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Keynesian Economic Thought and Its Modern Significance:A Case Study of the 2008 Global Financial Crisis

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Abstract: Against the backdrop of the 2008 global financial crisis, this paper explores Keynesian economic thought and its relevance today. In the context of classical economics' limitations, Keynes' theories on government intervention and effective demand management introduced new pathways for economic recovery, marking significant historical contributions. The crisis and the widespread use of Keynesian anti-crisis measures globally demonstrated the resurgence of Keynesianism and validated its effectiveness in addressing economic downturns. The paper emphasizes that, despite changes in times, Keynesianism remains invaluable for addressing both general and specific contemporary economic issues. Integrating Keynesian insights into today's economic climate enables sound and prudent government decision-making. Through an in-depth analysis of Keynesian economic thought, this paper not only provides a theoretical perspective for understanding modern economic crises but also offers policymakers a strategic reference for confronting future economic challenges.

Keywords: Keynesianism; Economic Crisis; Effective Demand; Government Intervention; Modern Significance

1. Introduction

Prior to Keynesianism, classical economic theory dominated mainstream thought. Influenced by Adam Smith and David Ricardo, classical economists trusted in the self-regulating nature of markets, believing that the economy would naturally return to a full-employment equilibrium. Following World War I, the British economy entered a prolonged period of economic depression after a brief boom, with rising unemployment. Simultaneously, the Great Depression began with the 1929 U.S. stock market crash, rapidly spreading across the globe and creating the historical context for Keynes' economic revolution. During this period, U.S. domestic investment plummeted by 90%, with 13 million unemployed and an actual unemployment rate of 37% [1].

In the Great Depression, the most severe economic crisis of modern history, classical economic theory posited that the market could spontaneously achieve Pareto optimality, viewing economic downturns as temporary corrections to eliminate surplus capacity. This approach argued that addressing the crisis required allowing the market to undergo a series of liquidations, such as lowering real wages and permitting over-invested firms to go bankrupt. Amid soaring unemployment, plummeting industrial output, and financial market collapse, laissez-faire market regulation was considered the best response. However, under this framework, the economic crisis only intensified, revealing classical economics' shortcomings and limitations in explaining economic crises.

As a result, Keynes' policy of government intervention emerged. He provided a way out for the capitalist world, which had reached an impasse. Keynes introduced a general theory that explained both full employment and less-than-full employment situations, asserting that a country's employment level depends on effective demand and that economic recession stems from insufficient demand. Keynesian economic theory holds a pivotal place in the history of economic thought, overturning the laissez-faire principles of classical economics and advocating a more active government role in economic activities and crisis management. Contrary to traditional economic perspectives that emphasized production, Keynes elevated consumption to paramount importance. In response to the 2008 global financial crisis, Keynesian policy principles were widely adopted, effectively mitigating its impact and proving their enduring significance in modern economic management.

The current economic challenges differ from those of the Great Depression, yet the fundamental conflict between socialized production and private ownership of capital persists, and periodic economic crises remain inevitable. Global economic fluctuations, growing income inequality between capital and labor, and other pressing realities are challenges we cannot overlook. In this context, Keynesian insights into crisis management continue to hold both relevance and necessity.

This paper first provides a brief overview of Keynes' theoretical framework. It then focuses on the 2008 global financial crisis and the application of typical Keynesian theories within this context. Subsequently, the paper analyzes the modern significance of Keynesian economic thought from both general and specific perspectives, especially in crisis prevention and response. Finally, the paper reflects on how modern economic crises validate and challenge Keynesian thought and speculates on Keynesianism's role in future economic developments. The discussion follows a chronological approach—theory introduction, analysis, and contemporary reflections—clarifying the understanding and analysis of Keynesian economic thought and its modern significance.

