, but also a moral failure because it could not provide economic means for its people. In their 1930 BBC Radio broadcast, Keynes and Sir Josiah Stamp discussed the issue of unemployment, and Stamp was taken aback by Keynes's opinion on the state of the system:

> KEYNES: Is not the mere existence of general unemployment for any length of time an absurdity, a confession of failure, and a hopeless and inexcusable breakdown of the economic machine?
>
> STAMP: Your language is rather violent. You would not expect to put an earthquake tidy in a few minutes, would you? I object to the view that it is a confession of failure if you cannot put a complicated machine right all at once. (Keynes 1981b, 321)

Although Stamp believed Keynes's opinions to be absurd and unrealistic, Keynes did not agree that unemployment was a natural occurrence in an economy that would fix itself. Stamp's rhetoric favored the prevailing classical economic thought at the time that an economy would naturally fix itself in the long run. However, Keynes believed excessive unemployment showed that the moral limits of capitalism were being tested, and without immediate radical change, the situation would not change.

Keynes never published an explicit argument about his thoughts on capitalism. However, he did not ignore the topic in his work. In fact, Keynes expressed his intentions to write a book titled *An Examination of Capitalism* in 1926 (Backhouse and Bateman 2009, 643), but it never came to fruition. In their article "Keynes and Capitalism," Roger Backhouse and Bradley Bateman argue that even with substantial changes in economic thought throughout Keynes's career, he held a consistent view that a sense of morality was central to capitalism (646). Keynes saw capitalism as "the best means to the best end" (669): capitalism is the best system to provide for a country's citizens, and a strong sense of morality needs to be inherent within the capitalist system if it is to persist. He understood that capitalism would not function if morality was not upheld. The persistent loss of employment and subsequent decline in the standard of living for workers and employers was evidence of the system failing those it was supposed to benefit. This was the moral failure, and Keynes did not agree with the prevailing classical doctrine that inaction was the necessary course to take and to allow the economy to fix itself.

To Keynes, waiting for the economy to fix itself was impractical. He understood consumers could not wait for the long run to bring the economy back into equilibrium to increase the demand for labor. He believed persistent unemployment and declining business profit would not provide people with the means to sustain themselves, and it would subsequently lead to a decline in the standard of living. In an article explaining the actions Great Britain needed to take to regain status as a financial leader, Keynes claimed that any policy would be better than waiting patiently. He said, "[T]he negative policy, by allowing unemployment steadily to increase, must lead in the end to an unanswerable demand for a reduction in our standard of life" (Keynes Papers 1931c, A/31/91). To Keynes, waiting for the economy to realign itself was not an option because it would force people to decrease their standard of living. If the standard of living in capitalist society continued to decline, Keynes feared the threat of Communism would grow stronger. While he understood the vices of capitalism, he still believed it was a better system to provide prosperity to society. In contrast to the classical economists' solution to the Great Depression, Keynes believed that governments needed to take action to restore the full economic potential of businesses and workers to maintain the integrity of the capitalist system.

However, Keynes's desire for immediate action and intervention in the economic system to preserve the livelihoods of people was met with contempt. The majority of economists at the time, both in the United States and in Great Britain, aligned themselves with the classical view that an economy would self-correct under Say's Law. Classical economists argued that any intervention in the market would be detrimental and that over time full levels of employment would be restored. In 1968, Valdemar Carlson published an article reflecting on his economics education as a Ph.D. student at Harvard University in the 1920s. He noted that, "classical economics was dominant and its adequacy as a basis for policy was hardly ever questioned" (1968, 102). The doctrine of classical theory had a stronghold on the economics discipline leading up to the Great Depression.

Keynes recognized that his ideas were radical, but he understood that classical theory could not adequately provide for society. Keynes opened *The General Theory of Employment, Interest, and Money* (1936) by explaining that the "special case" assumed to be the standard by classical economists would be "disastrous" for an economy (3). He argued that the classical doctrine held by both academics and government officials was not applicable to modern society and that "its teachings [were] misleading" (3) and unrealistic, especially with the crisis of the Great Depression. Keynes advocated for a more practical theory to explain the crisis and to provide an answer as to how to increase employment and business profits that would address the moral failure of classical economics.

