

ECONOMICS USA
PBS PROGRAM #5

JOHN MAYNARD KEYNES:
WHAT DID WE LEARN FROM THE GREAT DEPRESSION?

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5. JOHN MAYNARD KEYNES AND THE KEYNESIAN REVOLUTION

PURPOSE:

To discuss how the ideas of J.M. Keynes, specifically the Keynesian multiplier, contributed to a better understanding of why the Great Depression was so severe.

LEARNINGS:

1. One of J.M. Keynes' basic contributions to macroeconomics was to show how the multiplier process explains many of the swings in the economy.
2. For example, in a single economy with no government and no trade sector, aggregate demand is equal to consumption plus investment. Income is either spent by consumers or saved. In the economy there is one leakage (saving) and one injection (investment).
3. If investment increases, then aggregate demand increases, which in turn means that equilibrium GNP and national income increase.
 - a) Part of an increase of income is saved and part is spent by consumers. The new consumption spending means higher aggregate demand, more GNP, more income and again more consumption and saving.
 - b) Ultimately GNP and national income will have risen by a multiple of the original rise in investment.
 - c) The size of this multiplier depends on how much consumers spend out of each incremental dollar of disposable income (the marginal propensity to consume). The higher the marginal propensity to consumer, the higher will be the multiplier.
4. Keynes had two main complaints about classical economics
 - a) He felt that money not only had an impact on prices but on employment and output.
 - b) He emphatically felt that supply did not create its own demand.

KEY ECONOMIC CONCEPTS:

circular flow
leakages
injections
saving
investment

marginal propensity to consume
Keynesian cross
aggregate demand
consumption

ECONOMICS U\$A

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JOHN MAYNARD KEYNES:

Final Transcript

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Annenberg CPB Project (Logo and Music)

TEASER

DAVID SCHOUMACHER: (MUSIC IN) 1932...the nation is in the depths of a fearful depression...a quarter of the work force is idle...national income has been cut in half in less than four years...banks and businesses are toppling like dominoes. How long can this depression go on? The Depression can last indefinitely, according to British economist John Maynard Keynes. But is anyone listening? And can government intervention move of out of these terrible times? (MUSIC OUT) Keynes and Roosevelt met only once. Each man thought the other was well meaning but ineffectual. However between them, they changed the course of the world. What Did We Learn from the Great Depression? Well, we'll investigate that question with the help of economic analyst Richard Gill on this edition of Economics U\$A.

(MUSIC PLAYS--OPENING TITLES)

(JOHN MAYNARD KEYNES: WHAT DID WE LEARN FROM THE GREAT DEPRESSION? Appears on screen)

PART I

DAVID SCHOUMACHER: Hard Times. We've seen a lot of them over the years in America. But somehow, 1932 and the years that followed were different. The Hoover Administration tried to popularize the word "depression." They thought that that was a milder word that would somehow soothe the worried American public. But by 1932,

hope was just about gone. (MUSIC IN) The Depression was more than an economic problem. It was a human calamity. Millions went hungry...some to the point of starvation. Proud men and woman begged on street corners, asking for pennies to feed their children...pleading for jobs that no longer existed...The economic devastation seemed total...things couldn't possibly get worse, and yet they did. Over 4,000 banks failed... The value of stocks on the New York Exchange dropped from 89 billion dollars to 15 billion dollars... National income dropped... Investment, savings, consumption, everything plummeted. Fourteen million people, a quarter of the work force were without jobs. And the agricultural economy... a place of refuge in the earlier depressions... suffered through lean times during the 1920's, then collapsed in the 1930's... Nothing seemed to halt the downward spiral. How did the people respond to the national torment? (MUSIC OUT) Eric Sevareid remembers the anguish of his father's generation...

ERIC SEVAREID: "At first, I think, the instinct of that generation was to blame themselves. Somehow, they had not listened to God's word closely enough or they hadn't been very smart about how they handled the land or loans or something....only later did they begin to really sort of blame the government or the system... people have to have scapegoats-they can't feel personally responsible forever, and it was such a vast thing anyway. Something fundamental had broken down...we were plowing under food, killing little pigs, with people going hungry...millions of sick people and doctors going broke... what was going on? What was the sense of this in this rich country?"

