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John Maynard Keynes's most influential work, *The General Theory of Employment, Interest, and Money*, was published in 1936. The book constituted a vast assault on the classical economics tradition in which he had been raised. The era that had nurtured classical economics had been destroyed by the first world war, and for Keynes the cataclysms since had demonstrated the tradition's inadequacies. A new synthesis was necessary, and that is what Keynes sought to create.

In particular, he concluded that classical economics rested on a fundamental error. It assumed, mistakenly, that the balance between supply and demand would ensure full employment. On the contrary, in Keynes's view, the economy was chronically unstable and subject to fluctuations, and supply and demand could well balance out at an equilibrium that did not deliver full employment. The reasons were inadequate investment and over-saving, both rooted in the psychology of uncertainty.

The solution to this conundrum was seemingly simple: Replace the missing private investment with public investment, financed by deliberate deficits. The government would borrow money to spend on such things as public works; and that deficit spending, in turn, would create jobs and increase purchasing power. Striving to balance the government's budget during a slump would make things worse, not better. In order to make his argument, Keynes deployed a range of new tools—standardized national income accounting (which led to the basic concept of gross national product), the concept of aggregate demand, and the multiplier (people receiving government money for public-works jobs will spend money, which will create new jobs). Keynes's analysis laid the basis for the field of macroeconomics, which treats the economy as a whole and focuses on government's use of fiscal policy—spending, deficits, and tax. These tools could be used to manage aggregate demand and thus ensure full employment. As a corollary, the government would cut back its spending during times of recovery and expansion.

Keynes intended government to play a much larger role in the economy. His vision was one of reformed capitalism, managed capitalism—capitalism saved both from socialism and from itself. He talked about a "somewhat comprehensive socialization of investment" and the state's taking "an ever greater responsibility for directly organizing investment." Fiscal policy would enable wise managers to stabilize the economy without resorting to actual controls. The bulk of decision making would remain with the decentralized market rather than with the central planner.

With the outbreak of World War II, Keynes moved on to the questions of how to finance the war and then how to develop a postwar currency system. He was one of the fathers of the Bretton Woods accord, which established the World Bank and the International Monetary Fund, and which put in place a system of fixed exchange rates.

Keynes provided both a specific rationale for government's taking a bigger role in the economy and a more general confidence in the ability of government to intervene and manage effectively. Despite Keynes's fascination with uncertainty and his speculative talents in the marketplace, Keynesians deemed "government knowledge" to be superior to that of the marketplace.

In one of the most famous passages of *The General Theory*, Keynes had written, "The power of vested interests is vastly exaggerated compared with the gradual encroachment of ideas." There was nothing gradual, however, in the encroachment of Keynesianism or in its conquest of the commanding heights of economic thinking. Within a few years of his death, it was already taking a dominant place in economic policymaking both in Britain and in the United States. How far reaching its impact, or at least the perception of its impact, was demonstrated by a history of economic thought published in the mid-1960s: "In most Western economies Keynesian theory has laid the intellectual foundations for a managed and welfare-oriented form of capitalism. Indeed, the widespread absorption of the Keynesian message has in large measure been responsible for the generally high levels of employment achieved by most Western industrial countries since the second world war and for a significant reorientation in attitudes toward the role of the state in economic life."

COMMANDING HEIGHTS

Keynesian Economic Theory

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It was not until the 1970s that evidence began to accumulate in many countries that Keynes's theories, at least as implemented by Keynes's advocates after his death, might not perpetually yield the favorable outcomes Keynes himself had predicted.