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"History of Economic Thoughts"
John Maynard Keynes

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Abstract:

This assignment is addressed to spot the light on Keynes contributions to economics. It shows first an overview about historical economic though starting from Adam Smith who's the father of economics and who established the classical school of economics at late 18th century that is based on a thought that markets works in best efficiency when they are left alone and thus there should be no government intervention in markets, based on the concept of the Laissez faire and the Invisible hand that was widely accepted in that age. Until the later of 19th century when the industrial revolution takes place and bring big social and economic changes and many of these changes negatively affected societies, thisenabled Karl Marx to build the Classical political economic school that brought new terms such as Capitalism, Socialism and Communism. This theory is based on the thought the society should be one class and government should interfere to present equality between citizens. Beyond these Thoughts many economists like Alfred Marshall within that period brings important concepts and theories to economics such as the Marginal revolution. These developed concepts build the neo-classical schools of economics.

Till late of 19th century and begging of 20th century Keynes rose with a mix of experience based on previous economic schools and based on experiencing world events such as world war one and two, and the great depression. Keynes tried to set a logic balance between the previous schools; he brings very important economic concepts especially in the field of macroeconomics and was able to help many countries to solve problems like unemployment or to manage its monetary systems. Keynes economic concepts were all explained in his works (Indian currency and Finance, The Economic consequences of the Peace, A Treatise on Probability, the end of Laissez Fair, Treatise on Money, The Means to Propensity, The General Theory of Employment Interest and Money, how to Pay for the War…) and his contributions to set International

Monetary Institutions after world war, these monetary institutions that are still leading the monetary system of the world till now days. All what Keynes brings to economics was enough to name Keynes the economist of the 20th century

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Introduction

The history of economic thoughts deals with different thinkers and theories in the subject that became political economy and economics, from the ancient world to the present day. It encompasses many different schools of economic thought.

Economic thought may be roughly divided into three phases: Pre-modern (Greek, Roman, Arab), Early modern (mercantilist, physiocrats), Modern (since Adam Smith in the late 18th century) and Systematic economic theory has been developed mainly since the birth of the modern era.

Many economic philosophers and experts especially in modern stage such as Adam Smith, David Ricardo, Karl Marx, Alfred Marshall, John Keynes… all brought important theories and assumptions to economics that helped individuals, businesses, and governments to regulate their economics with better efficiency.

Through my research I would like to highlight on the work of John Keynes who was named the economist for the 20th century that’s for what he brings for economy in that century.

Historical overview for economic thoughts before Keynes

Modern economic thought is usually considered to have begun in the late 18th century with Adam Smith who is known by the father of modern economy who established the classical school that is developed by his followers like David Ricardo and Tomas Robert Malthus… The classical school was based on the idea that markets work best when they are left alone, and that there is nothing but the smallest role for government. The approach is firmly one of laissez-faire and a strong belief in the efficiency of free markets to generate economic development. Markets should be left to work because the price mechanism acts as a powerful 'invisible hand' to allocate resources to where they are best employed. In terms of explaining value, the focus of classical thinking was that it was determined mainly by scarcity and costs of production.

In terms of the macro-economy, the Classical economists assumed that the economy would always return to the full-employment level of real output through an automatic self-adjustment mechanism.It is widely recognized that the Classical period lasted until 1870 the late of 19th century.

All these concepts were explained in important publications for the classical school such as: “The Wealth of Nation” and“Invisible hand” for Adam Smith, “Principles of Political economy and taxation” for David Ricardo and “Principles of Political economy” for John Mill that summarizes all the classical economic thoughts and it was used as the standard text by most universities until 19th century.

In coincide with the development of the classical theory the industrial revolution starts in late of 19th century and brought social and economic changes: rural depopulation, precariousness, poverty, apparition of working class, deficiency in social classes, unemployment increases… all these conditions that raised at that time enabled Karl Marx to build the Classical political economic schoolthat brought new terms such as Capitalism, Socialism and Communism. Capitalism describesthe class that directly benefits from the industrial revolution such as the owners of the businesses, Socialism emerged in response to the miserable living and working conditions of the working class, and thus Communism theory found to eliminate the deficiency in social classes that raised, and this theory ended by a political revolutions in the early beginning of 20th century and was successful to create the soviet union that was based on the idea of eliminating deficiencies in social classes and make all the society one class and that's by generalization and government interference to mitigate unemployment, economic downturns, organize the economy within the state and this set the base for later Keynesian economics in 1930's.

