John Maynard Keynes wrote the economic classic The General Theory of Employment, Interest and Money in the midst of the Great Depression. The book's publication in 1936 was a watershed moment and the theory now defines economic orthodoxy. In fact, the theory is so important, that it is one of the few non-religious texts that has had an effect on all of humanity. Keynes' theory is as relevant today than it has ever been but for us to truly understand why, we must first look at its predecessor: classical economics.

The Great Depression, when Keynes' General Theory was written, had a lot of peculiar characteristics that went against prevailing economic logic. During the Depression the infrastructure of production was all in place. The factories were standing, the roads laid out, a trained work force was there but all of these things were not producing much. Classical economics, which was the orthodox thinking at the time of the Great Depression, was not explaining the Depression and, even worse, was offering no cure.

Classical theory states that an unrestrained economy will by its nature make maximum use of productive resources like money, labor, machinery, and materials because a series of simple and self-adjusting formulas will ensure maximum efficiency. The thinking behind those equations is that supply will create demand; if you build it, they will come. The cost to produce something is income to someone, so the money will be there to buy whatever is produced.

Further still, the part of income which does not go to production, and therefore consumption, will be saved and in classical economics, savings equals investment. Investment then creates the means of production and translates in to personal income. Without the excess income to go in to savings, and thus in to investment, the economic system stands still. So logically whatever investment is needed to keep the economic ball rolling will be reflected in the demand for savings. The price of savings is the interest rate and by looking at prevailing interest rates we can see the demand for savings and thus the demand for investment.

In classical economics the natural state of the labor market is full employment. Unemployment only exists when workers refuse to work for the wages offered and those offered wages are equal to the true value of the labor. The true value of the labor is what someone is willing to pay for the thing that the labor has produced. If the supply of labor is too high, wages will fall, as will the prices of the things that the labor produces until there is enough demand to support the full supply of labor.

Classical economics rests on the central idea that the natural state of an economic system is in equilibrium, or put another way: at maximum efficiency. The desire for profit and the discipline of competition drive this. The profit motive requires that resources will be used to create things that are most in demand and competition ensures the most efficient use of those resources, which translates to the lowest prices. Any deviation of any part of this economic system will be corrected by adjustments in the others. If there is not enough machinery to produce for the existing demand, interest rates will increase to attract money away from savings and in to investment, which will then go to producing the needed machinery. If employment falls so will wages, since the supply of workers is greater than the demand and when wages fall it will be worth it for employers to hire more workers.

Classical economics is all about supply.

Keynes comes around and says that's all fine and well as long as an economy is operating at its maximum potential. But, he objected, this happy circumstance is not the system's natural condition. The economy that Keynes sees is much more complicated and far more dynamic. There is no equilibrium and this idea that demand will always be there needed to be challenged. For Keynes, demand depends on employment, which meant wages, and employment depends on investment.

Investment also carried a broader meaning for Keynes. Investment could mean plant equipment or it could mean working capital, which is the money a business needs to sustain its operations before making a sale. Part of Keynes' dynamic view of the economy was the realization that not all businesses were the same and therefore their needs for capital also differed. For instance, Boeing has a long lag time between when it starts production of an airliner and when it receives the money from that airliners' sale, so it needs working capital in the interim to fund the purchase of the parts needed to build that airliner. Another business, like a retailer, needs money upfront to purchase inventory which could take time to sell. Remember, during the Depression all of the infrastructure for production, meaning the long-term investment, was there but to get the economy going again Keynes saw a serious need for working capital.

One of Keynes's biggest breaks from classical economics was his thinking about investment and also the importance he gives to expectation. In the classical model an investor would survey what the prevailing returns on an investment were and then find an investment that mirrors those returns. Keynes's investor would look at the cost of capital, the cost of a loan for instance, and then measure that against the expected return on an investment. If the expected return is higher than the cost of capital then the new project would be a go. This concept is the fundamental mechanism that modern day finance operates on and is the reason why interest rates, which are generally viewed as the cost of capital, are so important to the functioning of the economy.

For Keynes, interest rates were not determined by the supply of savings and the demand for investment. On the contrary, interest rates were dependent on expectations, just like investment. A person who is pessimistic about the future may save money but instead of putting the money in to a CD they might just keep it in their own pockets. Their expectation of an uncertain future means that having the money available to them is much more important than earning interest. This is what Keynes called the 'liquidity preference'. Interest then is not the price for savings, it is the price for giving up liquidity.

Keynesianism breaks the automatic link between investment and the need for investment, between the interest rate the demand for savings, between the desire to consume and a system's ability to satisfy that demand. In brief, the economy is too important to be left to irrational humans.

Keynesianism is all about demand.

The idea of government intervention in the economy would have drawn stark criticism from classical economists because to them, the government is the least efficient allocator of capital, this function should be left to businesses. To classical economists, the unfettered economy is, in its natural state, running at maximum efficiency. Keynes had a different idea: Government must intervene in the short-term by distributing money from those who can afford to save to those who will spend it immediately. By doing this the economy can sustain itself through sudden and unexpected shocks while it works through those shocks to get back to its normal level of functioning. And this is precisely the model we use today.

Through our central bank, the Federal Reserve, trillions of dollars of liquidity are pumped in to the economy during times of distress, like the pandemic we just had. In the short-term this results in a spike in demand by distributing money to consumers who will then spend it buying things. This props up the economy until it can return to a normal functioning state. This is where we currently are, we are dealing with the after effects of that spike in demand and waiting for the economy to return to some form of normalcy. The message to investors is to be patient.

We live in a Keynesian world and whether we know it or not, we are all Keynesians.

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