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Chapter 10
Keynes and the Multiplier

Economists, supposedly, are able to make accurate forecasts, and give valuable advice on dealing with economic problems. When Presidents have problems with the economy, they are supposed to consult their economic advisors. That's' what Herbert Hoover did in 1929, and they told him to balance the budget and not increase government spending.

The worst thing the government could do, Hoover's advisors, economic and otherwise, told him would be to increase the national debt. That would drive up interest rates and wages — which would make it more difficult for private industry to borrow money and expand. Furthermore, increasing the debt would raise doubts that it could be paid off causing a lack of confidence in the Federal government. Finally, raising the debt would be unfair to the children and grandchildren who eventually would have to pay it off.

One economist, an Englishman by the name of John Maynard Keynes, disagreed with those who spoke in favor of a balanced budget. He said the way to get out of the Depression was for the government to spend its way out.

In this chapter you will be asked to decide whether Keynes' unconventional economic advice could bring us out of the Depression.

GNP — C + I + G

Before proceeding in this chapter we need to learn some basic economic terms. Economists measure the change in the country's economic health by comparing the Gross National Product (GNP — now known as Gross Domestic Product — GDP) from one year to another. The Gross National Product is a measure in dollar value of all the goods and services produced in the country during the year. The GNP may be divided into three basic parts, Consumption, Investment and Government spending, as follows:

1. **Consumption** spending (C), which is by far the largest section of the GNP. It consists of the moneys spent by consumers within the following categories:

- **durables** - such as cars, furniture, and washing machines;
- **semi-durables** - such as clothes and light bulbs;
- **non-durable -** such as food, alcohol, and candy; and, services such as private tutors, hair dressers, and baby sitters.

2 **Investment** spending (I) which consists of spending for plants and equipment, including such things as rental cars; private dwellings, and, inventories which are goods on the assembly line in the process of being made, or in warehouses and on store shelves.

3. **Government** spending (G) which includes the money spent by the Federal, state and local governments on such things as education, roads, unemployment relief, and national defense.

The GNP and the Multiplier

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In 1929, our GNP was $104.4 billion; in 1930, it was $91.1 billion; in 1932, it was $58.5 billion, or:

Years	1929	1930	1932
Consumption spend	79	71	49.3
Investment spend	16.2	10.3	.9
Government spending	8.1	9.2	8.1
Gross national Product	104.4	91.2	58.5

A closer look at the chart shows that the largest percentage change between 1929 and 1930 was in I (investment spending). In fact, investments decreased by 35 percent, while consumption declined only by 10 percent. By 1932 investment had decreased to $0.9 billion or by 95%, while consumption only decreased to $49.2 billion or by 38%. Economists had long noted that investment spending declines much more rapidly than consumption spending and concluded that depressions may be caused by declines in investment spending.

Careful studies of past fluctuations in business cycles have indicated that each dollar of reduced investment spending will result in a far greater negative change in GNP. Likewise, every dollar of increased investment spending will result in a much larger change in GNP. Here is how it works:

Suppose Henry Ford decided to spend $1,000,000 in expanding one of his factories in Detroit. The money is paid directly to his workers or to other businessmen who will use it indirectly to pay their labor costs, dividends, etc. Studies have shown that people tend to spend about two thirds of their increased incomes. Therefore those receiving the dollars which Ford has pumped into the economy will spend about $666,666 and save the other $333,333. The increased spending will put cash in the hands of grocers, car salesmen, clothing store salespeople, etc. Two-thirds of this money is spent by those receiving it, and this process will continue as follows in an endless chain:

Stage	Amount
1. Ford's increased investment	$1,000,000
2. Money spent by Ford's workers (2/3rds X $1,000,000)	666,666
3. Money spent by grocers, etc. (2/3rds X $666,666)	443,556
4. Money spent by those who received from above (2/3rds X 443,--	295,403
5. Same as stage 4 (2/3rds X $295,403)	196,741
6. Same as stage 5 (2/3rds X $196,741)	131,030
7. Total of all spending so far.	2,733,396
8. All steps from stage 6 to infinity..	266,604
9.Total stages 1 to infinity	3,000,000

You should now understand the importance of business investment to the nation's economic well being. Each additional dollar invested results in as much as a three fold (3 times) increase in GNP!

Savings and Investments

Most economists before the Great Depression assumed that money saved by some individuals would eventually be borrowed by businessmen and invested. This assumption was so widely accepted that it was called a law -- Say's law -- named, after a French economist, J.B. Say.

Yes, economists admitted, in the short run savings may not go directly into investment. But the economy was basically self-correcting. In a recession the rate of interest will drop low enough to get businessmen to borrow money again. Wages will come down because unemployed workers will take whatever job they can get. As more and more people get jobs the recession ends and recovery begins. This leads to more buying, borrowing and employing. According to conservatives, interest rates, wages, and employment would adjust automatically as long as governments do not interfere.

Subscribing to the economic wisdom of his day, Herbert Hoover waited four years for the business cycle to correct itself. During his wait the GNP got lower and lower, unemployment increased, businesses failed, and banks closed their doors and went out of business. The Depression got worse every year!

