

The importance of the theory of keynesian economics



**ASSIGN
BUSTER**

The theory of economics called Keynesian Economics, or Keynesianism, is named after the British economist John Maynard Keynes. Keynes lived from 1883 - 1946, and was considered “ the greatest and most influential economist of the 20th century.” (Kangas, 1996). It was the use of the Keynesian Theory of economics by the government that was a strong influence of the Great Depression coming to an end. Because of this, he is known as “ the father of modern economics.” (Kangas, 1996).

When Keynes first suggested the use of his theory to help solve the problems of the Great Depression, he was not met with the same enthusiasm. Because of the incredible size and widespread effects of the Great Depression, many felt that any cause of such devastation must be as complicated as the results. Keynes, however, had a simple explanation of the cause of the Great Depression. In fact, upon sharing his theory with President Franklin Roosevelt, the President dismissed his words by saying that such a theory is “ too easy.” (Kangas, 1996).

The theory for which was considered “ too easy” (Kangas, 1996) by President Roosevelt was actually fairly simple. In regards to the explanation of slumps in the economy, Keynes had a simple reasoning. Keynes explained that in any normal economy, the level of employment is high, and therefore the earnings of the people are spent as usual, meaning there is a circular flow of money in the economy. With this circular flow, the money spent by one person becomes the income of another person, and those earnings are spent and become the earnings of the previous person. However, when something happens in the economy to worry consumers and shake their confidence, those consumers will then decide to save their money instead of spending it

<https://assignbuster.com/the-importance-of-the-theory-of-keynesian-economics/>

to prepare for whatever lies ahead. Unfortunately the saving of that consumer will affect other people because the money saved instead of spent is no longer given to the intended person. When people save instead of spend, it affects others that are no longer getting the expected income, and they will then start saving themselves. It becomes a viscous circle which makes the times and economy more difficult. (Kangas, 1996).

With the obviously negative effects that a slump would cause within an economy, Keynes devised a cure for the problem. The cure for this problem, which is also considered to be quite simple, is for banks to increase or expand the supply of money. By doing so, the people would have more money, which would increase confidence in the economy by the consumer now having more earnings. With the increased confidence, people would begin to spend, which would re-establish the circular flow of money. (Kangas, 1996).

The larger problem of the Great Depression, however, was much larger than that of a recession, or slump. Keynes belief of the depression was that it was actually a recession that had fallen into something called a " liquidity trap." (Kangas, 1996). A liquidity trap is due to those people that choose to save their money rather than spend, and will continue to do so regardless of how much the supply of money is increased by the government. Due to the lack of consumer spending, Keynes believed that the government should then be the one doing the spending, since the consumers were not. This idea of increasing government spending was considered a final effort by the government to " reestablish the circular flow of money." (Kangas, 1996). In

Keynes own words, he called this last-ditch effort by the government, “ priming the pump.” (Kangas, 1996).

Although in the end Keynes’ theories were used to end the Great Depression, they were at first rejected. To many economists, the end of the Great Depression was caused by World War II, in which the United States started spending massive amounts of money on defense. Because of this, many say that “ wars are good for the economy.” (Kangas, 1996). Wars are considered to cause an economic boom due to the massive amounts of spending during the war, which is in extent the definition of Keynesian spending. With Keynesian spending, the U. S. went to the greatest economic boom ever, from the greatest depression ever, all due to the theory of Keynesian Economics. The use of Keynesian Economics during this time was so successful that President Nixon declared, “ We are all Keynesians now.” (Kangas, 1996). This view of Keynesian Economics was dominant from the 1940s to the 1970s, until others began to challenge this theory. (Boyes & Melvin, 2008, p. 347).

In an explanation of Keynesian Economics by Alan S. Blinder (2008), he defines Keynesian Economics as “ a theory of total spending in the economy (called aggregate demand) and its effects on output and inflation.” Upon researching Keynesian Economics, there appear to be many principal ideas to the theory. The first idea, or belief, is that “ aggregate demand is influenced by a host of economic decisions – both public and private – and sometimes behaves erratically.” (Blinder, 2008). These economic decisions are based on things like spending and taxes. Many economists believe that both taxes and spending affect aggregate demand. (Blinder, 2008)
<https://assignbuster.com/the-importance-of-the-theory-of-keynesian-economics/>

Another belief of Keynesian Economics is that “ changes in aggregate demand, whether anticipated or unanticipated, have their greatest short-run effect on real output and employment, not on prices.” (Blinder, 2008). This idea is shown when inflation slowly rises as unemployment falls. This belief of Keynesians is that what can be seen in the short run is not necessarily the same as the long run. Also, due to the rigidity of prices, any changes or fluctuations in spending, whether by government spending, investment, or consumption, will cause a change or fluctuation of output. For example, if there is an increase in government spending, then an increase in output should occur, as long as the other areas of spending are constant. (Blinder, 2008).

In addition, this model of Keynesian economics also has a multiplier effect. With this multiplier effect, “ output increases by a multiple of the original change in spending that caused it.” (Blinder, 2008). For this multiplier to work, however, it must not be less than zero. Also, in yet another belief of Keynesians is that “ prices, and especially wages, respond slowly to changes in supply and demand, resulting in periodic shortages and surpluses, especially of labor.” (Blinder, 2008). In this belief, it is stated that flexibility is limited in terms of wages and prices, no matter the arrangements. (Blinder, 2008)

These beliefs are all included in the theory of Keynesian Economics. Although this theory was greatly used during the 1940s to the 1970s, it became much less commonly used, and was replaced with other economic theories. Since then, however, the theory of Keynesian Economics had made a comeback.

The main reason for this comeback was due to the ability of this theory to <https://assignbuster.com/the-importance-of-the-theory-of-keynesian-economics/>

explain the events that have happen since the end of the Great Depression better than many other economic theories. (Blinder, 2008).

In conclusion, the theory of Keynesian Economics was an extremely important part of the history of the economy. This theory was an enormous part of the end of the Great Depression. It also was a key in giving an explanation to the various changes in the economy, such as slumps and recessions. While not all economists may agree that this theory is the way to correct problems in the economy, it was very obviously the correct theory needed for its time. Because of the importance of this theory, the creator of the theory, John Maynard Keyes, is considered “ the father of modern economics.” (Kangas, 1996).