**KEYNESIAN ECONOMICS**

Classical/Neoclassical liberal economics had three basic assumptions or pre-suppositions:

1. **Invisible Hand.** Markets are self-regulating. An invisible hand adjusts the functioning of the economy. Therefore, there is no need for governmental regulation as the Mercantilists argued. Economies reach or restore equilibrium automatically.
2. **Rational Economic Man**. All agents functioning in the economy are rational, reasoned people. They plan, calculate, and act within a framework of profit and loss accounting.
3. **Primacy of Real Economy.** Classical and neoclassical economists were certainly aware of the symbolic economy of money and credit. Fluctuations in this realm always affect the real economy. However, they considered the economy of money and credit to be a shadow economy serving the real one. It just reflected what was going on in the real sector.

Keynes countered all these basic assumptions or articles of faith, *without leaving the liberal creed!...* He argued that

1. Markets are not *always* self-regulating. So we need government regulation and intervention if and when necessary.
2. Men are not *always* rational, and not all men are rational.
3. Symbolic economy may, at a certain stage of capitalism, take the central position and affect the real economy more than it has been the other way round.

So influential was John Maynard Keynes in the middle third of the twentieth century that an entire school of modern thought bears his name. Many of his ideas were revolutionary; almost all were controversial. Keynesian Economics serves as a sort of yardstick that can define virtually all economists who came after him.

In the 1920s Keynes was a believer in the quantity theory of money. His writings on the topic were essentially built on the principles he had learned from his neoclassical mentors, Marshall and Pigou. His major policy view was that the way to stabilize the economy is to stabilize the price level, and that to do that the government’s central bank must lower **interest rates** when prices tend to rise and raise them when prices tend to fall.

Keynes’s ideas took a dramatic change, however, as unemployment in Britain dragged on during the interwar period, reaching levels as high as 20 percent. Keynes investigated other causes of Britain’s economic woes, and *The General Theory of Employment, Interest and Money* was the result.

Keynes’s *General Theory* revolutionized the way economists think about economics. It was pathbreaking in several ways, in particular because it introduced the notion of **aggregate demand** as the sum of consumption, investment, and government spending; and because it showed that ***full employment could be maintained only with the help of government spending.***

Why shouldn’t government, thought Keynes, fill the shoes of business by investing in public works and hiring the unemployed? *The General Theory* advocated **deficit spending** during economic downturns to maintain full employment. Keynes’s conclusion initially met with opposition. At the time, balanced budgets were standard practice with the government. But the idea soon took hold and the U.S. government put people back to work on public works projects. Of course, once policymakers had taken deficit spending to heart, they did not let it go.

Contrary to some of his critics’ assertions, Keynes was a relatively strong advocate of free markets. It was Keynes, not Adam Smith, who said, “There is no objection to be raised against the classical analysis of the manner in which private self-interest will determine what in particular is produced, in what proportions the factors of production will be combined to produce it, and how the value of the final product will be distributed between them.” Keynes believed that once full employment had been achieved by **fiscal policy** measures, the market mechanism could then operate freely.

Capitalist economies are not self-adjusting: market forces might *eventually* restore an

economy of full employment, Keynes said, but *in the long run we are all dead.* Keynes proposed clear prescriptions for hard economic times: expansionary monetary and fiscal policy. He thought fiscal policy particularly important in situations where monetary policy was likely to be ineffective. So the visible hand of the state has always to be there to make the necessary corrections in the economy.