3. A Holistic Solution

To Keynes, the key to bringing the economy back into working order was a solution that appealed to both sides of the employer-worker relationship. Entrepreneurs needed a restoration of business confidence and a revival of investment to increase profits, whereas workers needed immediate jobs and security in the system in order to increase their spending. Only a solution that took a holistic approach by appealing to both businesses and workers could provide the necessary functional and moral fix to preserve the capitalist system.

Keynes understood businesses needed to expect demand in order to have an incentive to continue to produce. Although he disagreed with excessive greed for profit, he accepted the fact that capitalist entrepreneurs needed profit in order to generate output. In March 1931, Keynes explained how the machine needed profit to keep the cogs turning: "We live in a society organized in such a way that activity of production depends on the individual businessman's hoping for a reasonable profit or at least to avoid an actual loss" (Keynes Papers 1931b, A/31/90). Keynes understood that, at its heart, the capitalist system was run by the businessman's desire and need for profit. So, without the incentive and certainty of profit, the system would begin to fail, unemployment would ensue, and workers would face the consequences. Keynes further elaborated on the relationship between profit and unemployment in a similar article published a month later in *The New Republic*: "But, short of going over to Communism, there is no possible means of curing unemployment except by restoring to employers a proper margin of profit" (Keynes Papers 1931c, A/31/91). Keynes acknowledged the interdependence between, and the influence of, the needs of businesses and the needs of workers. If the capitalist system was going to persist, employers required a solution that could restore profits that consequently could increase employment.

While it was clear that profits needed to be restored to revive jobs and confidence in the economy, Keynes argued there was only one way to do so that would also fulfill workers' needs. The two ways of restoring profits were to decrease costs by cutting wages or to raise prices by increasing demand. He explained two reasons why reducing costs was not a viable option:

> The advantages to employers of a general reduction of wages are not so great, therefore, as they look. Each employer sees the advantage to himself of a reduction of the wages which he himself pays and overlooks both the consequences of the reduction of the incomes of his customers and of the reduction of wages which his competitors will enjoy. In the second place, it leads to social injustice and violent resistance, since it benefits some classes of income at the expense of others. (Keynes Papers 1931c, A/31/91)

Keynes made it clear that decreasing wages was an inadequate answer to increasing profits because of the potential for social unrest. If employers were to cut wages, then they would also be decreasing the incomes of potential consumers. If many businesses were to do this, then the demand for products would decrease. Keynes recognized the moral failure of the capitalist system was that one group was incentivized by the crisis to take advantage of the other. Moreover, Keynes made it clear that, socially, decreasing costs would create more problems and further threaten the capitalist system. He understood that without any sort of change, social unrest would plague societies as the working class and lower class continued without jobs. Keynes believed the classical economists were close-minded in their thinking and did not look at the full picture. As he said in a commencement luncheon speech at Columbia in June 1934, "One man's costs are another man's income. One man's spending is another man's sales" (Keynes Papers 1934a, AV/3/60). Keynes saw the holistic nature of the economy that classical economists overlooked. In the same speech at Columbia, he compared classical economists and their one-sided view of the economy to the original belief that the world was flat:

> Unfortunately, economists have studied the economic system as a whole almost as little as the businessman. They also have been too often accustomed to discuss a flat economic earth and they have too little to teach the administration about the good round world as a whole. (Keynes Papers 1934a, AV/3/60-61)

The purpose of this analogy was to show that classical economists were looking at their solutions to unemployment from only one side. Classical economists took the view of an individual firm and therefore failed to address the system as a whole, neglecting workers. Keynes argued a holistic solution was necessary so that it would benefit workers and businesses equally. A solution that addressed the problems of all entities in the economy would get the gears of capitalism turning again.