DAVID SCHOUMACHER: (MUSIC IN) The politicians of 1932 were prisoners of the economic theories of the day... theories that held that the economy would soon improve. That's the message President Hoover kept delivering to the American people. But in Cambridge, England, John Maynard Keynes was telling his students that the American economy was bound to get worse. As people lost jobs, they stopped spending... As they stopped buying, stores stopped ordering inventory... more factories closed...more jobs were lost...more stores and businesses failed...a vicious downward spiral. (MUSIC OUT)

ROBERT HEILBRONER: “We were increasingly convinced, because the Depression went on and on and on, that the belief of former economists - that the boat automatically righted itself - was wrong, that the metaphor was wrong...that it was not a rocking boat - it was some other damned kind of thing. What Keynes suggested (I’m putting these words in his mouth) was that the metaphor was not a boat. It was more like an elevator, which ordinarily ran up and ran down, but could stall...and that there was something in...that the system had no automatic self-regulatory device. And that appealed to us very much because we didn’t see any automatic self-righting or automatic resumption of the elevator back to floor one - we were in the basement!”

DAVID SCHOUMACHER: (MUSIC IN) It is a bitter irony of history that virtually everything the Hoover Administration tried to do only made things worse. Both the Republicans and the Democrats worshipped at the altar of a balanced budget. By 1932, the budget was so far out of balance that a revenue bill cut government expenditures and imposed a huge tax increase on the reeling economy. The effect was like pouring water on a drowning man. The people laughed bitterly and called their shanty towns “Hooverilles.” Finally the President was driven to a dramatic about-face. He authorized the creation of the Reconstruction Finance Corporation, to pump \$2 billion in investment money into the economy. The RFC was a milestone...a major involvement by the government in the economy. Large industries and financial institutions could turn to the RFC for investment capital. It was a bold step and it didn’t work. Why not? (MUSIC OUT)

ROBERT R. NATHAN: “Well, it was unsuccessful because...I’d sort of say, if you were involved in an avalanche and it had a tremendous momentum and you put up some kind of a barrier that just was impossibly moderate, or modest compared with that onward force, it couldn’t stop it very well...and the Depression had become so deep, and the slide so precipitous and the ongoing force of the decline in business so great that just pouring money into the business community to start new projects wasn’t working. And very simply, the problem was that the demand for goods and services was not there.”

DAVID SCHOUMACHER: But by 1932, millions of Americans were broke, hungry and homeless...Millions more watched their life savings disappear as banks toppled like dominoes...In 1929, Americans had saved almost \$4 billion dollars...In 1932, savings dried up. No savings meant no money for investment, and as the Reconstruction Finance Corporation showed, what businessman could afford to invest money to produce a commodity that no one could afford to buy. It took John Maynard Keynes to point out the obvious devastating truth: the system was not going to automatically correct itself...this Depression could last a long, long time. Richard Gill, what was going on here? What did Keynes see that the rest of the economic world was missing?

(MUSIC PLAYS – COMMENT AND ANALYSIS I)

(ECONOMICS USA LOGO – appears on screen)

RICHARD GILL: You can understand a good deal of what was happening in the first years of the Depression if you break down out total production--Our GNP---into its three main components: Consumer Goods, Investment Goods, and Government Expenditures. In total, government expenditures didn't change much over this period. But look at the private side of the economy! Gross investment fell drastically, by nearly 90%! And notice that consumption also fell during these years, by about 1/5. And here is where Keynes comes into the picture. According to most previous economic thinking, when one component of GNP fell, another would rise to take its place. If people consumed less, they would lend their savings to businesses who would invest more. If consumption goes down, investment goes up; or if investment goes down, consumption goes up. But there would be enough total demand to sustain full employment. What Keynes pointed out at this time was that both these components might be going down--not just a little and temporarily, but massively and persistently. And this was really a huge idea: namely, that total private demand--demand for both consumption goods and investment goods--might be insufficient to sustain full employment. This total demand might indeed be so weak that we might have what we did, in fact, have: The Great Depression of the 1930's!

