

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

Ella Needler¹

1. Introduction

The Great Depression was an unrivaled economic catastrophe. In February of 1931, British economist John Maynard Keynes evaluated the time period by exclaiming “the foundations of Capitalist society are being shaken.”² With the collapse of the US Stock Market, unemployment reaching unprecedented levels, and the persistent fear amongst consumers, the economic machine was broken. Keynes continued to explain the situation by saying, “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.”³ Businesses lacked profit and workers lacked jobs; neither side of the socio-economic spectrum was capable of reaching their full potential in the market. Capitalism's ability was being tested and, to many people, it did not look like it would succeed.

Keynes visited America, Russia, and various locations in Europe during the Depression to observe how the economic system was unfolding.⁴ Many newspaper firms and academics of the time wished for Keynes's input on the problem of unemployment and the situation of persistent fear that distressed the general public and governments. This essay looks at Keynes's perceptions and interpretation of the events in the early 1930's in order to explain why he believed government intervention was the necessary solution to recover the economic system from the Great Depression. Keynes saw the Great Depression not only as a functional failure, with high levels of unemployment and businesses experiencing low profits, but also as a moral failure because the system and prevailing economic thought of the time was not supporting the means and well-being of people. Overall, I hope to show how Keynes's holistic understanding of the economic system aided capitalism by putting the “broken machine”⁵ into a new working order that was practical for both businesses and workers. Keynes was able to help reframe capitalism to apply not just to the self-interested, profit-seeking entrepreneurs, but also to the everyday consumer who was in desperate need of a job.

¹ At the time of submission, Ella Needler was an undergraduate student at Washington University in St. Louis studying economics and finance.

² John Maynard Keynes, “The Internal Mechanics of the Trade Slump,” in *XX: 1929-1931 Rethinking Employment and Unemployment Policies*, ed Donald Moggridge (Cambridge: Cambridge University Press, 1981), 20:480.

³ Ibid.

⁴ Assorted papers of correspondence concerning Keynes visit to America, 1931 and 1934, A/1-2, Keynes Papers, King's College Archives, Cambridge, United Kingdom. The papers consist of universities, societies and academic groups asking for Keynes to give lectures, attend meetings and write articles during his time in America. In the majority of circumstances, Keynes politely replied with gratitude for the opportunity, but denied the opportunity because he wished to spend the bulk of his time in America observing and learning the situation.

⁵ Published copy of “The Great Slump of 1930,” December 1930, A/30/242, Keynes Papers, King's College Archives, Cambridge, United Kingdom.

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 and lack of confidence in participating in the system, Keynes saw this dilemma as evidence that traditional capitalism was failing. The Great Depression was an expression of failure and the doctrine of classical economics did not support the needs of society. Keynes believed the economic system was headed towards radical change.

The functional problem during the Great Depression was the perpetuating cycle of declining employment and business profits. In the United States, unemployment grew from 8.7% in 1930 to 24.9% in 1933 and in Great Britain, unemployment began at 16% in 1930 and hit its height at 22.1% in 1932.⁶ At the beginning of 1930, Keynes spoke on BBC radio with Sir Josiah Stamp, Director of the Bank of England at the time, about the unemployment problem from the previous few months. Keynes explained the severity of the situation to Stamp calling it a “vicious cycle.”⁷ The cycle began with a fall in prices, which meant the entrepreneur’s revenue fell and therefore so did their profit. While costs had also fallen, the decrease in prices was much more severe, so the fall in costs did not offset the fall in prices. With shrinking profit for businesses, they 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,”⁸ so, 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 and this “vicious cycle” but was also enduring a 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.”⁹ Many people were uncertain of what the slump would bring and if it would end in the near future. As people were uncertain and scared of what was to come, their desire to save more of their income increased in addition to their desire for security. Consumption halted, business investment declined, and savings increased. The economic machine was not running as classical economic theory had predicted, and it was clear to Keynes 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 that it was also a moral failure. He believed such persistent unemployment was a moral failure because the economic system could not provide economic means for its people. In his broadcast to Great Britain in 1930, Keynes and Sir Josiah

⁶ For reference, unemployment during the Great Recession hit a height of 10.0% in October 2009 per US Bureau of Labor Statistics. Data on unemployment rates for the United States per US Bureau of Labor Statistics and rates for Great Britain per the International Monetary Fund.

⁷ Ibid, 323.

⁸ John Maynard Keynes, “The World’s Economic Crisis and the Way of Escape,” in *XXI: Activities 1931-1939 World Crises and Policies in Britain and America*, ed Donald Moggridge (Cambridge: Cambridge University Press, 1982), 21:53.