To Keynes, the best response to fulfill the needs of workers and businesses was for effective demand to increase. He believed that if effective demand were to increase, then it would revive employment and investment because businesses could anticipate a higher demand. In a paper he reportedly brought with him to the United States Congress in 1934, Keynes argued there were two main ways to increase effective demand: increased propensity to consume and increased propensity to invest. He claimed "the first impulse" should come from an increased propensity to invest. If the government increased expenditure financed by borrowing rather than taxation, Keynes believed the government could stimulate investment and therefore rejuvenate employment (Keynes Papers 1934b, AV/3/63). Government stimulus could increase business investment and decrease the desire to save as it would create jobs and investment opportunities. Moreover, government stimulus would be increasingly effective due to the principle of the multiplier. Partially derived from his friend Richard Kahn's argument of primary and secondary employment (Kahn 1972, 1),[3] Keynes believed the initial expenditure would cycle through the economy. While it was evident to most that the stimulus package would immediately contribute to workers' wages, it would have even further repercussions. Those workers could then use their increased income to spend more and therefore fund the wages of other workers as effective demand had increased.

For Keynes, the best method to increase effective demand was for the government to invest in public works projects to break the vicious cycle of declining employment and business profits. Government intervention meant taking immediate action that could subsequently increase business profits and employment. By restoring the needs of both businesses and workers, the functional and moral failures could be remedied. For classical economists, the suggestion of government intervention was taboo. However, Keynes believed it was the best way to preserve the capitalist system and thus the economic prosperity of society. In a speech delivered in June 1931 at the University of Chicago, Keynes noted that "the view is held in Moscow that this is the last, the culminating crisis of capitalism and that our existing order of society will not survive it" (Keynes Papers 1934a, AV/1/181). However, according to "Economic Possibilities for our Grandchildren," originally published in 1930, Keynes believed that society needed capitalism and the free enterprise system to reach its full potential and highest standard of living.

4. Conclusion

The Great Depression brought capitalism to a breaking point, but Keynes wanted to fix the system rather than have society find itself on the brink of a new economic order. He believed the solution to be "evolutionary and not revolutionary" (Keynes Papers 1934a, AV/3/57). Keynes acknowledged both the functional and moral problems within the capitalist system and aimed to mend the situation rather than topple it. He argued that the classical perspective of the economic system was a special case when overall effective demand was large enough to induce full employment. This special case does not always apply, and it certainly did not during the unprecedented situation of the Great Depression. Keynes formulated an answer and a subsequent theory that applied to the "general" economy, not just the classical special case in his culminating work, *The General Theory of Employment, Interest, and Money.*[4] At its core, Keynes's proposed solution restored a sense of morality to the capitalist system by appealing more to the average consumer while still fulfilling the needs of businesses. Keynes was aware that the everyday person needed immediate work and could not wait for the economy to fix itself. His understanding of the needs of the working class helped capitalism progress to satisfy the needs of the current era. Ultimately, his insights into 1930s capitalism, despite significant opposition, have thrived into the twenty-first century.

Notes

[1] Assorted correspondence concerning Keynes's visit to the United States archived in the Papers of John Meynard Keynes, King's College Archives, Cambridge University, abbreviated in citations in this article as "Keynes Papers" and followed by archive series, file, and document numbers if available. The correspondence consists of requests from universities, societies, and academic groups for Keynes to give lectures, attend meetings, and write articles during his time in the United States. In most cases, Keynes politely replied with gratitude, but denied the opportunity because he wished to spend the bulk of his time in the United States observing and learning about the economic situation.

[2] For reference, U.S. unemployment reached a high of 10 percent in October 2009 during the Great Recession per U.S. Bureau of Labor Statistics. Data on unemployment rates for the United States per the U.S. Bureau of Labor Statistics and rates for Great Britain per the International Monetary Fund.

[3] Kahn argued for public works projects claiming they created primary and secondary employment. Primary employment was the additional employment directly added by the project. Secondary employment came from the increase in expenditure and therefore production of consumption-goods that required further employment. So, Kahn argued a multiplying effect of employment occurred throughout the economic system.

[4] Many ideas Keynes outlined in *The General Theory* were derived from his earlier pieces published from 1930 to 1934.

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