PART II

DAVID SCHOUMACHER: Talk of the revolution filled the air in the 1930s. Not surprisingly, the debate raged hottest on college campuses. But what was surprising was that the idea that finally prevailed...the idea that changed the nature of capitalism forever...came not from the left but from the right...not from those who would vanquish capitalism, the followers of Karl Marx, but from a man who would vindicate capitalism. That man was John Maynard Keynes and in the 1930s his ideas spread from Cambridge, England here to Cambridge, Massachusetts...to an entire generation of young economists waiting to spread the message across the United States. (MUSIC IN) But Franklin Roosevelt was not a young economist. He was the leader of a nation beset with problems in 1933, Keynes was but one among a babble of voices.....is it any wonder that an open letter to the President would go unheeded? But John Maynard Keynes had some new ideas about the economy, and he was rushing with untidy haste to get these ideas before the public. (MUSIC OUT) Dr. Lorie Tarshis was a student at Cambridge in 1933...he remembers the desperate rush to publish. Why didn't Keynes take his time?

DR. LORIE TARSHIS: "Well, I think the reason why he didn't was the sense of urgency that was communicated to him by developments within Britain but also in Europe, in Germany, for example, where Hitler had come to power...in the United States where revolution was in the air, although you never knew whether it was going to come from the right or left...and in other parts of Europe...and Britain too, most certainly, where the intellectual class was moving to the left faster than the eye could follow them. He felt that he had an answer that was superior to Marx as to analyzing capitalism's discomforts, and an answer that was not only superior to Marx, but was much more congenial to him, for how to handle it."

DAVID SCHOUMACHER: (MUSIC IN) John Maynard Keynes is one of the truly memorable figures of the 20th century. He married a ballerina, managed a theatrical company, ran an insurance business, and wrote a learned treatise on mathematical probability. But first and foremost he was a teacher. (MUSIC OUT)

DR. LORIE TARSHIS: "...and the imagination he showed made...his ability to associate - something he found interesting with something that had been said, that by

itself was uninteresting, it just stood out in your, just impressed you...you were in a state of semi-shock listening to him, all the time, I think. I was also impressed by the support and the warmth he gave students.”

DAVID SCHOUMACHER: (MUSIC IN) For all his brilliance in the fields of economics and mathematics, Keynes was at heart a realist...and one deeply concerned about the effects of economic theory on everyday life. This ability to see the world as it was led Keynes to argue that the Depression could last far longer than anyone imagined. When The General Theory of Employment, Interest & Money was published in 1936, it was a devastating blow to traditional economics. Not everyone was ready for the revolutionary theory of aggregate demand or the call for government intervention. (MUSIC OUT)

PAUL SAMUELSON: “I read it. And I rebelled. It didn’t fit in...I was not going to accept something just because it was new. So, like a seminarian fighting against theology, I rebelled and I rebelled and it was a long period of conversion that lasted about a year and a half.”

DR. LORIE TARSHIS: “It was a painful effort for them. Keynes said it would be. He said it would be terribly hard for people brought up on the old ideas to get rid of them. The new ideas, he said were easier - this was in the preface to The General Theory...- but the real job was to get rid of the old ideas.”

PAUL SAMUELSON: “To be a Keynesian in 1937 - 1938 was to be not able to get a job in an American university. One of my professors was talking at lunch, and we were talking about certain effects, and he said, ‘Gee that sounds very sensible. Whose ideas are those?’ And my friend, who became a vice president of a large bank said, ‘Well, what do you mean, that’s John Maynard Keynes - that’s The General Theory...?’ And the old professor said, ‘Well, now that’s strange. Why is that our department is so much against it then if it’s so sensible?’ Well, funeral by funeral science make progress!”

DAVID SCHOUMACHER: From Cambridge to Cambridge...the revolution marched and eventually conquered. Although Keynesian economics swept American universities long before it became the basis of public policy in Washington. President Roosevelt had

a depression to fight after all and he had little time for theory. Still today, we can look back and see that the science of economics and the public policy it generates are fundamentally different because of John Maynard Keynes. Professor Gill, what was so revolutionary, after all, about Keynesian economics?

