DISCUSSION

Keynes’ Theory on America’s Great Depression: An Essay
Eighty Years since the “First New Deal” (1933-1934)

Agree with New Title

Nguyễn Quốc Viết*,1, Nguyễn Minh Thào2

1VNU, University of Economics and Business,
144 Xuân Thủy Str., Cầu Giấy Dist., Hanoi, Vietnam
2Central Institute of Economic Management - MPI Vietnam,
68 Phan Đình Phùng Str., Ba Đình Dist., Hanoi, Vietnam

Received 11 December 2014
Revised 15 December 2014; Accepted 25 December 2014

Abstract: The New Deal was a packet of economic policies and measures introduced by the American government to deal with the Great Depression during the years 1929-1933. The First New Deal was introduced in the first term of the thirty-second US president, Franklin Roosevelt (1882-1945). After 80 years, we can ask questions about the impacts of The New Deal, especially on the increasing influence of state interference and regulation of the economy. To analyze the basis of The New Deal, we need to understand Keynes’ theory on America’s Great Depression. Keynes is known as the “father of modern economics” because he was the first to accurately describe some of the causes and cures for recessions and depressions. Do Keynes ideals help us to understand the current economic recession of the world economy that has some things in common with the Great Depression, and to understand the current economic policies and measures of governments around the modern world? Those questions are the main goal of our paper on 80 years since the “First New Deal” (1933-1934).

Keywords: Great depression, Keynes’ theory, economic history.

1. Introduction

As with the current world depression, the Great Depression was a worldwide business slump in the 1930’s that affected almost all nations at that time. Why was the Depression so Great? In any study of the historical causes of the depth, breadth, and length of the Great Depression of the 1930s, one must discover the origins of its four main phases: (i) the Great Collapse, from 1929 to 1933; (ii) the Great Stagnation, from 1933 to 1937; (iii) the abortive recovery and recession toward the end of the 1930s; and (iv) the actual recovery at the start of World War II. The issue at stake in this paper concerns the first of these - the Collapse 1929-1933.

As Bernanke (1995, p.1) stated, “to understand the Great Depression is the Holy Grail of Macroeconomics” (cited Wheeler
1998) [1]. In this paper, we try to examine John Maynard Keynes’ explanation of the Depression. Some suppose that to understand the Great Depression, it is important to know the theories of Keynes (rhymes with “rains”)\(^1\). John Maynard Keynes (1883-1946) is one of the most important figures in the entire history of economics. He revolutionized economics with his classic book, *The General Theory of Employment, Interest and Money* (1936) [2] - hereafter known as *The General Theory*. This is generally regarded as probably the most influential social science treatise of the 20th Century, in that it quickly and permanently changed the way the world looked at the economy and the role of government in society. No other single book, before or since, has had quite such an impact. Heavily anticipated, cheaply priced and propitiously timed for a world caught in the grips of the Great Depression, the General Theory made a splash in both academic and political circles.

With the aim of initiating a comparative research on the theoretical aspect of the economic crisis and recession, this paper is organized into three parts. The first part provides an overview of the Great Depression 1929-1933 in the United States and some alternative explanations of the Depression. Part II sketches Keynes’ theory - the General Theory, and Keynes’ arguments about the Depression. The final part summarizes the conclusions of the paper and discusses the successes and critiques of Keynes’ theory.

2. Overview of the Great Depression 1929-1933 in the United States

The Great Depression 1929-1933 was the worst economic slump ever in U.S. history, and one which spread to virtually the entire industrialized world. The ensuing period ranked as the longest and worst period of high unemployment and low business activity in modern times. Workers who kept their jobs, even with reduced hours, and financiers whose money was invested in bonds prospered during the Depression. Their nominal incomes in dollars dropped, but prices dropped even more: the baskets of goods they could buy increased. Farmers and workers who lost their jobs and entrepreneurs who had bet their money on continued prosperity were the big losers of the Depression. Production was a third less than normal and the distribution of income had shifted toward those who kept steady employment or who had invested their financial wealth conservatively. As a result, at the nadir the standard of living of losers taken all together was perhaps half of what it had been in 1929 (Delong, 1997) [3]. The impact of the Depression in the U.S. can be realized through Table 1 and 2.

