

COMMANDING HEIGHTS

John Maynard Keynes

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(1883-1946)

John Maynard Keynes was a British economist during the first half of the 20th century best known for his revolutionary theories on the causes of unemployment and recession, which came to be known as Keynesian economics.

Excerpted from *The Commanding Heights* by Daniel Yergin and Joseph Stanislaw, 1998 ed., pp. 39-42.

The most influential economist of the 20th century, John Maynard Keynes was a product of the late Victorian and Edwardian eras, a period when stability, prosperity, and peace were assumed and when Britain ruled the world economy. Keynes never lost the self-confidence, self-assurance, and indeed the optimism of that time. But his intellectual career, and his profound impact, arose from his efforts to make sense of the disruptions and crises that began with the first world war and continued through the Great Depression.

Descended from a knight who had crossed the English Channel with William the Conqueror, Keynes was the son of a Cambridge University economist. Educated at Eton and Cambridge, he demonstrated from his early years a dazzling, wide-ranging intellect, along with an arrogance and what seemed to some a dismissive elitism. His establishment habits (including the signature homburg normally associated with a City of London stockbroker) and his pride in being a member of what he called the "educated bourgeoisie" were combined with chronic social and intellectual rebellion, orneriness, and the lifestyle of a Bloomsbury bohemian and aesthete. His daunting mathematical dexterity was complemented by a considerable literary grace, whether the subject was the subtleties of economic thought or his obsession with the hands of statesmen. He celebrated "vigilant observation" of the real world as one of the requirements of a good economist, and he loved to pore through statistics. His best ideas, he liked to say, came "from messing about with figures and seeing what they must mean." Nevertheless, he could not resist endlessly toying with ideas, and he compulsively sought to spin out all-encompassing theories and generalizations from particulars.

As an economic advisor to the British delegation at the Versailles conference in 1919, he became convinced that the Carthaginian peace that the Allies were imposing on Germany would undermine European economic recovery and guarantee new crises. Disgusted, he

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resigned and retired to the English countryside, where, in a matter of weeks, he brought together his searing criticisms in *The Economic Consequences of the Peace*. That book made him famous. In the 1920s, he focused mostly on monetary issues. He lambasted the decision by Winston Churchill, at the time chancellor of the exchequer, to return Britain to the gold standard with an overvalued pound in a work entitled "The Economic Consequences of Mr. Churchill."

During those years and into the 1930s, he split his week between King's College in Cambridge, where he did his teaching, and London, where he busied himself speculating in currencies, commodities, and stocks. He was also on the board of a number of investment and insurance companies, and in fact served as the chairman of one. He was a master of markets and their psychology. As bursar of King's College—during the Great Depression—he increased the college's endowment tenfold. He also made himself very wealthy managing his own portfolio, despite periodic reverses. He did not hesitate to take risks. "The academic economist," said a close friend of Keynes, "never really knows what makes a businessman tick, why he wants sometimes to gamble on an investment project and why he sometimes prefers liquidity and cash. Maynard understood because he was a gambler himself and felt the gambling or liquidity instincts of the businessman." As Keynes himself once explained, "Business life is always a bet."

Persistent unemployment in Britain, and then the mass unemployment of the Great Depression, redirected Keynes's intellectual agenda from monetary affairs to unemployment and led to his most influential work, *The General Theory of Employment, Interest, and Money*, published in 1936. Here was Keynes as vigilant observer, keen mathematician, self-confident rebel, and grand generalizer. The book constituted a vast assault on the classical economics tradition in which he had been raised. The era that had nurtured classical economics had been destroyed by the first world war, and for Keynes the cataclysms since had demonstrated the tradition's inadequacies. A new synthesis was necessary, and that is what Keynes, working with his "kindergarten" of disciples in Cambridge, sought to create.

