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# 1

## An Introduction to Keynes and His Revolutionary Views

Dear reader, may I ask you who you believe was the greatest Englishman of the 20th century – a man whose efforts enabled the possibilities for democracy and a civilized society to flourish on our planet? Some may answer Winston Churchill, but it is the purpose of this volume to convince you that the Englishman was John Maynard Keynes, an economist who never held elected political office.

Keynes was not an ivory tower academic economist. Besides his teaching position at Cambridge University, as Bursar of Kings College in Cambridge, Keynes made important investment decisions involving the College's portfolio. Keynes also served on the boards of several insurance and investment companies and in so doing obtained firsthand knowledge of the behavior of participants in financial markets. Moreover, his experience as a civil servant in the India Office between 1906 and 1908, as well as his service in the Treasury during the two world wars, enabled Keynes to recognize the need to convert theoretical prescriptions into politically acceptable, workable plans. Keynes was truly an economist of the real world.

Churchill fought to preserve the British Empire and in so doing created a bulkhead that produced sufficient time for the United States to join the conflict against Hitler. Churchill's economic policies, however, were based on a 19th-century classical economic theory that has a propensity to produce an economic system with two outstanding faults: (1) a failure to provide persistent full employment for all who want and are qualified to work at the going wage and (2) an arbitrary and inequitable distribution of income and wealth that often creates living conditions for the poor and lower middle class that are unnecessarily uncivilized (cf. Keynes, 1936a, p. 372). To Keynes, the existence of human distress resulting from the inability of the economic system to

persistently generate a fully employed economy, and the gross inequalities of income and wealth under the existing economic system, should not go unheeded. If at all possible, institutions and policies should be developed to abolish these faults of the economic system in which we live (see Harrod, 1951, p. 192).

Through his economic teachings, writings, and advising to governments, Keynes developed and championed a revolutionary economic theory to overthrow the 19th-century classical economic theory that had dominated economic thought for more than 130 years. Even though his revolutionary theory was misunderstood by most professional economists, Keynes's policy prescriptions were followed by post-World War II governments to develop prosperous economic conditions. The result was an era of historically unprecedented real economic growth that lasted for a quarter of a century – from the end of World War II until the early 1970s.

Development economist Irma Adelman has called this quarter century the “golden age of economic development” for all nations that organized its economic system on capitalist principles. During this “golden age”, these nations experienced no significant unemployment problems. Moreover, the income and wealth of these nations grew more rapidly than they ever had in the history of mankind. Existing inequalities were reduced, and almost all residents of these countries experienced substantial improvements in their living standards. This record of economic performance promoted the possibility that a globalized civilized society could be achieved – perhaps as early as the end of the 20th century.

Unfortunately, as we will see, Keynes's revolutionary theory was never completely understood by the post-World War II political leaders, their economic advisors, mainstream academic economists, and economics textbook writers during the last half of the 20th century. Consequently, by the 1970s, a counterrevolution occurred in both economic theory and policy. The result was that by the mid-1970s the last vestiges of Keynes's policy proposals were being rejected by most mainstream professional economists and economic advisors to governments. Keynes's policy recommendations were superseded by more orthodox classical prescriptions that were supported by a hi-tech version of the old 19th-century classical economic theory resurrected by economic theorists under the claim that their approach made economics a “hard science”. Keynes's policies were rejected on principle, although sometimes followed in practice, especially in the form of “military Keynesianism” by conservative United States presidents (e.g., Ronald Reagan and George W. Bush) who, by encouraging massive increases in military and defense expenditures, produced

huge budget deficits that provided strong short-term growth stimulus for the United States economy.

Nevertheless, the reintroduction of the classical theory's *laissez-faire* approach as an overriding principle for the government relationship toward market behavior reversed the progress that had been made in reducing the two major faults of the capitalist economic system. Since 1973, real economic growth for many developed and less developed nations has slowed significantly. Persistent unemployment problems and increasing inequalities of income and wealth again haunted the global economies of the late 20th century and early 21st century.