2. Keynesianism Economic Theory Framework

Keynes' theories centered on economic cycles, monetary theory, and employment theory, profoundly shaping the development of macroeconomics. Among Keynes' economic theories, several stand out in discussions of economic crises. First and foremost is Keynes' theory of insufficient effective demand. As early as 1820, British economist Thomas Malthus proposed that due to insufficient social demand, capitalism held the potential for economic crises. In 1936, Keynes published *The General Theory of Employment, Interest, and Money*, revisiting the idea of insufficient effective demand and establishing a comprehensive theory. This principle forms the foundation of Keynes' employment theory and lies at the core of his economic framework. It challenges the classical economics Say's Law which posits that markets can always self-regulate to achieve full employment equilibrium.

Effective demand refers to the total social demand at the equilibrium of aggregate supply and aggregate demand prices. Keynes argued that demand for goods and services is often insufficient to spur economic growth and create employment; insufficient demand leads to economic recession. Due to this deficiency, capitalist economies typically operate at a sub-optimal level, with goods stagnating and production cutbacks leading to layoffs and unemployment. According to Keynes, declining marginal propensity to consume, decreasing marginal efficiency of capital, and liquidity preference all contribute to potential demand shortfalls, leading to recession and unemployment. Furthermore, Keynes considered aggregate demand as comprising both consumption and investment demand, highlighting that both household consumption and business investment are vital in boosting effective demand—a concept further developed in the analysis of modern economic impacts. Based on the effective demand theory, Keynes also expanded on the multiplier theory, the multiplier effect, and the theory of interest rate determination.

Keynes emphasized the role of government intervention and broke away from the traditional belief in the market's self-healing ability, advocating instead for an active government role in stabilizing the economy. He developed this theory in the 1930s in response to the Great Depression, arguing that in cases of insufficient private sector demand, the government should employ expansionary fiscal policies and monetary policies to stimulate the economy. This concept of "government intervention" became a cornerstone for decision-making in President Roosevelt's administration, leading to a series of government-led economic relief efforts. Examples include the 1933 Federal Emergency Relief Act, which distributed funds to states, and the subsequent shift to work relief the following year, providing jobs for the unemployed through infrastructure projects like airports, schools, and hospitals. By the pre-war period, federal spending on various projects and economic aid had reached $18 billion, and by 1936, the U.S. national output had recovered to pre-Depression levels. The 1946 Employment Act, revised post-war, established the federal government's responsibility to pursue maximum employment and control over monetary and trade policies, once again cementing Keynesian macroeconomics as a crucial government tool. This theoretical framework later served as the foundation for Keynesian economics and policy practices.

3. Keynesianism and the 2008 Global Financial Crisis

The 2008 global financial crisis inflicted substantial losses on Western capitalist countries, especially the United States. Following the crisis, the neoliberal ideology advocating privatization, liberalization, and marketization, resurgent since the 1970s stagflation crisis, faced widespread criticism within capitalist circles. Many attributed the crisis to the laissez-faire policies prevalent at the end of the 20th century, leading to a cooling interest in neoliberalism and signs of a return to Keynesianism [3]. The anti-crisis measures adopted by various countries further underscored this shift.

3.1 U.S. Measures and Keynesian Economics

For the U.S. federal government, a series of government expenditure were passed to tackle the Troubled Asset Relief Program and relieve the shock of capital market after the GFC occurred. To prevent the financial crisis from deepening further, the US Senate and the US House of Representatives passed the government's proposed bailout package of $850 billion on October 3, 2008. The bailout plan jointly launched by the US Treasury and the Federal Reserve aims primarily to stabilize the financial system by issuing treasury bonds to purchase troubled assets from major financial institutions, rescuing the deteriorating balance sheets of financial firms, and strengthening their liquidity and solvency. This round of bailout plans by the United States is essentially an attempt to stop the crisis from spreading further by breaking a key link in the financial collapse, which is the best choice that can be made in the face of a financial crisis. This aligns with the spirit of the New Keynesian debt deflation hypothesis.