⁹ John Maynard Keynes, “Economic Possibilities for our Grandchildren” in *IX: Essays in Persuasion*, ed Donald Moggridge (Cambridge: Cambridge University Press, 1978), 9: 321.

Stamp discussed the existing unemployment and Stamp was taken aback by Keynes opinion on the existing state of the system. Their discussion was:

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.¹⁰

While 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 of the time that an economy would naturally fix itself in the long run. However, Keynes believed the excessive unemployment showed that the moral limits of capitalism were being tested and without immediate radical change it would not overcome the situation.

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 1926.¹¹ Although the book never came to fruition, Roger Backhouse and Bradley Bateman, in their article *Keynes and Capitalism*, argue Keynes nonetheless had a consistent underlying view of capitalism throughout his career. Through a systematic analysis of Keynes's work, Backhouse and Bateman determine that even with substantial changes in economic thought throughout his career, Keynes held a consistent view that a sense of morality was central to capitalism.¹² Backhouse and Bateman argue Keynes saw capitalism as "the best means to the best end".¹³ Meaning that capitalism was the best system to provide for a country's citizens and a strong sense of morality needed to be inherent within the capitalist system if it was to persist. Keynes 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 who 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, the classical idea to wait for the economy to fix itself was impractical. Keynes understood consumers could not wait for the long run to bring the economy back into equilibrium to increase the demand for labor. Keynes believed persistent unemployment and declines in business profit would not provide people with the means to sustain themselves and subsequently lead to a decline in the standard of living. In a piece written in 1931 explaining the actions Great Britain needed to take to regain status as a financial leader, Keynes claimed how 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

¹⁰ Keynes, "Unemployment," 20:321.

¹¹ Roger E. Backhouse and Bradley W. Bateman, "Keynes and Capitalism." *History of Political Economy* 41, no. 4 (2009): 643.

¹² Ibid, 646.

¹³ Ibid, 669.

reduction in our standard of life.”¹⁴ To Keynes, waiting for the economy to realign itself was not an option as it would force people to decrease their living expectations. If the standard of living in capitalist society continued to decline, Keynes feared the threat of Communism would grow stronger. While Keynes understood the vices of capitalism, he still believed it was a stronger system to provide prosperity to society. For Keynes, the classical solution to the Great Depression of inaction was inadequate. He believed actions needed to be taken 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 livelihood of people was viewed with contempt. The majority of economists at the time, both in the United States and in Great Britain, aligned themselves with the classical views that an economy would self-correct itself under the rules of 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 a piece reflecting on his economics education as a PhD 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.”¹⁵ 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. However, he did not believe classical theory could adequately provide for society. In *The General Theory of Employment, Interest, and Money*, published in 1936, Keynes opens the book by explaining the “special case” assumed as the standard by classical economists would be “disastrous” for an economy.¹⁶ Keynes argued the classical doctrine, held by both academics and government officials, was not applicable to the reality of society and “its teachings [were] misleading.”¹⁷ Keynes did not believe classical theory was realistic and applicable to modern society and especially with the crisis of the Great Depression. Keynes urged for a more practical theory to explain the crisis and provide an answer as to how to increase employment and business profits. Keynes understood society could not wait for the economy to fix itself when classical theory was not providing a realistic response. To him, the reliance on classical doctrine to wait for the economy to fix itself was an expression of the moral failure of the system.

3. A Holistic Solution

To Keynes, the key to bringing the economy back into working order was a solution that appealed to both ends of the employer-worker relationship. Entrepreneurs needed a restoration of business confidence and a revival of investment to increase profits, whereas workers needed a job immediately and security in the system in order to increase 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. While Keynes disagreed with excessive greed for profit, he accepted the fact capitalist entrepreneurs needed profit in order to generate output. In 1931, Keynes explained

¹⁴ Published copy of “Revenue Tariff for Great Britain,” April 8, 1931, Keynes Papers, A/31/90, Keynes Papers, King’s College Archives, Cambridge, United Kingdom.

¹⁵ Valdemar Carlson, “The Education of an Economist before the Great Depression: Harvard’s Economics Department in the 1920’s.” *The American Journal of Economics and Sociology* 27, no. 1 (1968): 102.

¹⁶ John Maynard Keynes, “The General Theory of Employment, Interest, and Money.” *Macmillan*, London, 1936, Pg 3.

¹⁷ *Ibid*, 3.

how the machine needed profit to keep the cogs turning. He stated, “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.”¹⁸ At the heart, Keynes understood that the capitalist system of the time 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 an article published in 1931. He explained, “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.”¹⁹ Keynes acknowledged the interdependence between the needs of businesses directly influenced the needs of workers. If the capitalist system was going to persist, employers required a solution that could restore profits which consequently could increase employment.