All these Marxian thoughts explained in "Das Kapital" and "Communist Manifesto" some of most important books for the 19th century, and these books developed later by Friedrich Engels, Karl Kautsky and others supports.

Beyond that in the late of 19th and the beginning of 20th century, further developments, discoveries,theories, assumptions, terms and models introduced to economics and shifts economics to a new developed leveland thus build the Neo-classical school of economics.

Many economists crystalized the Neo-Classical school such as John Clark who introduced the margin theory and published "The distribution of wealth", William Jevons who introduced the Diminishing Marginal Utility and published "Theory of political economy", Alfred Marshall who introduced math and econometrics to economics. Due to the importance of these new theories the Neo-Classical school is also known by the 'Marginalist' school.

Moreover many othereconomists referred to this school like Arthur Cecil Pigou who published "The wealth and welfare" where he insisted on the possibility of market failure claiming that markets are inefficient in-case of economic externalities and government must interfere to regulate markets, also he explained the theory of unemployment and this set the base for John Maynard Keynes who established the Keynesian school of economics that leads the world economics in the 20th century and it was efficient enough to name Keynes the economist for the 20th century.

The Neo-classical school encompasses many variants within itself such as Austrian and Stockholm school of economics but all have the same underlying theoretical principles.

The Neo-classical school continues until today and it brings many important aspects to economics that makes the economic study more tangible rather than philosophical.

The 20th century events and the rise of Keynes

Through the 20th century world faces a lot of events that changed the world such as the world war one in 1914, Russian revolution and the raise of communism in 1917, economic depression in 1929, world war two in 1939, Bretton wood system in 1945 that set the base and the reference for the economic and monetary policies of the world countries until today, and the cold war and the end of communism in 1991.

In addition there were rapid Information, communications, technological innovations and an accelerated world population growth in the presence of scarcity… All these events needed a prudent economic thought that is able to save the economies with best efficiency and help countries to overcome economic crises under such conditions.

One of the most important economists who lived such events at that time was John Maynard Keynes who was able to establish the Keynesian school of economics that enlightens the economic plans for many countries in the 20th century till now days.

Keynes and his brings to economics

John Maynard Keynes (1883-1946) was born in Cambridge-England and he is a British economist, at his early life he was so intelligent and showed talent in mathematics thus he studied mathematics in Cambridge university,further he studied economics and philosophy and he was supervised by Alfred Marshall who discovered Keynes talent and begged him to be an economist.

Economist John Maynard Keynes made many contributions to the field of macroeconomics;his theories influenced governments on both sides of the Atlantic Ocean. The major work of Keynes: Indian Currency and finance (1913),The Economic Consequences of the Peace (1919), The End of Laissez-Faire (1926), The Means to Prosperity (1933), and General Theory of Employment, Interest and Money (1936),In addition to A Treatise on Probability and The Economic

Consequences of Peace.Keynes was an incredible influence in the field of economics, and there is an entire school of thought around his influence known as Keynesian economics.

Indian Currency and finance

In 1906 Keynes took a position with the civil service in Britain, his career began as a clerk in the India Office. While there, he collected the material for his first book in economics, “Indian Currency and Finance” that was published in 1913, it demonstrates the beginnings of the philosophies of macroeconomics and government intervention into economic matters that would characterize his later work in which he described the workings of India’s monetary system. Keynes discussed how changing from a silver to a gold standard impacted the Indian economy, some surprising differences between coins and paper currency, governmental policies regarding reserves and cash balances, the strengths and weaknesses of the Indian banking system . This book was very successful and helpful for governments to better manage its monetary systems especially for India.

The Economic Consequences of the Peace

In 1915 Keynes took an official government position in treasury in London, then he was appointed as financial representative for the Treasury to theVersailles peace conference that was done by allied nations after world war one.

Keynes proposed very important economic ideas in Paris conference, he tried to prevent or minimize the high compensation payments and lower theheavy economic sanctions that allied nations imposed on Germany. He explained his idea that such sanctions will have a direct negative effect on the innocent Germany citizens who were not involved in war and the actual sanctions should be focused on the Germany’s army leaders. Keynes stated that such sanctions will decrease the Germany’s capital to import from neighbor countries and this will badly affects the overall European countries trade and economy; Keynes also came up with a plan that he argued would not only help Germany and other impoverished central European powers but also be good for the world economy as a whole. It involved the radical writing down of war debts, which would have had the possible effect of increasing international trade all round, but at the same time thrown the entire cost of European reconstruction on the United States that was the largest creditor, but America refuses the proposed plan.