Additionally, the Depression became a worldwide business slump in the 1930’s that affected almost all nations. When the Great Depression hit worldwide, it fell on economists to explain it and devise a cure. Most economists were convinced that something as large and intractable as the Great Depression must have complicated causes. However, there is no fully satisfactory explanation as to why the Depression happened when it did.

\(^1\) See further in http://www.huppi.com/kangaroo/events
Table 1: The Depression’s impact on the economy

<table>
<thead>
<tr>
<th></th>
<th>1929</th>
<th>1933</th>
</tr>
</thead>
<tbody>
<tr>
<td>Banks in operation</td>
<td>25,568</td>
<td>14,771</td>
</tr>
<tr>
<td>Prime interest rate</td>
<td>5.03%</td>
<td>0.63%</td>
</tr>
<tr>
<td>Volume of stocks sold (NYSE)</td>
<td>1.1 B</td>
<td>0.65 B</td>
</tr>
<tr>
<td>Privately earned income</td>
<td>$45.5B</td>
<td>$23.9B</td>
</tr>
<tr>
<td>Personal and corporate savings</td>
<td>$15.3B</td>
<td>$2.3B</td>
</tr>
</tbody>
</table>


Table 2: The Depression’s impact on people: Consumer spending on selected items, 1929-1933

<table>
<thead>
<tr>
<th></th>
<th>1929</th>
<th>1933</th>
</tr>
</thead>
<tbody>
<tr>
<td>Food</td>
<td>$19.5</td>
<td>$11.5</td>
</tr>
<tr>
<td>Housing</td>
<td>$11.5</td>
<td>$7.5</td>
</tr>
<tr>
<td>Clothing</td>
<td>$11.2</td>
<td>$5.4</td>
</tr>
<tr>
<td>Automobiles</td>
<td>$2.6</td>
<td>$0.8</td>
</tr>
<tr>
<td>Medical care</td>
<td>$2.9</td>
<td>$1.9</td>
</tr>
<tr>
<td>Philanthropy</td>
<td>$1.2</td>
<td>$0.8</td>
</tr>
<tr>
<td>Value of shares on the NYSE</td>
<td>$89.0</td>
<td>$19.0</td>
</tr>
</tbody>
</table>

*Source: Historical Statistics of the United States, p. 319[^3]*

![Figure 1: The United States business cycle, 1890-1940.](http://iws.ccccd.edu/kwilkinson/Online1302home/20th%20Century/DepressionNewDeal.html)

[^1]: See http://iws.ccccd.edu/kwilkinson/Online1302home/20th%20Century/DepressionNewDeal.html
Theories of business cycles are provided by numerous economists to explain the causes of the mysterious 1929 Depression. Figure 1 shows the business cycles of the U.S. in the Depression.

The Austrian school explains that all business cycles are due to government intervention in the market. “Malinvestment” is a term coined by the Austrian school of economics to sum up their explanation of the causes of business cycles. In particular, government efforts to manipulate the interest rate causes a boom and bust cycle because people over-invest (“malinvestment”) when interest rates are low, and when interest rates are raised to stave off the inevitable inflation, a bust is caused due to the mismatching of consumer and business goods. Austrian economists believe that if the government, through the Fed, had not manipulated the money supply and striven as it did during the Roosevelt administration, with far from total success, to keep the price level from falling, that the economy would have self corrected and, as a result, not have declined so much or stayed in depression so long.

Another cause of the Depression can be interpreted by the Marxian approach of over-accumulation. Devine (1994) invokes Marx (1849) argument that unlike the passive competition of vendors under simple commodity production, competition among capitalists is dynamic and aggressive. Each capitalist must worry about falling behind actual and potential rivals and so must actively expand - invade old markets, create new ones, introduce new technologies and management strategies, and so forth. Each must accumulate to survive as a capitalist, rather than fall into the overworked petty-bourgeois fringe or even lower.