(MUSIC PLAYS – COMMENT & ANALYSIS II)

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RICHARD GILL: I think what really excited academic economists at this time was the idea I mentioned earlier: that total demand---demand for consumers' goods plus business demand for investment---might not be sufficient to maintain a high level of employment in the economy. We have already noticed that business investment demand collapsed in the Depression. Nobody was building new plants or adding new machines---why should they when they were already operating with unused capacity? Now what Keynes showed was that this fall in investment demand might bring down consumers' demand as well. What determines consumption demand? Keynes asked. His answer: Basically, the level of income in the economy. If my income is \$10,000 a year, I will spend say \$9,000 on consumers' goods. If my income is \$20,000, I'll spend more than that, say \$17,000. If my income is less, say only \$4,000, I'll want to spend only \$3,900 on consumption. We can now begin to see what happens in the Keynesian world when investment falls. This fall brings down income here. This in turn brings down consumption. In fact, the process does not even stop with this first step. Consumption, according to Keynes, ultimately falls by a MULTIPLIED amount. Suppose for example a business has been spending \$1 million a year on labor to expand its plant capacity. Now suddenly it stops this investment. The income of these laborers is cut by \$1 million. Let's suppose that they would normally have spent 3/4 of the \$1 million on consumption goods, say, food and automobiles. As a result of their layoff, there is now a \$750,000 cut in the consumption demand for food and autos. Does it end there? Of course not. For now automobile producers and farmers have less income. Their spending on shoes, movies, houses, and singing lessons will be reduced. Down, down we go. First the \$1 million. Then three-quarters of that and then three-quarters of that...until finally, as you see, the fallen

incomes has become quite substantial. Let me stress what a shocking idea that was. Once the demand for good starts falling, it does not simply reverse itself. It may fall further. A lot further! For the first time the economics profession had a way of looking at the Great Depression that seemed to make sense. This was what caused such a tidal wave of interest in the universities of the land.

PART III

DAVID SCHOUMACHER: Popular history has it wrong. Franklin Delano Roosevelt did not come to the White House convinced of the need for a Keynesian program of public spending to revive the shattered economy. In fact, he considered deficit spending a desperate and dangerous measure. FDR had spent much of the 1932 campaign declaring his faith in a balanced budget and blasting Hoover as a big spender.

SOUND EFX of applause & excitement under DS.

DAVID SHOUMACHER: Roosevelt combined his criticism of Republican deficits with an appeal to what he called, “the forgotten man.” In November, “the forgotten man” spoke. Millions voted for Roosevelt and hope. But in the four months between the election and the inauguration the Depression grew deeper. In March 1933, Roosevelt took over as the leader of a nation with a quarter of its workforce unemployed. Clearly, something had to be done and quickly.

FDR: “...So first of all, let me assert my firm belief that the only thing we have to fear is fear itself...nameless, unreasoning, unjustified terror which paralyzes...

DAVID SCHOUMACHER: Rosina Tucker remembers the hope returning...

ROSINA TUCKER: “I do remember his saying, ‘.....there’s nothing to fear but fear itself.’ He had his fireside talks, and the people listened to them all over the United States. They made it a point to have nothing to do during those fireside talks. They saw, it seemed to me, it as a sacred time, as if a father was talking to his children who were afraid.”

ROBERT R. NATHAN: "...But it was in that period of despair and distress that Roosevelt did one great thing and he decided to experiment. 'Let's try. If this doesn't work, we'll try something else, we'll try another manner...'"

FDR: "...This nation is asking for action and action now..."

DAVID SCHOUMACHER: (MUSIC IN) March 1933 was the bottom of the Depression. Slowly the economy began to inch upwards. Keynes visited Washington in 1934 to meet with Roosevelt. The meeting was not a success. (MUSIC OUT)

DR. LORIE TARSHIS: "FDR had such a lack of interest in economics. I mean, his interest was not simply zero. If it could be negative, it was negative. He was concerned with how things worked. But not analytically. He wanted to have confidence that somebody who was willing to be patient could advise him, 'Do this. Do that.' Keynes talked to FDR as though he were talking to a student, and FDR wasn't going to follow the way a student would follow."

PAUL SAMUELSON: "Well, Franklin Roosevelt did not know a lot about economics, but he knew which whiskey wasn't working and he was ready to shop around in a way that Herbert Hoover, of course, by temperament, could not have done...and try one method after another."

DAVID SCHOUMACHER: (MUSIC IN) If the President had little time for Keynes mathematics, he showed a keen interest in another set of numbers...the ones that told how many Americans were still without jobs. In the first four years, the Roosevelt Administration launched the NRA, the CCC, the WPA...a virtual alphabet soup of programs to relieve unemployment. Newly employed workers spent more money, creating more jobs. By 1936, it appeared to Roosevelt that the Depression was ending and that it was time to get back to a balanced budget.