Moreover he stated that these sanctions will create a deficiency between the Germany’s economy and society and the other European countries economy and society and this will keep Germany in political and economic uncertainty and will lead to a second world war. Despite his efforts the conference ended with a treaty that didn’t take into consideration Keynes idea’s and keep on the strict sanctions on Germany. Keynes was disappointed and resigned from his position, and in 1919 he published "The Economic Consequences of the Peace" a book that analyzes and explains the predicted damaging effects of the treaty and warns from a second world that actually happened after a decade and half, and many economists and politicians then discovered that Keynes was right.

A Treatise on Probability

"Treatise on Probability" was published by John Maynard Keynes in 1921. The Treatise contains a critical assessment of the philosophical foundations of probability and of the statistical methodology at the time. Keynes deeply studies and explained probability science in his treatise,this pure mathematical and philosophical work was expanded to benefit the economics to better understand uncertainties and decision theories in economics based on probability concepts.

The end of laissez faire

The term "Laissez faire" refers to a French term that means "leave alone", the driving idea behind laissez-faire as a theory was that the less the government is involved in free market capitalism, the better off business will be. The theory states that when markets are left alone without any government intervention then the markets will be regulated naturally in the best efficient way. The government intervention according to this theory includes eliminating any type of intervention such as setting minimum wages, taxation, monetary policies… and the role of government should be limited to provide security, defense, support health, education, and infrastructure.

The "laissez faire" originated in seventeenth century when 'Marqiusd Argenson'who said "to govern better, one must govern less", and then flourished in the eighteenth and nineteenth century by Adam Smith when he explained the concept in his theory in the concept of "invisible hand", and it gained a large support from many economists and many economies were operating based on this theory.

Such economic system resulted many negative outcomes especially in 1920's. Capitalists became the leaders of the markets, great social wealth in equalities, very few people are over rich and many people are poor since the business shareholders employed minimum number of employees and labors to minimize their costs and maximize their revenues, this increased unemployment to high levels, increased child labors, increased poverty and boost the wealth of capitalists that find no place to invest their wealth other than gambling and speculating in financial markets without carrying for losses, thus fluctuations in prices of financial assets increased in financial markets…

All these effects encouraged Keynes at that time to say it's the time to "The end of Laissez fair"and it's the time again to government intervention.Keynes published his book "The end of Laissez faire" in 1926 this book explained the importance of government interference to regulate the economyat least in the minimum level to regulate the macroeconomic events such as unemployment, minimum wages, monetary system, monopoly and competition, prevent child labors… Keynes explained in his book that the economy cannot operate efficiently and cannot return to its full employment without government intervention, and he explained further that the circumstances of Laissez Faire system threatens the stability of economy.

Keynes was not intended to eliminate the capitalism system but he insisted to regulate it by minimum government intervention to eliminate it's bad economic circumstances that negatively affects the health of the economy. And after three years from publishing "The end of laissez faire a great financial depression raised in the world one of its most important reasons was the bad circumstances of Laissez faire system and capitalism that already Keynes tried to explain three years before.

This work for Keynes was the beginning that gave him the push to explore his great theory later on in 1936 that is known by "The General Theory".

Treatise on Money

In 1920s Keynes began a theoretical work to examine the relationship between unemployment, money and prices. His great work shined in 1936 with the theory "General theory of employment, Interest and money" which was one of most brilliant and famous macroeconomic findings in the 20th centurydue to its effectiveness and efficiency in helping to solve major macroeconomic issues such as unemployment, managing interest rates and monetary systems.

Many countries at that time were in need for Keynesian General Theory to know how to manage these issues that were inflated due to the great depression that started in 1929.

The General Theory passes into stages of works from 1920s till 1936,

First Keynes published his work "Treatise on Money" that was published in two volumes, in 1923 he wrote Tract on Monetary Reform, and later he published Treatise on Money.His writings on the topic were essentially built on the principles he had learned from his mentors, Marshall and Pigou.

In Keynes's Treatise, he explained how recessions could happen, he stated that booms and busts emerge in an economy when there are discrepancies between savings and investments, and thus amajor policy view was that the way to stabilize the economy is to stabilize the price level, and 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.

When prices tends to rise people have a lower propensity to investment and consume and a higher propensity to save, this may boost the savings over investments and may lead to recession, thus the government can stabilize the seesaw by decreasing the interest rates to set a downward pressure on saving and upward pressure on Investment and consumption. Vice versa is true.