Alternatively, or in tandem, each capitalist tries to dump such costs onto other capitalists, intensifying capitalist competition. Competitive accumulation also drives the business-cycle expansion, which is allowed and encouraged by the competition among banks in supplying credit. Such expansion complements - and thus amplifies - the results of multiplier-accelerator interaction and other reasonable mainstream explanations of instability. This regularly leads to aggregate over-investment and crisis ending a boom (Devine, 1994) [4].

Overproduction is one of the favourite explanations of depressions. It is based on the common-sense observation that the crisis is marked by unsold stocks of goods, excess capacity of plant, and unemployment of labour. The fact that the world commodity depression involved the U.S. has an important implication for Kindleberger’s view (1986) [5]. He sees the unwillingness of the U.S. to accept “distress goods” (goods in extreme excess supply) as a key element of the failure of U.S. leadership in the 1930s. Kindleberger argued, the 1929 Depression was so wide, so deep and so long because the international economic system was rendered unstable by British inability and U.S. unwillingness (1986, p. 292) [5]. He minimized the role of U.S. internal events in causing The Collapse. In view of Kindleberger, the shock to the system was partly from the overproduction of certain primary products, from the 1927 reduction of interest rates in the U.S. He also believed that the depression of the 1930s in the U.S. saw capital reversed. The U.S. cut down on imports and lending at the same time. The cut in lending actually preceded the stock-market crash and the subsequent depression as investors were diverted from the boom in foreign bonds to a boom in domestic stocks.

---

3 See http://iws.ccccd.edu/kwilkinson/Online1302home/20thCentury/DepressionNewDeal.html
4 See further at http://www.amatecon.com/greatdepression.html
The “underconsumption” theory is also popular in interpreting depressions, but it occupied the “underworld” of economics until rescued, in a sense, by Lord Keynes (Rothbard, 2000, p. 101) [6]. It alleges that something happens during the boom - in some versions too much investment and too much production, in others too high a proportion of income going to upper income groups - which causes consumer demand to be insufficient to buy up the goods produced. Hence, the crisis and depression occur. Classical underconsumptionism posited that depression is normal for a capitalist economy, arising from a persistent tendency toward low consumer spending (Bleaney, 1976, p. 11 cited Devine 1999) [4].

The reason for the stock market crash of 1929 has also received a great deal of attention. Kindleberger (1986) [5], Delong (1997) [3] and Eichengreen at al. (2003) [7] point out that the great depression was a credit boom gone wrong.

For a recession, the classical theory claims that the economy automatically self-recovers. The classical economists argue that a free market advocate's response would be to do nothing and let the market work itself out. The recession is a necessary process of internal self-adjustment in response to external disruption. The government should do nothing except balance the budget. There is nothing to be done about it and “Supply will call forth its own Demand” - Say’s Law (Martinez, 2003) [8]. Ideally, what would happen is that businesses would realize that no one was buying and lower prices accordingly until people started buying again. The same thing would happen with labour and capital. Prices would be lowered until they reached the market clearing price and the economy would recover. Therefore, the economy automatically self-recovers and tends to a position of full employment. This approach is criticized vigorously by John Maynard Keynes (1936) [2]. In the following part, I focus on the Keynes’ explanation of the Depression in the United States.

