British economist John Maynard Keynes is one of the fathers of modern macroeconomic theory and widely considered to be one of the three most important economists of all time, along with Adam Smith and Karl Marx. His ideas shook up the dominant framework of classical economics and continue to influence both economic and fiscal policy for Western governments many decades later.

The crux of Keynes' views was that government interventionist policy was necessary in order to combat excessive boom and bust cycles in a nation's economy. This marked a significant paradigm shift among economists at the time, many of whom argued for minimal governmental interference. Keynesian ideas began to gain favor during the Great Depression when many of his proposals influenced the American and British governments, particularly Roosevelt's New Deal policies. And while it took some time for Keynes' ideas to take hold, they eventually gained ground and became a dominant school of economic thought for the next 40-plus years.

**Key Theories and Principles**

Keynes' seminal work, *General Theory of Employment, Interest, and Money*, published in 1936, articulated what would later become known as the foundation for modern macroeconomics. It challenged the established consensus of the time, which was that an economy will naturally restore itself to full employment after a period of downturn.

One of the key principles Keynes theorized was that savings and investment are determined independently of each other -- savings rates being determined by a society's propensity to consume and investment by an expected rate of return relative to interest rates. He also believed that a nation's income is the aggregate of its consumption and investment. During a downturn, this could potentially create a never-ending spiral as businesses invest less, jobs are lost, consumers spend less, businesses have even less reason to invest, and so on. Therefore, in a period of unemployment and decreased production, these two problems are best resolved by increasing the amount spent on investment and consumption.
According to Keynes, that's where the government comes in. He argued it was the government's responsibility to step in and use the many tools at its disposal to stimulate investment and consumption. This meant that during hard times, governments must engage in deficit spending in order to stimulate activity. This would consequently lead to policies such as the reduction of long-term interest rates, public works projects, infrastructure spending, and the like. The implication that deficits could be a good thing for the economy was quite revolutionary at the time.

Many people note Keynes' influence on Roosevelt's New Deal policies but this is somewhat disputed as to the degree of his actual influence on policies of that time. What is more widely acknowledged as significant is the acceptance of his theories near the end of the Depression and the adoption of Keynesian economics as de facto American policy going forward.

Bretton Woods, World Bank, and IMF
The contributions of John Maynard Keynes did not end there. As World War II began to wind down, he played a significant role in the Bretton Woods negotiations in 1944. Along with others, Keynes advocated for the establishment of a world central bank and an international currency regulation body. Keynes was instrumental in the formation process of the bodies, which would later take form as the World Bank and the International Monetary Fund.

He is also noted for what was considered a more sweeping proposal of a world reserve currency. In his proposal, Keynes suggested using what he named the "Bancor" as a world reserve currency. The Bancor would be fixed to 30 commodities and would encourage the stabilization of commodity prices and achieve trade balance through taxation of current accounts. Although not adopted, the idea has periodically seen renewed discussions up to the present day.

Resurgence
Keynesian economics began to fall out of favor during the 1970s when recession, the oil crisis, and rapid inflation hit the U.S. Prominent economists such as Milton Friedman criticized tenets of Keynesian thought and advocated a move toward Monetarist principles, which were adopted in-kind.

While Keynesian economics never truly fell out of perception among policy makers, it would experience a renaissance of sorts near the onset of the financial crisis in 2008. The passage of stimulus packages and heavy government spending in the U.S., Europe, and China to combat the crisis marked its return to prominence.
Is Keynesian Economics Relevant Today?

Though I am a fiscal conservative, I do believe that we shouldn't try to apply economic austerity measures until a recession is in our rear view mirror. John Maynard Keynes said it far more eloquently than I: "The boom, not the slump, is the right time for austerity." If we consider what happened during the Great Depression, we have a bird's eye view of economic principles and policies at work.

By Theodore F. di Stefano
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How many of us still remember John Maynard Keynes? Keynes, also called "1st Baron Keynes," was a British Economist who lived from 1883 to 1946. He has had a profound influence upon macroeconomics, including the economic policies of various governments.

Keynes believed in applying monetary and fiscal policies to lessen the deleterious effects of both recessions and depressions. Keynes went against the classicists of his time who believed that the free markets provided the answer for economic prosperity, even in times of recession. His approach talked about aggregate demand -- buying power -- that would lift a country out of recession or depression.

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Has Keynesian Economics Worked in the Past?