Moreover Keynes discussed the issue of unemployment he stated that if the amount of money being saved exceeds the amount being investedthat can happen if interest rates are too high, then unemployment will rise since people prefer to save their funds rather that spending them. So to decrease unemployment central bank should decrease interest rates to encourage investments and spending.

The means to prosperity

At the height of the Great Depression in 1933, Keynes published his next work the "Means to Prosperity", which contained specific policy recommendations for solving unemployment within a global recession. His idea was that government could engage in counter-cyclical public spending to offset the deficit in private spending. This means that the role of government is to increase public spending when private spending decreases to keep a balance in spending. Since as spending increase, investments increase and unemployment decreases. Keynes argued for a public works program stating that under less than full employment conditions, an increase in expenditure translated into a higher level of income rather than higher prices. Also, the income generated by the expenditure process created the required savings to 'finance' the more investments. In this sense, Keynes explained that a loan financed program of public works need not generate a budget deficit, and it is a complete mistake to believe that that there is a dilemma between schemes for increasing employment and schemes for balancing the budget. There is no possibility of balancing the budget except by increasing the national income, which is much the same thing as increasing employment.

The "Means to Prosperity" contains one of the first mentions of the multiplier effect that studies relation how an X variable can change for a change in Y variable.He used the multiplier to explain relations in his theory between the level of spending, investments and level of unemployment and also to study the leveraging of the economy with credit.

Even though this book was mainly addressed to the British government, it proved to be very useful for other countries around the globe that were affected by recession. Copies of this book were sent to various leaders across the world. It is for this reason that most people came to accept the Keynesian ideas later on.

The General Theory of employment interest and money

Keynes general theory of employment, interest and money came to be published in 1936 and it is often viewed as the foundation of modern macroeconomics, it was helpful for many governments during 20th century to solve their unemployment or manage their monetary systems or to face any other macroeconomic issue.
The General Theory can be viewed as a completion of previous Keynesian works, and the mother of his works.

It explains the issue of unemployment by aggregate demand which comprises of the total spending (consumption and investment) of business investors, consumers and public agencies. Based on Keynes demand is the key variable governing the overall level of economic activitysince as aggregate demand in market increases, profits for businesses increases, savings increases, investments increases, employment increases and the overall wealth of economy will be better, and vise-versa is true. So to solve the problem of unemployment nations should stabilize their aggregate demand.
Also Keynes related the aggregate demand by the level of the income that people earn which is directly related to the level of salaries. Thus the salaries should be in an acceptable level to be able to stimulate the business cycle.

According to Keynes an economic well functioning refers to the continuous of a balanced savings and investments in an economy,

When savings exceed investments people have a high propensity to save and lower propensity to spend, then the overall aggregate demand will decrease, and since demand is the key variable governing the overall level of economic activity so the result will be a recession in the economy and will increase unemployment.
Keynes stated the best thing to do during recession is to come up with public substitutes for deficiencies of private investments, that's by increasing public spending and public investments such as creating public works. Many economists blamed Keynes on his theory because increasing government spending in a recession will increase the government deficit, but Keynes explained that increasing the government deficit for the aim of increasing the spending and investments in the economy and stimulating the aggregate demand is the right choice to solve unemployment and recover the economy.
Keynes clarifies his theory by "the multiplier effect." According to the theory, a single dollar of government spending might increase total economic output by more than $1.

Keynes stated another thing to do during recessions depending on encouraging the private investmentand that's by following easier credit monetary policies together with lower interest rates would stimulate investments in businesses and therefore bring back the aggregate demand to normal by full employment. That's why Keynes went on in practice to place great emphasis on the reduction of long-term interest rates to protect the wealth on the economy on the long-term.

On the other hand when savings are less than investments people have a low propensity to save a high propensity to spend, then the overall aggregate demand will increase this will stimulate the investments beyond the abilities of the saved resources in that economy. So the market will respond to such situation by increasing the prices to re-stabilize the demand, this will cause inflation in the market.This was known by Keynes "Inflation theory".
Keynes explained that governments can respond to such issue by strict credit policy together with higher interest rates to discourage investments and stimulate savings and therefore bring back the aggregate demand to normal by full employment.

According to Keynes in both cases without government intervention economy can remain trapped in low employment equilibrium, and thus it is wrong to assume like the classical school of economics that markets are efficient and unemployment will be re-stabilize naturally in the long run in the markets.