3. The Keynes’ theory and explanation of the Great Depression

3.1. A review of Keynes’ theory

To understand the Great Depression, it is important to know the theory of Keynes - the General Theory. The General Theory is a highly technical, even abstruse exposition of new ideas that had been partly foreshadowed in A Treatise on Money (1930) [9] written by Keynes. With the General theory, Keynes comprehensively challenged the Classical orthodoxy. He sought to develop a theory that could explain the determination of aggregate output - and as a consequence, employment. He posited that the determining factor to be aggregate demand. Among the revolutionary concepts initiated by Keynes was the concept of a demand-determined equilibrium wherein unemployment is possible, the ineffectiveness of price flexibility to cure unemployment, a unique theory of money based on “liquidity preference”, the introduction of radical uncertainty and expectations, the marginal efficiency of investment schedule breaking Say’s Law (and thus reversing the savings-investment causation), and the possibility of using government fiscal and monetary policy to stabilize the economy.

(1) In a recession there is an excess of goods supplied to the market: if \( q_S > q_D \), then price (P) will fall. Consumers respond to the lower price and buy-up excess goods at a lower price.

(2) In a recession there is an oversupply of unemployed labour: if \( N_S > N_D \), then wage (w) falls. Employers respond by re-hiring unemployed labours at lower wage.

(3) In a recession there is oversupply of unemployed capital (K): if \( K_S > K_D \), then interest rate (r) falls. Investors/borrowers respond and re-invest/borrow at lower rate.
help eliminate recessions and control economic booms. He almost single-handedly constructed the fundamental relationships and ideas behind what became known as “macroeconomics”. In this paper, I try to highlight five main points in his theory, which criticized Say’s Law of classical economics.

First, Keynes [2] demonstrated that classical theory is based upon models and mathematics borrowed from physics and engineering and re-interpreted for economics, but not on empirical observation of actual economies. Thus, classical theory concludes that economic processes are necessarily automatic and complete when they are not. He said, “The classical theorists resemble Euclidean geometers in a non-Euclidean world, who, discovering that in experience straight lines apparently parallel often meet, rebuke the lines for not keeping straight - as the only remedy for the unfortunate collisions which are occurring. Yet, in truth, there is no remedy except to throw over the axiom of parallels and to work out a non-Euclidean geometry” (Keynes 1936, p. 16) cited in Martinez (2003) [8].

Keynes also postulated the classical theory is applicable to a special case only, and not the general case, the situation which it assumes being a limiting point of the possible positions of equilibrium. He argued, “The characteristics of the special case assumed by the classical theory happen not to be those of the economic society in which we actually live, with the result that its teaching is misleading and disastrous if we attempt to apply it to the facts of experience” (Keynes, the first chapter, cited Brothwell 1998) [10]. Second, Keynes demonstrated that prices may not completely adjust. The Keynes’ models rely on what is referred to as “sticky wages”\(^7\) (or “sticky prices”\(^8\) to explain why the cycles occur. Under these models, wages or prices fail to reach their market clearing level. Keynes claimed, consumers, employers, investors, borrowers may not re-act to the change in prices due to poor expectations about the state and future of the economy. He also emphasized, some prices or wages will be “sticky” and may take a long time to reach their market clearing price, causing needless suffering along the way.

Third, Keynes realized that the market is inherently unstable due to the importance and volatility of investor expectations. Investors can rapidly de-stabilize an economy due to rapidly changing speculation and expectations of the future. Furthermore, investors may not re-invest even if interest rates collapse if expectations are poor (Keynes, 1936) [2].

Fourth, since the adjustment process is not guaranteed to succeed, a market economy can get stuck in a depression (or period of high inflation). Self-adjustment may not be fully successful if effective demand\(^9\) is depressed. The market can generate sub-optimal equilibrium - below full employment (full potential) output. Keynes said, “Full, or even approximately full, employment is of rare and short-lived occurrence and an intermediate situation which is neither desperate nor satisfactory is our normal lot” (Keynes 1936, p. 250) [2], and “The outstanding faults of the economic society in which we live are its failure to provide for full employment and its arbitrary and inequitable distribution of wealth and incomes” (Keynes 1936, p. 372) [2].

---

\(^7\)E.g. employees resist lowering their wages; employers prefer to lay a few people off rather than cut everyone’s wages.

\(^8\)E.g. firms resist lowering prices (menu costs).