3.2 EU Measures and Keynesian Economics

EU's measures were aimed at easing the panic of Eurozone market. The leaders of the 15 Eurozone countries convened in Paris on October 12, 2008, for the first Eurozone summit and launched a joint bailout plan to collectively address the ongoing financial crisis. The key points of this plan are: debt guarantee, where Eurozone member countries will guarantee new debts of up to 5 years for banks by the end of 2009 to help boost investor confidence in recovering their investments and returns, and to reduce the difficulty of bank lending; bank capital restructuring, where Eurozone national governments commit to rescuing large financial institutions in crisis through capital restructuring and other "appropriate means"; government stakes, where the government can directly inject capital into banks and other financial institutions by purchasing preferred shares; accounting rules, where the government will seek to change the mark-to-market accounting rules to prevent banks from being undervalued due to the impact of the financial crisis, thereby exacerbating market panic.

3.3 China's Measures and Keynesian Economics

China's measures were centered around expanding the effective demand of China's domestic market, to further expand domestic demand and promote steady and rapid economic growth. They identified ten measures to further boost domestic demand and economic growth. Preliminary estimates suggest that the investment required for the implementation of these engineering projects will amount to about 4 trillion yuan by the end of 2010. To accelerate the construction progress, they decided to increase central government investment by 100 billion yuan in the fourth quarter, and to advance the arrangement of 20 billion yuan for the post-disaster reconstruction fund next year, mobilizing local and social investments to a total scale of 400 billion yuan.

4. The Modern Relevance of Keynesian Economic Thought

Keynesianism has withstood the test of various economic crises and continues to hold value in the modern economic landscape. It provides a distinct path for governments in answering the pressing question: What actions should we take?

To understand the contemporary significance of Keynesianism, it is essential first to examine the current global economic environment. Following global recovery from the COVID-19 pandemic in 2023 and easing of deglobalization trends, world economies began to stabilize by 2024. However, amidst significant global transformations, economic globalization has continued to deepen, global supply chains are undergoing reconfiguration, and employment remains unstable in many regions, while nations also face rising non-traditional security threats.

The threat of economic crises and recessions persists.

A key takeaway from *The Road to Prosperity* is that economists and finance ministers should not merely focus on balancing national income and expenditure but should also assess the overall level of national income, or what Keynes termed aggregate demand. As established earlier, Keynesianism directs us to boost economic activity and employment by stimulating aggregate demand. The government should regulate both consumption and investment demands through macroeconomic policies to prevent or respond to economic crises.

On the consumption demand side, the government could implement tax reduction policies to increase household disposable income, thereby unlocking greater consumption potential. On the investment demand side, the government could increase infrastructure investments in sectors such as transportation, energy, and information networks, not only creating employment but also driving growth in related industries. Additionally, by offering policies like reduced financing costs and subsidies for research and development, the government could encourage corporate investments, especially in high-tech and strategic emerging industries. These measures also invoke Keynes's multiplier effect, where initial government spending circulates through the economy, creating amplified economic growth. Although the multiplier varies across nations, it inevitably yields substantial returns [4].

5. Conclusion

Modern economic crises have continually validated the relevance of Keynesian economic thought. In the face of financial crises and recessions, Keynesian measures such as government intervention and effective demand management have played critical roles in crisis response and economic revitalization, reinforcing Keynesianism's significance in economic theory and practice and underscoring its effectiveness in promoting economic recovery and social stability.

At the same time, Keynesianism invites thoughtful reflection. Its capitalist economists do not seek to overturn the capitalist economic system at its core but instead propose adjustments to render it more complete, which cannot eliminate the inherent cyclical economic crises of capitalism. Unlike Marxist macroeconomic thought, which possesses a clearly defined labor theory of value and surplus value as its microeconomic foundation, Keynesian analysis of capitalist macroeconomic functioning in *The General Theory of Employment, Interest, and Money* lacks a micro-foundation[2]. Consequently, underpinned by an idealist methodology, Keynesianism relies on three psychological principles of society for its theoretical grounding, ultimately preventing Keynes from delving into the intrinsic nature of capitalism to identify a solution for eliminating economic crises. Thus, it is crucial to approach Keynesianism with a critical eye rather than accepting it uncritically.

Nevertheless, we cannot only think of Keynes' thoughts when capitalism crises hit us. As Nobel laureate Robert Lucas, one of Keynesianism's fiercest critics, ultimately conceded: "I guess everyone is a Keynesian in a foxhole." It is clear that Keynesianism's role in future economic development is indispensable.

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