

Due: February 18

On pp. 262-267, Heilbroner discusses Keynes' views on the business cycle and the potential for an economy to remain in a state of depression. Keynes' interpretation of the economy was in direct contrast to that of the Classical economists, and at the bottom of page 266, we find the quote: If our savings do not become invested by expanding business firms, our incomes must decline. Discuss this statement keeping in mind that this is how Keynes rationalized long-term unemployment and the situation that existed in the U.S. and other parts of the industrialized world in the 1930's.

Keynes' *A Treatise on Money* (1930) attempts to explain how the economy operates and to examine in particular the problem of unexplained bursts of prosperity followed by lows. Earlier writers accounted for this phenomenon by such theories as mental disorders of the economy or the effect of sunspots. Keynes, however, returned to Malthus' warning—saving can result in depression.

To understand Keynes' thesis, it is necessary to grasp the meaning of prosperity in market economy. The true measure of a nation's prosperity is not gold and silver nor physical assets, but its national income, which is the total of all individual incomes in a country. The chief characteristic of income is its flow from pocket to pocket via daily purchases and sales. Thus, this movement is largely natural and arises from the use and consumption of goods.

On the other hand, one part of income which does not flow in daily transactions is savings, which represent the portion that is removed from the even flow of income. If that portion is hoarded, it serves no useful purpose. Significantly, no harm comes from the act of saving in modern nations because savings are usually put into banks and invested in stocks and bonds, becoming available when business wishes to expand production. In this event, savings flow into the economy. The increased capacity for production of more goods assures jobs and greater prosperity. Depression arises when savings are not invested into capitalistic expansion but are allowed to lie idle.

Keynes' line of reasoning, which he did not invent, but only helped to explain, is known as the see-saw theory of savings and investment. As a see-saw goes up and down, savings goes up when investment goes down. The reverse is also true. In his polished examination of the see-saw theory, Keynes concluded that depression arises from a decline of investment on one side and an increased accumulation of savings on the other. However, depression is only temporary, for an abundant supply of savings reduces interest rates, leading to a higher rate of return to be gained from investment. Thus, prosperity returns.

Unfortunately, the see-saw theory has one shortcoming—its failure to explain a prolonged depression, such as the Great Depression of the 1930s. While interest rates declined during that period, no upswing of investment occurred. Recognizing this shortcoming, Keynes pondered the problem and published a revolutionary solution: *The General Theory of Employment, Interest, and Money* (1936).