\(^9\)Effective Demand: people must have the money to buy what they need/desire for their demand intentions to be economically effective.
A final important point in Keynes’ theory is that the government must intervene to stabilize the market in order to save the capitalist system internally generates instability. In particular, the government must use fiscal and monetary policies to keep: (i) employment high; (ii) the economy growing; (iii) inflation under control. Keynes said, “Whilst, therefore, the enlargement of the functions of government, involved in the task of adjusting to one another the propensity to consume and the inducement to invest would seem to a nineteenth-century publicist or to a contemporary American financier to be a terrific encroachment on individualism, I defend it, on the contrary, both as the only practicable means of avoiding the destruction of existing economic forms in their entirety and as the condition of the successful functioning of individual initiative... The authoritarian state systems of to-day seem to solve the problem of unemployment at the expense of efficiency and of freedom. It is certain that the world will not much longer tolerate the unemployment which, apart from brief intervals of excitement, is associated - and, in my opinion, inevitably associated - with present-day capitalistic individualism. But it may be possible by a right analysis of the problem to cure the disease whilst preserving efficiency and freedom” (Keynes, 1936, 380-381) [2].

Keynes believed that government involvement in the economy is necessary to save capitalism from the social upheaval that would result from prolonged Depressions or dramatic fluctuations caused by volatile expectations. The policies are often known as demand management policies or counter-cyclical demand management policies, aptly named since the idea of them is to manage the level of aggregate demand. They are termed thus because the government should do the exact opposite to the trade cycle. When economic activity is depressed the government should spend more, and when the economy booms the government should spend less. These policies are shown on the diagram below (see Figure 2).

Output (Q) is on the horizontal axis; price on the vertical. AD is the aggregate demand. If aggregate demand is low (AD1) then the government should pursue reflationary policies such as cutting taxes or boosting government spending to push aggregate demand higher and boost employment and output. However, if aggregate demand is too high (AD4) and causing demand-pull inflation, then the government should pursue deflationary policies. These may include increasing taxes or cutting government spending to reduce demand.

Keynes’ theory is generally regarded as probably the most influential social science treatise of the 20th Century, in that it quickly and permanently changed the way the world looked at the economy and the role of government in society. In the following I focus on the causes of the Great Depression in the U.S. that were interpreted by Keynes’ theory.

3.2. Keynes’ explanation of the Great Depression

Most economists were convinced that something as large and intractable as the Great Depression must have complicated causes. Keynes, however, came up with an explanation of economic slumps that was surprisingly simple. In a normal economy, Keynes said, there is a circular flow of money. My spending becomes part of your earnings, and your spending becomes part of my earnings. For various reasons, however, this circular flow can falter. People start hoarding money when times become tough; but times become tougher when everyone starts hoarding money. This breakdown results in a recession.
Keynes supposed that depressions are recessions that have fallen into a “liquidity trap”\textsuperscript{10}. A liquidity trap is when people hoard money and refuse to spend no matter how much the government tries to expand the money supply. He claimed that “liquidity preference” (demand for money) may be so persistently high that the rate of interest could not fall low enough to stimulate investment sufficiently to raise the economy out of the depression. This statement assumes that the rate of interest is determined by “liquidity preference”.

The Great Depression is the greatest case of self-inflicted economic catastrophe in the twentieth century. As Keynes wrote at its very start in 1930, the world was “... as capable as before of affording for everyone a high standard of life... But today we have involved ourselves in a colossal muddle, having blundered in the control of a delicate machine, the working of which we do not understand.” Keynes feared that “the slump” that he saw in 1930 “may pass over into a depression, accompanied by a sagging price level, which might last for years with untold damage to the material wealth and to the social stability of every country alike”\textsuperscript{11}.

