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# **The Global Economic Crisis in the Perspective of Keynesian Business Cycle Theory**

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**Abstract:** As a starting point, the article reviews Keynesian business cycle theory and identifies the cause of economic crisis to blind investment and lack of demand. The article also indicates that fundamentally, the 1929 Great Depression and current global economic recession are the inevitable outcomes of capitalist mode of production. After that, it demonstrates that the strategy of trying to develop public economy as well as increasing its influences and controls over investment and consumption is the only way to limit vicious expansion of capitalist mode of production and prevent future economic crises.

**Keywords:** business cycle, effective demand, public assets

The 1825 crisis in UK is the first economic crisis of the world. Since then, capitalist economy has been fluctuated between boom and depression. Various business cycle theories evolved for explaining the phenomenon. As China is strengthening its connection with the outside world, its economy becomes part of the world economy. The fluctuation of world economy will inevitably exert great influence on export-driven Chinese economy on one hand. On the other hand, in consideration of quick expansion of Chinese economy and its participation in the world economy, each economic policy adopted by China will also play an indicative role in the world economy. Under the current conditions of global economic crisis, one of the most pressing tasks of economics is to combine research on business cycle and the development of Chinese economic conditions.

## **I. Review of Keynesian business cycle theory**

Keynesian business cycle theory had significant influence on macroeconomics regulatory policies of various western countries. According to Keynes, there are two fundamental causes of crisis. One is collapse of marginal efficiency of capital, which is embodied by sudden lost of unrealistically optimistic expectation. The expectation increases expected return (price) of capital in the capital goods market to a dangerous level and blows the bubble. The bubble will eventually burst and lead to collapse of marginal efficiency of capital. The process of collapse is considerably short in terms of the long period of incubation and accumulation of crisis. The other cause is deficiency of effective demand. Marginal propensity to consume is less than 1 and gradually decreases the propensity to consume. It is obvious that expanding gap between riches and poors will

decrease the propensity to consume of whole society and make the problem of over-investment even worse. Unreasonable high price of assets and decrease of actual demand render the reality of world economy in 1928 and 2007.

During the Great Depression of 1929, American economy suffered two setbacks in just one year. That is, the stock market crash in October of 1929 and bank crisis in October of the following year. Productivity index, wholesale price index, and personal income index decrease by 26%, 14%, and 16% respectively. <sup>1</sup> After analysis of the crisis, Keynes believes that the recovery of marginal efficiency of capital needs to absorb abundant capital inventory. It is a negative investment process, which will inevitably result in decreasing of employment rate. The rate will only start to increase after the inventories are absorbed and the negative investment completed.

Keynes believes that the business fluctuates as market expectation and investor psychology fluctuate irrationally, an inevitable outcomes of free market economy. In order to avoid the influence of business cycle, “The duty of ordering the current volume of investment cannot safely be left in private hands”. In the last chapter of “General Theory”, Keynes clearly proposes that the pursuit of surplus value shall be limited and believes that “the rentier aspect of capitalism as a transitional phase which will disappear when it has done its work.” <sup>2</sup> He also realizes that “And with the disappearance of its rentier aspect much else in it besides will suffer a sea-change.” <sup>3</sup>

## **II. The essence of the financial crisis – investment bubble and insufficient of effective demand**

Is there is any fundamental difference between the current global economic crisis and the 1929 ones? Negative. Loose regulation of US financial sector and the uncontrolled development of sub-prime mortgage and other financial derivatives with high risks are the superficial origination of the crisis. When the bubble in US real estate market bursts, systematic risks in the financial sector emerge. However, the deep cause of the crisis is capitalism itself. It is the inevitable outcomes of rapid development of capitalism and vicious expansion of capital rather than an accident.

On one hand, as the rapid development of global productivity and unbalanced distribution of income, a large portion of capital accumulated is controlled by a few people. These capitals are looking for new investment channel to generate new profit, thus large amount of international hot money, such as hedge fund, actively participates in the global market and flows rapidly in the international financial market. The hot money directly or

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<sup>1</sup> Milton Friedman (2008). *The Great Depression 1929-1933*. China Citic Press, 1st edition, 8

<sup>2</sup> John Maynard Keynes. *The General Theory of Employment, Interest and Money*. Re-translated version 2005. The Commercial Press. 390

<sup>3</sup> Same as above

indirectly causes a series of financial crises worldwide since 1990s, especially the Asian financial crisis. Under such conditions, many countries adopt strict regulations for preventing the free flow of hot money. Thus, a lot of international financial capital, including the hot money, flow back to US. It may not be a bad news for US facing double deficient in trade and revenue. However, the inflow of hot money generates the bubble of technology stock. The bubble of technology stocks bursts in 2000. After that, 911 attack occurs. These events are the indirect cause of today's crisis. America adopted an expansive fiscal and monetary policy for dealing with recession induced by technology stock and supporting huge military expenditure for anti-terrorism war and Iraqi war. A series of measures like lowering interest, increasing money supply, huge amount of deficit boomed the economy and debt of America at the same time. The over-supply of US dollars worldwide increased the global financial capital rapidly and abnormally. In terms of futures market, trade volume of futures and options exchanged in US was about 0.63 billion contracts in 1998 while in 2007, was up to 3.2 billion contracts, increasing by more than 500%. Over the past ten years, in Chicago Board of Trade for corn and wheat and New York Mercantile Exchange for crude oil, number of large dealers required to report positions increased by 43%, 116%, and 74% respectively. According to the data published by Commodities Futures Trading Commission, in the foreign exchange market, daily trade volume was about 1.4 trillion US dollars in 2001, while in 2007, the volume was more than 3 trillion US dollars, increasing by more than 200% over just 6 years.