If we consider what happened during the Great Depression, we have a bird's eye view of economic principles and policies at work. In 1937, our country was making good headway against the depression. Unfortunately, Franklin Delano Roosevelt, the president at the time and economically conservative by nature, somehow became convinced that the way to move the country out of recession even faster would be to drastically cut spending (a truly anti-Keynesian move). It didn't work, and he prolonged the pain of the recession even longer.
In times of economic recession, it's easy for some of us to believe that what we should do is to pull ourselves up by our bootstraps and "find a job." Though elegantly simplistic, it really doesn't and hasn't worked that way.

**Why Austerity in Times of Recession Hasn't Worked**

Let's suppose that our government made very deep cuts to spending. That would mean that government projects would be shut down, employees would be put out of work, and government programs that might have been around for years would be cut back or eliminated. Though this might sound like a good idea, what would this do for employment and consumer demand?

One theory is that cutting spending and immediately balancing the budget would increase business confidence, and therefore businesses would be willing to up their production. Sounds good, but in practice, it really doesn't work that way.

Though cutting spending and balancing the budget might give some companies confidence, what would happen if they upped their production and starting manufacturing more goods simply because they felt confident? One could argue, that their collective work force would temporarily increase, thus giving some push to consumer demand.

One could also argue that there would be such a boost in an already high unemployment rate that the hiring done by some of the businesses wouldn't go anywhere near to replacing the vast displacement of employees resulting from slashing government budgets. If you thought otherwise, then you might be arguing that it is the responsibility of businesses to blindly hire people in the hopes that demand would increase thereby. It just won't happen!

Wikiedia's entry on Keynes reads: "Keynesian economics provided the theoretical underpinning for economic policies undertaken in response to the crisis by Presidents George W. Bush and Barack Obama of the United States, Prime Minister Gordon Brown of the United Kingdom, Prime Minister Kevin Rudd of Australia, and other global leaders."

It goes on to state: "Keynes is widely considered to be one of the founders of modern macroeconomics, and to be the most influential economist of the 20th century. In 1999, *Time* magazine included Keynes in their list of the 100 most important and influential people of the 20th century, commenting that: 'His radical idea that governments should spend money they don't have may have saved capitalism.'"

**When Should Deficit Spending Be Stopped?**

Deficit spending -- simply spending more money than our government takes in -- cannot go on forever. A balanced budget amendment ensuring that some time in the not-to-distant future we stop spending more than what we're taking in might solve the problem in the long run. However, we all know how difficult it is for our two political parties to come to some kind of a conclusion that will help the country more than it hurts either or both of the parties. That said, I don't have much hope in a balanced budget amendment.
What then are we to do? We might pass a law that says once unemployment goes below a certain percentage point, there will be no deficit spending in the following year. This might work, though it's still difficult for me to believe that at this point in our history our political parties could get together on such a task.

Debt Limit Fights - A False Argument

The problem, as I see it, with the debt limit standoff between the two parties is that it is a false argument to begin with. Let me explain. If your family incurred debts that it later thought were too high to maintain, would it call a family meeting and say that no debt over a certain amount would be paid? No, because at that point it would be too late to set a debt limit; the family still has to pay all of its debt incurred unless it wants to consider filing for bankruptcy.

During a governmental fiscal year, Congress passes a budget for a later fiscal year. That's when the arguments should occur, during budget negotiations. It makes no sense for a bipartisan congress to pass a budget, then later argue that it won't pay the government's debt because the budget pushed the debt too high. That argument should occur during budget negotiations and not after the budget has been passed.

Democrats and Republicans both have their economic views. Whatever they are, they should be supported by facts and sound economic theory. In the long run, overspending will seriously hurt this country. In the short run, it may be a temporary way to get us out of this recession. Look to history and the Great Depression to get an idea on what works.

In any event, I remain an optimist for our country and am sure that, somehow, we'll work it out in the long run. Oops! I just contradicted John Maynard Keynes, who said: "The long run is a misleading guide to current affairs. In the long run we are all dead."

Good Luck!

Theodore F. di Stefano is a founder and managing partner at Capital Source Partners, which provides a wide range of investment banking services to the small and medium-sized business. He is also a frequent speaker to business groups on financial and corporate governance matters. He can be contacted at Ted@capitalsourcepartners.com. Follow Theodore F. di Stefano on Twitter.