Keynes believed that the Great Depression's cause was under-investment. Investor pessimism caused investment spending to decline. Because investors spent less, the public's income declined. Because their income declined, they reduced the amount they spent on consumption. Because consumers spent less, business produced less. Because they produced less, they laid off workers or cut their pay. As a result, consumer spending fell to a lower level, and so on and so on. Due to the impact of negative investor expectations and loss of consumer buying power (i.e. loss of income due to high unemployment) the U.S. economy was stuck in an economic depression. The U.S. economy had come to rest at an equilibrium output level far below its full-potential output level.

In the view of Keynes, wages were very rigid downward and that many employers could keep their prices from falling by reducing supply. Labour unions and a minimum wage law which did not exist in the U.S. when the Great Depression began making wages rigid downward. Lack of competition makes prices rigid downward. Keynes claimed, investors are motivated by animal spirits, that is, they are either unreasonably optimistic or pessimistic. Therefore, according to Keynes, the economy could not self-adjust out of the depressed equilibrium. Interest rates were extraordinarily low yet investment was not stimulated. Wages were extraordinarily low yet employment was not recovering. Prices for goods were extremely low, yet consumption was not responding.

It is remarkable that the period of the Great Depression in the U.S. was dominated by Republican presidents: Warren Harding (1920-1923), Calvin Coolidge (1923-1929) and Herbert Hoover (1929-1933). Under their conservative economic philosophy of laissez-

\textsuperscript{10} See further in http://www.huppi.com/kangaroo/events

\textsuperscript{11} See more in Delong (1997) [3].
faire\textsuperscript{12}, markets were allowed to operate without government interference. Taxes and regulation were slashed dramatically, monopolies were allowed to form, and inequality of wealth and income reached record levels. The country was on the conservative's preferred gold standard, and the Federal Reserve was not allowed to significantly change the money supply. As Eichengreen et al. (2003) \textsuperscript{5} stated, the Great Depression in the United States was clearly compounded by the blunders of U.S. policy makers.

The fact that the Great Depression began in 1929, on the Republicans' watch, is a great embarrassment to conservative economists. President Herbert Hoover held office when the Great Depression began. Many try to blame the worsening of the Depression on Hoover, for supposedly betraying the \textit{laissez-faire} ideology. President Herbert Hoover resisted calls for government intervention on behalf of individuals. He reiterated his belief that if left alone the economy would right itself and argued that direct government assistance to individuals would weaken the moral fiber of the American people. Hoover further believed that during hard times the government should adopt austerity measures, that is, cut spending even further.

Contrary to what actually happened, Keynes believed monetary policy could only revive the economy. According to Keynes, interest rates could not be pushed below a certain level because further increases in the money supply after this level was reached would not further reduce interest rates because people would simply hold onto the additional money. The cure for this, Keynes said, was for the central bank - in the U.S., the Federal Reserve System - to inflate the money supply. This would put more money in people's hands, inspire consumer confidence, compel them to start spending again, and the circular flow of money would be re-established. Keynes even whimsically suggested leaving jars of money around where enterprising young boys could find them. He called this "priming the pump" of the economy, a final government effort to re-establish the circular flow of money.

Furthermore, Keynes also argued that a slump was not a long-run phenomenon that we should all get depressed about and leave the markets to sort out. A slump was simply a short-run problem stemming from a lack of demand. If the private sector was not prepared to spend to boost demand, the government should instead. It could do this by running a budget deficit. When times were good again and the private sector was spending again, the government could trim its spending and pay off the debts they accumulated in the slump. The idea, according to Keynes, should be to balance the budget in the medium term, but not in the short run. The following is one of his best known quotes summarizing this focus on short-run policies: \textit{"In the long-run we are all dead"} (Keynes, 1924, \textit{A Tract on Monetary Reform}, Chapter III)\textsuperscript{13}.

The foregoing is Keynes' explanation of the Great Depression in the U.S. In the final part, I summarize the aforementioned issues, and discuss the successes of Keynesian economics and some critiques of Keynes' theory as well.