This book will attempt to explain how Keynes was able to free his mind from the bonds of traditional classical economic theory with its Panglossian philosophy. As Keynes (1936a, pp. 33–4) put it:

The celebrated *optimism* of traditional economic theory, which has led to economists being looked upon as *Candides*, who, having left this world for the cultivation of their gardens, teach that all is for the best in the best of all possible worlds provided we will let well enough alone. ... For there would obviously be a natural tendency towards the optimum employment of resources in a Society which was functioning after the manner of the classical postulates. It may well be that the classical theory represents the way in which we should like our Economy to behave. But to assume that it actually does so is to assume our difficulties away.

Keynes was not one to assume our difficulties away.

In 1945, at a dinner given in his honor by the Royal Economic Society, Keynes offered a toast to “economics and economists who are the trustees, not of civilisation, but the possibilities of civilisation” (Harrod, 1951, pp. 191–2). The great thinker that he was, Keynes freed his mind from the binds of the classical analysis that was the conventional wisdom of economists of his (and our) time. He was able to reorient economic analysis in his mind toward a realistic analysis of the economic world in which we actually live. By so doing, Keynes was the best trustee for a stable, peaceful, and civilized global economy available for all mankind.

## I. Keynes's early intellectual surroundings

John Maynard Keynes was born on June 5, 1883, the first of the three children of John Neville Keynes, a Cambridge University don, and

Florence Ada Keynes. The Keynes family, residing at 6 Harvey Road in Cambridge, England, represented a Victorian family “living in moderate circumstances, but solid comfort, the house well staffed with domestic servants, the passing days full of [intellectual] activity and the future secure” (Harrod, 1951, p. 1). As a young boy, Maynard Keynes was brought up with what Harrod has called the “presuppositions of Harvey Road” (Harrod, 1951, pp. 183, 192–3), which embodied the stable values of a Victorian civilization that “assumed peace, prosperity, and progress to be the natural order of things” (Skidelsky, 1996, p. 2).

In Cambridge, at the end of the 19th century, the belief in religion as the predetermination of one’s life and one’s society was being replaced by the notion that by studying the principles of the “moral sciences” one could recognize the source of social order and wisdom (Greer, 2000, p. 20). At that time, Cambridge’s Moral Sciences Tripos examination was composed of studies in moral philosophy, political philosophy, logic, psychology, and economics.

While Maynard Keynes was growing up, visitors at the Keynes family’s Cambridge residence included some of the most famous economists and philosophers of the day. Intellectual discussions in the moral sciences were daily exercises at 6 Harvey Road. The learned discussions that must have occurred there during Keynes’s childhood and adolescent days surely had an impact on the developing mind of the young Maynard Keynes.

One of the suppositions of Harvey Road was that the search for knowledge by a small but influential intellectual group of moral scientists provided the guidelines for government to follow to achieve peace, prosperity, and progress under the principles of a *laissez-faire* system where governments would not interfere in markets, since it was assumed that unfettered markets permitted individuals to pursue their self-interest and in doing so promote the social good.

Unfortunately, World War I and its economic aftermath would dispel these rosy Harvey Road expectations. Consequently, as a young man in his twenties, Keynes recognized there was a problem with this Panglossian *laissez-faire* philosophy in economics. Nevertheless, Keynes never lost faith in the view that an intellectual group of moral scientists would light the pathway to continuous progress and improvement of the human condition. It is therefore not surprising that through his writings and teachings, Keynes would urge the creation of economic institutions and policies that, with the exercise of intelligence by *pro bono* managers, would establish a civilized, peaceful society that created conditions of prosperity and progress for all its inhabitants without destroying the market economy system.