In particular, he concluded that classical economics rested on a fundamental error. It assumed, mistakenly, that the balance between supply and demand would ensure full employment. On the contrary, in Keynes's view, the economy was chronically unstable and

subject to fluctuations, and supply and demand could well balance out at an equilibrium that did not deliver full employment. The reasons were inadequate investment and over-saving, both rooted in the psychology of uncertainty.

The solution to this conundrum was seemingly simple: Replace the missing private investment with public investment, financed by deliberate deficits. The government would borrow money to spend on such things as public works; and that deficit spending, in turn, would create jobs and increase purchasing power. Striving to balance the government's budget during a slump would make things worse, not better. In order to make his argument, Keynes deployed a range of new tools—standardized national income accounting (which led to the basic concept of gross national product), the concept of aggregate demand, and the multiplier (people receiving government money for public-works jobs will spend money, which will create new jobs). Keynes's analysis laid the basis for the field of macroeconomics, which treats the economy as a whole and focuses on government's use of fiscal policy—spending, deficits, and tax. These tools could be used to manage aggregate demand and thus ensure full employment. As a corollary, the government would cut back its spending during times of recovery and expansion. This last precept, however, was all too often forgotten or overlooked.

Keynes intended government to play a much larger role in the economy. His vision was one of reformed capitalism, managed capitalism—capitalism saved both from socialism and from itself. He talked about a "somewhat comprehensive socialization of investment" and the state's taking "an ever greater responsibility for directly organizing investment." Fiscal policy would enable wise managers to stabilize the economy without resorting to actual controls. The bulk of decision making would remain with the decentralized market rather than with the central planner.

Keynes had worked on *The General Theory* with feverish intensity, convinced that new apocalypses were waiting close in the wings even as the world struggled with the Depression. The alternative to reform was totalitarianism. And it was not only the new vistas of macroeconomics but also the dangers of the time that helped explain the fervor with which others embraced the argument. As one of his students explained, "Finally what Keynes supplied was hope: hope that prosperity could be restored and maintained without the support of prison camps, executions, and bestial interrogations."

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A new apocalypse came soon enough. With the outbreak of World War II, Keynes moved on to the questions of how to finance the war and then how to develop a postwar currency system. He was one of the fathers of the Bretton Woods accord, which established the World Bank and the International Monetary Fund, and which put in place a system of fixed exchange rates. He also returned to a subject that had obsessed him since the first world war—how to cope with, and limit, Britain's submission to America's financial might. After all, he had come to maturity in an age when Britain ruled the international economy. Now, however distastefully, he struggled to adjust Britain to the new reality of American ascendancy. His last major enterprise was to negotiate a multibillion-dollar U.S. loan for Britain in 1946. It was a very nasty business. The stress literally killed him.

Keynes provided both a specific rationale for government's taking a bigger role in the economy and a more general confidence in the ability of government to intervene and manage effectively. As Keynes's work turned into "Keynesianism" in the post-World War II years, the self-confidence that had animated its author continued to be at its root. Despite Keynes's fascination with uncertainty and his speculative talents in the marketplace, Keynesians deemed "government knowledge" to be superior to that of the marketplace. In the words of Keynes's biographer Robert Skidelsky, the unstated message in its most extreme form was this: "The state is wise and the market is stupid."

In one of the most famous passages of *The General Theory*, Keynes had written, "The power of vested interests is vastly exaggerated compared with the gradual encroachment of ideas." There was nothing gradual, however, in the encroachment of Keynesianism or in its conquest of the commanding heights of economic thinking. Within a few years of his death, it was already taking a dominant place in economic policy making both in Britain and in the United States. How far-reaching its impact, or at least the perception of its impact, was demonstrated by a history of economic thought published in the mid-1960s: "In most Western economies Keynesian theory has laid the intellectual foundations for a managed and welfare-oriented form of capitalism. Indeed, the widespread absorption of the Keynesian message has in large measure been responsible for the generally high levels of employment achieved by most Western industrial countries since the second world war and for a significant reorientation in attitudes toward the role of the state in economic life." Keynes's self-confidence lived on in his thought.

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