\section*{4. Conclusions}

The Great Depression was the worst economic slump ever in U.S. history, and one which spread to virtually the entire industrialized world. The Depression was a

\textsuperscript{12} Laissez-faire was, roughly, the traditional policy in American depressions before 1929. The laissez-faire precedent was set in America's first great depression, 1819, when the federal government's only act was to ease terms of payment for its own land debtors. See further in Murray (2000) [6].

\textsuperscript{13} See http://www.bizednet.bris.ac.uk/virtual/economy/library/economists/keynesth.htm or Martinez (2003).
complex and multifaceted event. With the General Theory, Keynes could explain the determination of aggregate output - and as a consequence, employment. Concerning the Great Depression in the U.S., he believed that its cause was underinvestment and suggested that the Federal Reserve System in the U.S. should inflate the money supply.

However, after many years since the General Theory was published, there are numerous criticisms of Keynes’ theory. Brothwell (1998) and Gerrard (1998) demonstrate that Keynes failed to convince the majority of his fellow economists that orthodox economics was at fault and should be thrown over in favour of his General Theory. The main reason was that not even Keynes could escape completely from the old ideas. He failed to realize that the neo-classical theories of output, employment, value and distribution are inseparable and needed to be discarded. Boland (1989) claims, until mainstream neoclassical economics drops its dependence on narrow psychologistic-individualism, Keynes’ assault will not provide a struggle for neoclassical economic theorists.

Moreover, Hodgson (1989) [13] shows the treatment of Keynes’ work as the assertion of imperfections in the market system not only leads to the possible interpretation of the General Theory as a special case, it can easily lead to economic policies opposed to those of Keynes. Instead of government action to compensate for wage rigidities and other imperfections it can lead to the conclusion that what is required is the very removal of those imperfections themselves. Therefore, the General Theory is vulnerable to this inversion of its policy conclusion.

Rothbard (2000) [11] criticizes Keynes’ identifying saving and investment. The task of government in a depression, according to Keynes, is accordingly to stimulate investments and discourage savings, so that total spending increases. Savings and investment are indissolubly linked. It is impossible to encourage one and discourage the other. Aside from bank credit, investments can come from no other source than savings. Not only consumers save directly, but also consumers in their capacity as independent businessmen or as owners of corporations. But can’t savings be “hoarded”? This, however, is an artificial and misleading way of putting the matter (Rothbard 2000, p. 84). Rothbard [11] also condemns Keynes’ explanation of the “liquidity trap”. Keynes maintained that if the “speculative” demand for cash rises in a depression, this will raise the rate of interest. Whereas Rothbard states that the rate of interest depends solely on time preference, and not at all on “liquidity preference”.

Although Keynes’ theory has been criticized, it is undeniable that Keynes’ theory is a revolution in economic thinking never took place. It should be noted that Keynes’ advice on ending the Great Depression was rejected. President Roosevelt tried countless other approaches, all of which failed. Almost all economists agree that World War II cured the Great Depression. That was because the U.S. finally began massive public spending on defense. This is a large part of the reason why wars are good for the economy. Although no one knows the full secret to economic growth, wars are an economic boon, in part, because governments always resort to Keynesian spending during them. Of course, such spending need not be directed only towards war - social programs are much more preferable.

In seven short years, under massive Keynesian spending, the U.S. went from the greatest depression it has ever known to the greatest economic boom it has ever known. The success of Keynesian economics was so resounding that almost all capitalist governments around the world adopted its policies. It is obvious that its policies have dramatically reduced the severity of recessions since then, and appear to have completely
eliminated depression from the world’s economies. And the result seems to be nothing less than the extinction of the economic depression. Before World War II, eight U.S. recessions worsened into depressions (as happened in 1807, 1837, 1873, 1882, 1893, 1920, 1933, and 1937). Since World War II, under Keynesian policies, there have been nine recessions (1945-46, 1949, 1954, 1956, 1960-61, 1970, 1973-75, 1980-83, 1990-92), and not one has turned into a depression. The success of Keynesian economics was such that even Richard Nixon once declared, “We are all Keynesians now”.

References