Keynes Advocates Deficit Spending

John Maynard Keynes was much less optimistic than Herbert Hoover or Say about the power of the economy to correct itself. Keynes had seen no sign that the U.S. economy was correcting itself in any way. He concluded that, contrary to Say, savings are not automatically reinvested. He noted that the decline in the value of stocks and the loss of money through bank failures completely destroyed the savings of millions.

According to Keynes there was both bad and good news. The bad news was that a nation may skid along at the bottom of a business cycle almost indefinitely. Contrary to Say, there may be no automatic way out of a depression.

The good news was that government spending could have the same beneficial multiplier effect as business spending. The multiplier, Keynes claimed, would work just as effectively if the government borrowed and spent money as when businessmen spent it. According to Keynes, a nation could spend its way back to prosperity using government spending (G) rather than business spending (I).

A Summary

Both Say and Keynes would agree on the importance of savings and investments. However, Say assumed investments and savings would always tend to equalize in the long run. The government's job according to Say, was not to interfere with these self-correcting forces. Keynes disagreed and said that government spending can and should make up for decreases in business spending. Keynes believed the Government could and should spend its way out of a Depression and not worry about balancing the budget. The budget would be balanced as soon as the depression ended. Once the economy recovered, government spending would be replaced by business spending. At that point the Government could collect enough taxes to pay off its debt. In short, Keynes, believed that government spending could end depressions and create self-sustaining growth. (Growth that could continue without the government spending more money.)

Could Government Spending End the Depression Decrease the Deficit?

When Keynes' met with Roosevelt he told the President to increase Government spending between 12 to 15 billion dollars (about 550 billion, 2001 dollars) a year. Roosevelt in fact increased Government spending but only by a few billion dollars. When the President decreased Government spending to balance the budget in 1937, (see chart - next page) the GNP declined sharply. The rate of decline was faster than the rate of decline between 1929-33. Roosevelt pumped more money into the economy in 1938 and the GNP went up. Beginning in 1939 the U.S. government began preparing for World War II. During

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World War II, Government spending increased sharply and by 1944 the GNP was twice as high as the GNP of 1929.

The National Association of Manufacturers, however, stayed with the conventional wisdom that Government increased spending hurts rather than helps the economy. This businessmen's organization published a report in 1941, restating long standing opposition to deficit spending.

> *Deficit spending has actually discouraged a greater amount of new private spending than it replaced. It has had little effect other than cause a staggering debt burden. The theory that by deficit financing we can achieve economic recovery overlooks the fact that government spending by itself cannot begin to provide the plant and equipment needed to put people back to work, that recovery is dependent on the stimulation of private investment, and that investors must be confident that private enterprise will be permitted to employ capital and labor properly (without government interference).* [4]

One might say that history has proved the manufacturer's association wrong. But it is a far more open question whether deficit spending has ever done what Keynes claimed it would do -- create self-sustaining growth. And as the 5 trillion dollar (125 billion 1930's dollars) deficit of the 1990's proves - it is far easier for the Government to go into debt than it is for the Government to reduce it.

GNP. Expenditures, Deficits, and Unemployment						
Year	**Total GNP Billions**	**Total C billions**	**Total I Billions**	**Total G Billions**	**Surplus Surplus or Deficit**	**% Unem-ployed**
1929	104.4	79.0	16.2	8.5	+ 1.2	3.2
1930	91.1	71.0	10.3	9.2	+ .3	8.7
1931	76.3	61.3	5.5	9.2	_ 2.1	15.9
1932	58.5	49.3	.9	8.1	_ 1.5	23.6
1933	56.0	46.4	1.4	8.0	_ 1.3	24.9
1934	65.0	51.9	2.9	9.8	_ 2.9	21.7
1935	72.5	56.3	6.3	10.0	_ 2.6	20.1
1936	82.7	62.6	8.4	11.8	_ 3.5	16.9
1937	90.8	67.3	11.7	11.7	_ .2	14.3
1938	85.2	64.6	6.7	12.8	_ 2.0	19.0
1939	91.1	67.6	9.3	13.3	_ 2.2	17.2
1940	100.6	71.9	13.2	14.1	_ 1.4	14.6
1941	125.8	81.9	18.1	24.8	_ 5.1	9.9
1942	159.1	89.7	9.9	59.7	_ 33.2	4.7
1943	192.5	100.5	5.6	88.6	_ 46.7	1.9
1944	211.4	109.8	7.1	96.5	_ 54.6	1.2

Suggested student exercises:

1. a. Note how much business investment decreased between 1929 to 1932.
   b. Show that the multiplier would explain the effect of reduced investment spending on GNP during that period. c. Based on this analysis, try to explain why Keynes thought Roosevelt should increase G by somewhere between $12 to $15 billion to end the Depression.

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4 Fallacies about the Free Enterprise System (National Association of Manufacturers, 1941), p. 26

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2. Graph changes in G, I, & GNP between 1929 and 1945. Look at your graph and explain what it says about Keynes' economic advice. Does it prove either Keynes or the National Association of Manufacturers correct? Explai

	RELATIONSHIP BETWEN G, I, AND GNP, 1929-45																		
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