Can a government end a depression?

In 1933 one American worker in four had no job. Many economists said: wait, wages will fall. John Maynard Keynes said output follows spending, spending can fall and stay down, and the state can move it back.

1 The question

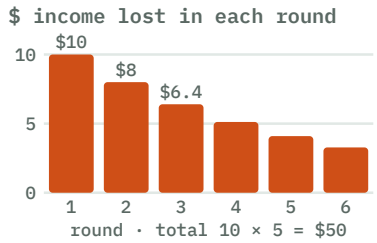
idle for years?

- **Great Depression** = long, deep slump of the 1930s · US **1933** → ≈ **25** workers in 100 without a job · factories standing, workers willing
- Classical answer (Lesson 4: prices clear markets) → idle workers → wages fall → all hired → **wait** · Keynes → what if nobody is buying?

2 The multiplier

spending in rounds

- **Effective demand** = total spending actually planned → decides output and jobs · too low → firms hire too few → no market force pushes it back
- **MPC** (marginal propensity to consume) = share of an extra $ spent · Coralia `0.8`
- Spending –$10 → round 1 `$10` → round 2 `0.8 × 10 = $8` → `$6.40` … · **multiplier** `1 ÷ (1 − MPC)` = 5 → income **–$50** · MPC 0.5 → ×2 → –$20
- Runs both ways · practice: road `$20`, MPC 0.75 → `1 ÷ 0.25 = 4` → income **+$80** (not $35 = 2 rounds)



3 The spiral

paradox of thrift

- Coralia before: income `$500`, spending `$460`, saving `$40` = investment `$40` (every $ spent = someone's income → `S = Y − C = I`: saving = income − spending = investment)
- Everyone saves $10 more → income `$500 → $450` · spending `$460 → $410` · saving still **$40** (= investment, unchanged) → **paradox of thrift**: all save more at once → income falls → total saving may not rise
- Spend less → shops sell less → lay-offs → incomes fall → spend even less ↻
- **Animal spirits** (General Theory, 1936, ch. 12) = mood behind investment, "a spontaneous urge to action rather than inaction" · practice: dim → machines –$10 → pay –$10 → shops –$8 … → `10 × 5 = $50` · rounds shrink: only 0.8 of each lost $ was spending

4 Keynes

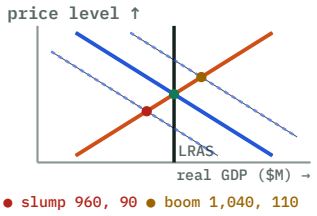
the person

- **John Maynard Keynes** · English · `1883–1946` · Cambridge (Marshall's student) · The Economic Consequences of the Peace, **1919** → Versailles (1919 treaty after World War I): payments demanded from Germany could not be paid
- A Tract on Monetary Reform, **1923**, ch. 3: "But this long run is a misleading guide to current affairs. In the long run we are all dead." (on money and prices) → long-run answers no help in a crisis now · **not** about debt
- The General Theory of Employment, Interest and Money, **1936** → effective demand · **1944** Bretton Woods → led British team → IMF (International Monetary Fund) + World Bank

5 AD/AS

the state moves AD

- (Macro 4) **AD** (aggregate demand) = all spending · **SRAS** = short-run aggregate supply · **LRAS** = potential `$1,000M` (every worker + factory in use) · government spending ⊂ AD
- **Recessionary gap** (GDP below potential) → spend more → AD → · Coralia `$960M, 90 → $1,000M, 100` → GDP ↑ prices ↑ (little, idle factories)
- **Inflationary gap** (GDP above potential) → Keynes's logic in reverse → spend less → AD ← · practice `$1,040M, 110 → $1,000M, 100` → both ↓



6 The evidence

still debated

- US jobless in 100 (Lebergott, via Richmond Fed): `1929 3 · 1933 25 · 1939 17 · 1943 2` · above 10 every year **1931–1940** (NBER) · `25 − 17 = 8` → `17 − 2 = 15`
- What ended it? → **spending**: federal spending `8.0% → 43.6%` of GDP (1933 → 1944, OMB), New Deal (Roosevelt, from 1933) then war · **money**: US money –⅓ 1929–33 (Friedman and Schwartz, 1963), leaving the gold standard (money tied to gold) earlier → earlier recovery (Eichengreen) → Lesson 6 · not exclusive · dates show when, not why
- `FOR` idle workers + factories → state $ puts people to work, multiplier spreads it · `AGAINST` tax or borrow → debt can crowd out (squeeze out) private spending, hard to stop (Policy 9)
- Survived → spending can fall and stay down, the multiplier, watching demand in a slump · argued → size of the multiplier, how far to borrow, inflation (Lesson 6)
- **Timeline of ideas** · 1776 · Smith · prices coordinate strangers → 1798–1817 · Malthus and Ricardo · land is limited, people are not → 1867 · Marx · profit comes from unpaid work (he said) → 1871–1890 · Jevons, Menger, Walras, Marshall · value is the last unit → **1936 · Keynes · spending decides output; when it collapses, the state can spend**

Watch out: multiplier = `1 ÷ (1 − MPC)`, not `1 ÷ MPC` · all saving more ≠ more total saving (S = I) · government spending moves **AD**, not SRAS · "deficits (spending > taxes) never matter" = a later label, not Keynes's words