On the other hand, according to the data published by International Monetary Fund in 2007, national income of richest country in the world (44500 US dollars of Luxembourg) was more than 445 times of that of the poorest country (100 US dollars of Burundi). Although it is an extreme example, according to a research of World Bank, in terms of purchasing power parity, world Gini coefficient was 0.619, 0.652, 0.642, and 0.652 for 1998, 1993, 1998, and 2002 respectively. This means that in terms of purchasing power parity, 50.4% of world wealth is possessed by 90% world population while richest 10% of population possesses other 49.6% of wealth. In terms of exchange rate to US dollars, the richest 5% possesses 45% wealth; the richest 10% possesses 67.5% wealth, while the poorest 5% and 10% possess only 0.15% and 0.45% of wealth respectively. In the comparison of Germany and other lower income countries, the income of poorest 5% of Germany was greater than that of 77% world population and that of 5% of richest population in India and a few richest in Sri Lanka for the year 2002. In Brazil and China, the income of one thirds and one-fourth richest population are comparable to that of the poorest 5%. Such huge gap between the rich and poor will inevitably result in the decrease of effective demand.

In summary, it is impossible for market real demand to satisfy that of capital investment in the condition of over expansion of capital and decrease of effective demand. The nature of international financial capital is to pursuit profit restlessly. It is the driving

force of financial derivatives innovation and the source of derivatives with high leverage and high risk. Such innovation is far beyond the fundamental production and supply and demand, large amount of over investment will generate a blind optimistic mode in the financial market. Under the conditions, expectation of capital return will totally exceed the actual price of capital. In the end of 2007, a downturn in the US real estate market eventually caused the collapse of marginal efficiency of capital in the financial sector the crash of stock market with faster speed and stronger destructiveness than that of 1929.

### **III. Public ownership – policy recommendation for tackling crisis**

How should we curb the economic recession and absorb over investment in the boom period while encourage consumption? Actually, neither to increase interest rate and curb the inflation of capital, nor to limit investment to block the source of world economy turbulence is the correct answer to the question. Based on the assumption that “irrational private investment is the root cause of crisis”, we shall adopt policies to increase consumption and to socialize investment.

First, we shall adopt bolder measures, especially distribution and redistribution measures, to increase consumption. The governments of many countries and regions have adopted the policies that range from distribution of coupon to supporting local service industries to stimulate household consumption. However, these policies are insufficient to address the key problem in the distribution area. Temporary measures will only have temporary effects. In the end, radically change the situation in the distribution area is the only way to put the social consumption to its right track. In consideration of current conditions, the most direct method is to enhance the size of redistribution. The state shall have more power in the process of social distribution for realizing a more reasonable distribution among various social tiers.

Second, as the over-investment is a relative term, the key issue is guiding investment rather curbing investment. Strictly speaking, over-investment means that any further investment is the waste of social resources. Actually, the profit-driven over-investment only exists in a few sectors. Foreign trade and processing industry is a remarkable example of over-investment. China’s foreign trade increased by 20% annual rate in the boom period and a lot of investment flew to foreign trade and related areas. The shrinkage of foreign trade is also uncontrollable once the world economy turned down.

However, from the overall perspectives, the issue of over-investment is far beyond the absolute over-investment in China. Except a few sectors, many sectors and public services that are fundamental to common people are less invested. Medical care, education, social security, and infrastructure are among many sectors that face the shortage of investment. It is unfair to blame private investment for all these undesirable outcomes. We believe that

second measure to be adopted by China or the world community is to enhance the capability of public ownership, put more resources under the control of state, and increase the public portion of investment for resolving various problems induced by the economic crisis.

From the above analysis, it is obvious that public ownership is the key measures for overcoming the crisis and increasing effective demand. China has over 16 trillion Yuan of savings deposit by its residents. Although it is not simply a characteristic vector of effective demand, such vast amount of differences represents the inability of the banks to transfer the deposit to investment and depicts the image of idle social resources. Private investment is unable to absorb fully such a huge amount of money. The issue of insufficient of effective demand will be resolved if the money can be transferred to public expenditure of the government and lead the increase of private investment. At the same time, public investment can share profit with private investment and part of the profit will go to education, medical care, and social security. These measures can establish and develop China's current medical and social security systems for improving income expectation and reducing preventive deposit and further stimulate consumption and improve the wellbeing of our people.