## II. Keynes's intellectual development

In 1897, at the age of 14, Keynes won a scholarship to Eton, one of Britain's most prestigious public schools. At Eton, Keynes was an outstanding student who excelled at mathematics, classics, and history (Skidelsky, 1996, p. 18). In 1902, Keynes was enrolled as an undergraduate student at King's College, Cambridge. There Keynes came under the influence of the philosopher G. E. Moore, whose *Principia Ethica* (1903) became a "manifesto of modernism" to Maynard Keynes and his generation of intellectuals. In an essay written in 1938 entitled "My Early Beliefs", Keynes noted that the effect of Moore's book "dominated, and perhaps still dominates, everything else" in establishing his views of the world (Keynes, 1949, p. 81).

Keynes wrote that "under the influence of Moore's method ... you could hope to make essentially vague notions clear by using precise language about them and asking exact questions" (Keynes, 1949, p. 88). It was this drive for a precise taxonomy and exposition that permitted Keynes to break away from the grip of orthodox classical economics that he had been exposed to at Cambridge as a student of the leading economist of the day, Alfred Marshall. The influence of Moore's method led Keynes to his revolutionary way of thinking about economics that could only be brought about by Keynes's ability to create a new taxonomy regarding the vague notion of savings held by classical economic theorists.

As Keynes's first biographer, Roy Harrod (1951, p. 463–4), noted:

It is true to say that the Keynesian scheme consisted in essence in a set of new definitions and a re-classification. He asked us to look upon the multifarious phenomena of business life, and order them in our mind in a different way. ... Classification in economics, as in biology, is crucial to the scientific structure. It is not by the intrinsic importance of the considerations which gave him [Keynes] his points of departure that he must be judged, but by what he achieved when he made the departure [from 19th century economic theory]. The older school [*sic*] were concerned to argue that new considerations could perfectly well be accommodated within the old conceptual framework ... a new conceptual framework was not called for. Such an inference was fallacious.

Harrod (1951, p. 463) observed: "The real defect with the classical system was that it deflected attention from what most needed attention. It was Keynes' extraordinarily powerful intuitive sense of what was important that convinced him the old classification was inadequate. It was his highly

developed logical capacity that enabled him to construct a new classification of his own. It took him ten years to do so”.

In the end, Keynes provided a scientific taxonomic structure for economic analysis which, at least for a while, allowed economists and advisors to government to transform their thinking about the causes of unemployment and economic growth.

How many of today's eminent economists would be willing to work for a decade on developing a new taxonomy (following Moore's dictum regarding precise language and developing exacting questions) to understand the shortcomings of the well-established classical theory that is taken to be the absolute truth by the leaders of the economics profession? Yet for Keynes, the pursuit of knowledge “meant philosophy and economics and more the first than the second” (Skidelsky, 1996, p.17). Consequently, Keynes, the philosopher-economist, was a “great thinker” willing to devote his time to develop a precise classification system and language to explain the causes of the two great faults of the economic system we live in – unemployment and the arbitrary and inequitable distribution of income and wealth (Keynes, 1936a, p. 372). Writing in the midst of a period of mass unemployment, it was obvious to Keynes that any significant movement toward full employment would not only increase the aggregate income of the community, but would also significantly increase the income of the majority of the poorer members of society – the unemployed workers. Thus, adoption of Keynes's analysis and full employment policies were likely to reduce income inequality. Keynes, however, did not believe in a complete equality of incomes. He wrote:

For my own part, I believe that there is social and psychological justification for significant inequalities of income and wealth, *but not for such large disparities as exist today*. There are valuable human activities which require the motivation of money-making and the environment of private wealth ownership for their full fruition. Moreover, dangerous human proclivities can be canalised into comparatively harmless channels by the existence of opportunities for money making . . . , which, if they cannot be satisfied in this way, may find their outlet in cruelty, the reckless pursuit of personal power and authority, and other forms of self-aggrandisement. It is better that a man should tyrannise over his bank balance than over his fellow-citizens. . . . But it is not necessary . . . that the game should be played for such high stakes as at present. Much lower stakes will serve the purpose equally well, as soon as the players are accustomed to them. The task of transmuting human nature must not be confused with the task of managing it.

(Keynes, 1936a, p. 374, emphasis added)

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