This demonstration has been described as the revolutionary formal achievement of the work and the base of what is known by Keynesian theory or what is best known by Keynesian school.

How to pay for the war

In 1940 Keynes published his last book "How to Pay for the War".
Keynes argued that governments should finance for the war by high taxation, austerity and compulsory savings. This strategy can avoid the country from high inflation that can be resulted if the country financed the war by deficit spending. Since financing by deficit spending in case of war may increase the inflation and thus push the prices of goods to high levels that people may not burden.
He argues that compulsory savings should help in dampening domestic demand and therefore assist in directing some resources towards efforts in war. This would not only be fair but would also help to prevent post war slump.
This book was directed to allied nations in world war two and it was very useful for those countries to know the best choice to finance their military needs.

Keynes works for International monetary institutions:

In the General theory and in his other works Keynes argued that capitalism especially at the great depression caused war because it created conflict between nations and what actually caused the

Second World War is the conflict that rose between nations. He argued that if capitalism was managed domestically and internationally through coordinated international policies, an international monetary system, and a high degree of freedom of trade; then this system of managed capitalism could promote peace rather than conflict between countries.

After World War Two in 1944 the allied nations met in Bretton wood in Washington to set new international monetary policies and regulate international and nations' economies.

Keynes was the representative for British government in the conference; he called for the creation of a large institution with the resources and authority to step in when imbalances occur. This approach was consistent with his belief that public institutions should be able to intervene in times of crises. The Keynes plan envisioned a global central bank called the Clearing Union. This bank would issue a new international currency, the "bancor," which would be used to settle international imbalances. This bank will be financed by surplus nations to help deficit nations.

The result of the conference was extrapolated from Keynes idea to fix the world currencies with the most stable currency which was the US dollar at that time, and consider it the international currency for the world. And to create three main international economic institutions that are still leading the world economic and monetary systems till now days. International Monetary Fund to regulate countries' currencies and exchange rates, World Bank to help deficit countries and it is financed by surplus countries, and World Trade Organizer to regulate and encourage the international trade between countries.

After Keynes

In the late 1930s and 1940s, economists like John Hicks, Franco Modigliani and Paul Samuelson attempted to interpret and formalize Keynes's writings in terms of formal mathematical models. In what had become known as the neoclassical synthesis, they combined Keynesian analysis with neoclassical economics to produce neo-Keynesian economics, which came to dominate mainstream macroeconomic thought for the next decades.
Keynes died in 1946but his theories stayed immortal till now days, his theories was the economic base and reference for many countries especially in Europe to manage their macroeconomic issues. Between 1950 and 1960s the developed countries following Keynesian concepts lived a golden economic certainty with high growth and low unemployment.
Moreover Keynesian theories and books became the most famous to be learned in universities.

In late of 1960s the power of private interests starts to re-increase and the capitalism return to divert from its normal side towards its extreme side that Keynes warns about it, where even speculation and gambling starts to increase.

And until 1970s when US faces difficulties to finance its war with Vietnam and it refuses to finance the war with increasing taxes and forcing increasing savings so US dollar starts to depreciate so many countries refuses to keep fixing there currency with US dollar and the Bretton wood system broke down in 1974.

Moreover Milton Friedman an American economist suggested that sustained Keynesian policies could lead to both unemployment and inflation rising at once – a phenomenon that soon became known as stagflation. In the early 1970s stagflation appeared in both the US and Britain just as Friedman had predicted, with economic conditions deteriorating further after the 1973 oil crisis. And Friedman expectation was against Keynesian theories that explained an inverse relation between unemployment and inflation.

These main events negatively affected Keynesian theories to be still applicable.

Due To these facts Keynesian theories were in need to maintenance to coincide and match the updated events. In late 1980's macroeconomists such asStanley Fischer, George Akerlof , Janet Yellen, John Taylor and others found the New Keynesian School.

New Keynesianism refers to a branch of Keynesian economics which places greater stress on microeconomic foundations to explain macro-economic disequilibrium. New Keynesian economists assumes that markets have imperfect competition and prices and wages are sticky that's they do not adjust quickly on the short term, and thus based on imperfect competition assumption so the new Keynesian assumes a variety market failures.

The imperfect competition, wage and price stickiness, and the other market failures present in New Keynesian models, imply that the economy may fail to attain full employment. Therefore, New Keynesians still argue that macroeconomic stabilization by the government using fiscal policy or by the central bank using monetary policy can lead to a more efficient macroeconomic outcome than a laissez faire policy would.

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