FDR: "...Federal revenues are increasing...emergency expenditures are decreasing...a balanced budget is on the way. Does that sound like bankruptcy to you?"

DAVID SCHOUMACHER: Roosevelt won a landslide reelection victory, but the celebration was brief. He cut spending! Then, in October 1937, the Stock Market took another dive...Unemployment began to rise once again...Suddenly it appeared that all the progress of the past four years was about to unravel. (MUSIC OUT)

DAVID SCHOUMACHER: President Roosevelt may have been an economic conservative, but he was a social liberal. He saw rising unemployment and responded by resuming government spending with a \$3 & 3/4 billion measure. This government intervention stimulated the economy in a way that Keynes had been urging since 1933. And if Franklin Roosevelt was not himself a Keynesian, by 1938, he had surrounded himself with plenty of economists who were. One of those young economists was Walter Salant - a student of Keynes turned New Dealer.

WALTER S. SALANT: "There were a lot of people, as a matter of fact, who were in favor of spending, and in quite a few countries. But they never had any answer to the objections of classical theorists, because...Well, essentially, as somebody has said, facts don't kill a theory. It takes a theory to kill a theory, or it takes another theory to kill a pre-existing theory...and that was the contribution that the Keynes book made, in my opinion. It gave the pro-spenders a refutation of the objections of classical theorists."

DAVID SCHOUMACHER: But deep in his heart, Roosevelt simply did not trust theories or the economists who invented them. The idea of countering a Depression by lowering taxes and increasing government spending, and doing it year in and year out, was simply too fanciful. It defied common sense, and common sense ruled Roosevelt.

(SOUND EFX FROM FOOTAGE)

DAVID SCHOUMACHER: And so the government spent a little...and the economy improved a little... and the country limped into the 1940's, watching from the sidelines...As the world began to tear itself apart. The German Army overran Europe. The German Airforce seemed ready to pulverize Britain. The Allies turned in desperation to the Americans for weapons to continue the war. Keynes feared that the

fragile economy might not stand the strain of the increase demand. (MUSIC OUT) But in Washington, his young disciples disagreed...

WALTER SALANT: “We were more expansionary than he. He thought it was time to put the damper on aggregate demand. We disagreed, partly because our view was that the capacity of the economy to produce was greater than he thought.”

DAVID SCHOUMACHER: The Great Depression finally ended with the vast production of the wartime economy. Government spending, which had frightened Roosevelt when it topped \$15 billion in 1936, soared above one hundred billion in the middle of the war. The massive government intervention in the economy finally brought full production and full employment. Richard Gill, why couldn't the private sector have brought us out of the Depression?

(MUSIC PLAYS – COMMENT & ANALYSIS III)

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RICHARD GILL: What Keynes was saying was that private demand in total might not be sufficient to sustain full employment national income. Suppose this is the level of national income when everyone is fully employed. But suppose investment demand plus consumers' demand only equals this level. There simply isn't enough demand to sustain that high a level of income. Now what Keynes said, in essence, was that full employment could be achieved if we added PUBLIC demand---government spending on goods and services---to make up this difference. Suppose we filled the gap with a big G---standing for government. Then, according to Keynes, everything would be all right. If that was so, why then didn't the New Deal and other spending programs of Roosevelt get us out of the Depression? The reason according to Keynes was quite simply that they were on too small a scale. Roosevelt may have seemed like the big spender of all times to his Republican opponents...But as Keynes saw it, he didn't do enough. This little bit of G here obviously doesn't fill the gap. And then, of course, along came World War II, with a really huge G filling the gap---in fact, overfilling it. We had to go on double and triple shifts, work overtime to meet the new demand for tanks, ships and planes. And this

convinced, not all, but the majority of economists that Keynes was right on the money. The problem of great depressions, and even the business cycle itself, seemed to have been solved for all time.

DAVID SCHOUMACHER: You can argue over the causes of the Great Depression and the relevance of Keynesian theory to modern economics, but there is not much debate over the fact that our economy today is fundamentally different from the system that crashed in 1929. Back then, the federal budget totaled less than 3% of the national income. By the 1980s, that figured had jumped to 25%. Of course, in recent decades there have been other recessions, but nothing like those terrible years in the 1930's. The man whose theories helped us understand the Great Depression was John Maynard Keynes. How those theories becomes public policy will be the subject of future editions of Economics U\$A. I'm David Schoumacher.

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