While it was clear that profits needed to be restored in order to revive jobs and confidence in the economy, Keynes argued there was only one way to do so which would also fulfill the needs of workers. The two ways of restoring profits were to decrease costs by cutting wages or raise prices by increasing demand. In an article published in *The New Republic* in the spring of 1931, Keynes explained two reasons why reducing costs was not a viable option for society by saying:

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.²⁰

Keynes made it clear that decreasing wages was an inadequate answer to increasing profits because of the potential 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 as 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 closed minded in their thinking and did not look at the full picture. As he said in a Columbia Commencement luncheon speech in 1934, “One man’s costs are another man’s income. One man’s spending is another man’s sales.”²⁰ Keynes saw the holistic nature of the economy that classical economists overlooked. In the same speech at Columbia, Keynes related classical economists and their one-sided view of the economy to the original belief that the world was flat:

¹⁸ Keynes Papers A/31/90.

¹⁹ Keynes Papers A/31/91. ²⁰

Keynes Papers A/31/91.

²⁰ Typescript of a speech Keynes delivered to Columbia Commencement luncheon, June 5, 1934, AV/3/60, Keynes Papers, King’s College Archives, Cambridge, United Kingdom.

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.²¹

Keynes's purpose of this analogy was to show that classical economists were looking at their solutions to unemployment from one side. Classical economists took the view of an individual firm and therefore failed to address the system as a whole due to their neglect of workers. Keynes argued a holistic solution was necessary so that it would benefit workers and businesses equally. By proposing a solution that addressed the problems of all entities in the economy, such a solution would come full circle and 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. If effective demand were to increase, Keynes believed it would revive employment and investment because businesses could anticipate a higher demand. Keynes argued there were two main ways to increase effective demand: increased propensity to consume and increased propensity to invest.²² In a paper Keynes reportedly brought with him to the United States Congress in 1934, he claims "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. Due to his theories of effective demand and the multiplier, Keynes argued government stimulus could increase business investment and decrease the desire to save as it would create jobs and investment opportunities. Moreover, Keynes argued 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,²³ Keynes believed the initial expenditure would cycle through the economy. While it was evident to most that the stimulus package would immediately contribute to someone's wages, it would additionally have further repercussions. That worker could then use their increase in income to spend more and therefore fund the wages of someone else as effective demand had increased.

For Keynes, the method to increase effective demand was for the government to invest in public works projects in order 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. The suggestion of government intervention was taboo for classical economists. However, Keynes believed it was the best way to preserve the capitalist system and thus the economic prosperity of society. While visiting Moscow in 1931, Keynes understood people in Russia did not believe capitalism would survive and the Depression was simply the "culminating crisis."²⁴ However, according to *Economic Possibilities for our*

²¹ Keynes Papers AV/3/60-61.

²² Typed paper titled "U.S.A 1934 New Deal," May 22, 1934, AV/3/63, Keynes Papers, King's College Archives, Cambridge, United Kingdom.

²³ Kahn argued for the public works projects by claiming there was 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 which required further employment. So, Kahn argued there was a multiplying effect of employment that occurred throughout the economic system. Richard Kahn, "The Relation of Home Investment to Unemployment," in *Selected Essays on Employment and Growth* (Cambridge: Cambridge University Press, 1972), 1.

²⁴ "An Economic Analysis of Unemployment." AV/1/181, Keynes Papers.

Grandchildren, published in 1930, Keynes believed capitalism and the freeenterprise system were needed for society to reach its full potential and highest standard of living.

4. Conclusion

The Great Depression brought capitalism to a breaking point and Keynes wanted to fix the system rather than have society find themselves on the brink of a new economic order. He believed the solution to be “evolutionary and not revolutionary.”²⁵ Keynes acknowledged both the functional and moral problems within the capitalist system and aimed to mend the situation rather than topple it. Keynes argued that the classical perspective of the economic system was a special case when overall effective demand was large enough to induce full employment. That special case did not always apply, and certainly not during the unprecedented situation of the Great Depression. Keynes formulated an answer and a subsequent theory that applied to the “general” economy and not just the classical special case; hence his culminating work, *The General Theory*. Many of the ideas Keynes outlined in *The General Theory* were derived from earlier pieces published from 1930 to 1934. At the 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 the everyday person needed work immediately 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, Keynes’s insights into 1930s capitalism, despite some significant opposition, have largely thrived into the 21st century.

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²⁵ Columbia Commencement luncheon, AV/3/57, Keynes Papers.

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