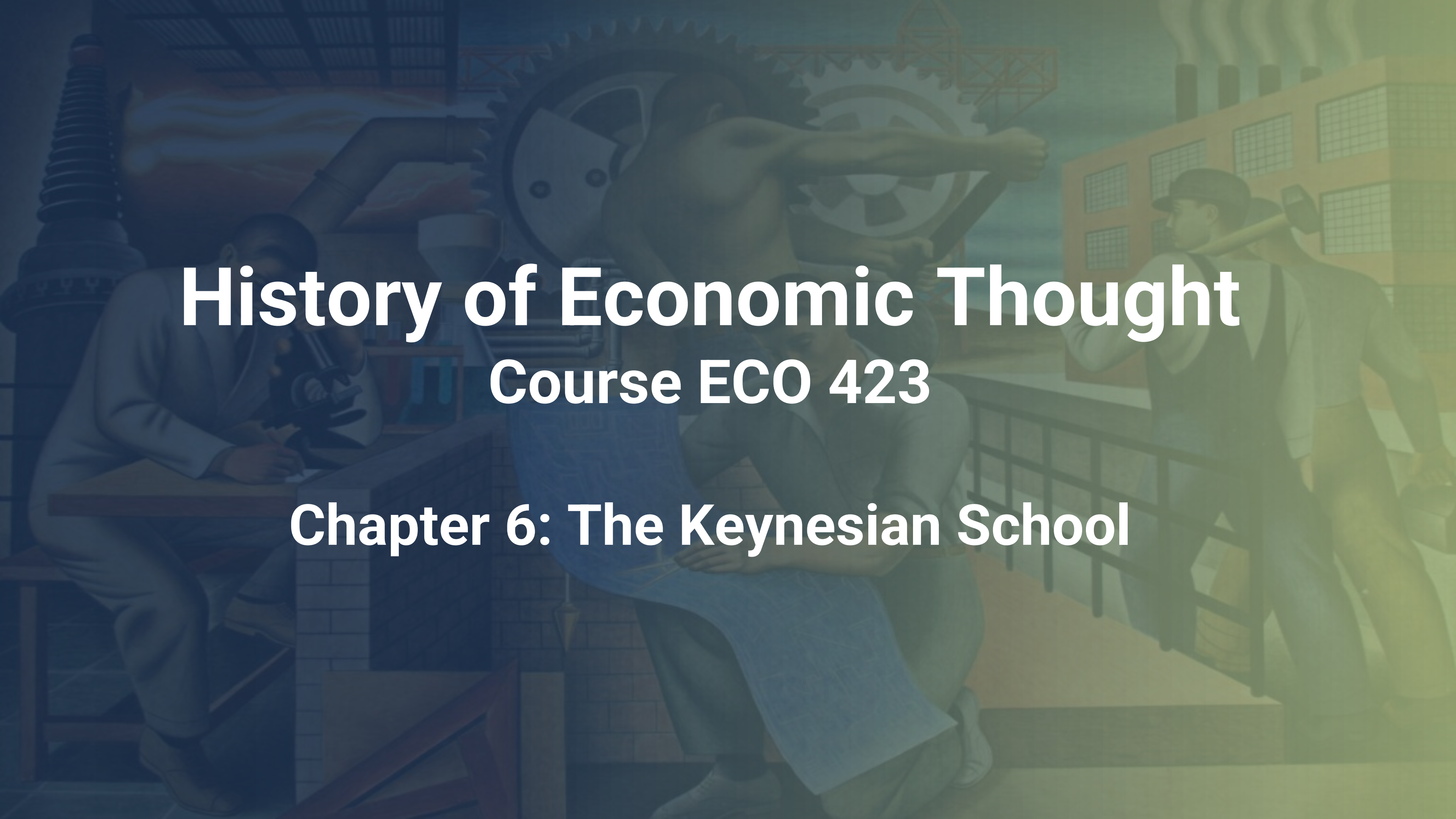


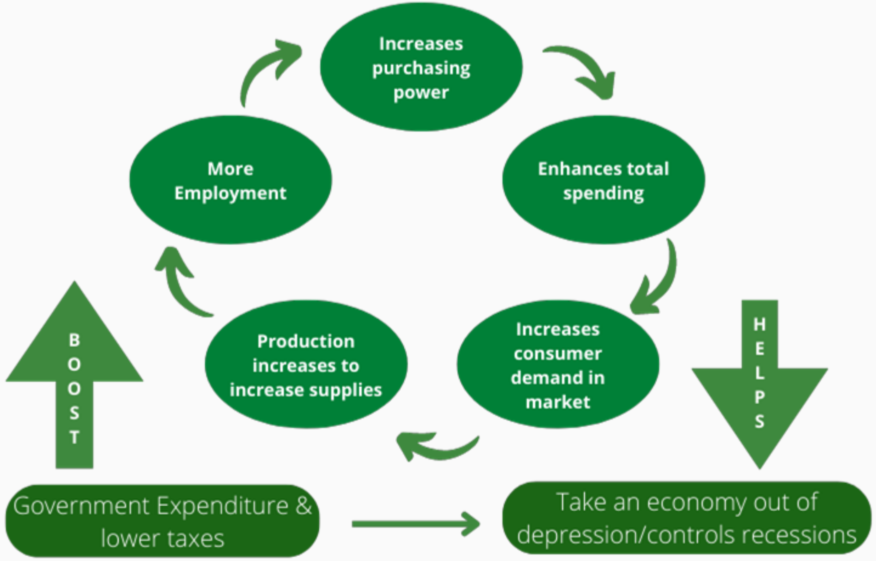
History of Economic Thought

Course ECO 423

Chapter 6: The Keynesian School

Economic thinkers

John Maynard Keynes



Historical Background

- World War I and the economic controls enacted required an overall view of the economy.
- The growth of large-scale industrial production and trade made the economy more susceptible to statistical measurement and control, making the inductive, aggregate approach more feasible than in the past.
- This approach was increasingly necessary as the public became more eager for the government to deal actively with unemployment.
- Keynesian thinking also had its roots in the spreading concern about secular stagnation, or a declining rate of growth.
- The mature private-enterprise economies of the Western world were less vigorous after World War I than before it.
- The rate of population growth was declining; most of the world had already been colonized; no room for further geographic expansion; production appeared to outrun consumption as incomes and savings rose.
- There were no new inventions like the steam engine, the railroad, electricity, and the automobile to stimulate new and vast capital investments.
- The decline of vigorous price competition reduced the rate of replacement of old machinery with new and better machines, and the economy was dragged downward when the growing accumulation of depreciation funds from past investments were not spent quickly enough.
- **Keynes provided the analytical framework that integrated the ideas of macroeconomic policies to recover from the Great Depression and touched off the "Keynesian revolution" in economics.**

Major Tenets of the Keynesian School

- **Macroeconomic emphasis.** Keynes and his followers focused on the overall levels of consumption, saving, income, output, and employment in the economy, rather than individual firm decisions, emphasizing the link between total spending and aggregate employment.

- **Demand orientation.** Keynesian economists emphasized effective demand (aggregate expenditures) as the key driver of national income and employment. When total spending falls short of output, unsold goods pile up, leading firms to cut production and lay off workers, causing actual output to fall below full employment levels.

- **Instability in the economy.** Keynesians argue that economic instability stems from volatile investment spending. Changes in investment affect income and output more than the initial shift. Investment depends on interest rates and expected profits, both of which are unstable, making investment a key source of business cycles.

- **Wage and price rigidity.** Keynesians believe wages and prices are rigid downward due to factors like union contracts and minimum wage laws. In downturns, firms cut output and jobs instead of wages or prices, leading to lower employment rather than falling prices. Deflation happens only in deep depressions.

- **Active fiscal and monetary policies.** Keynesians support active government intervention using fiscal and monetary policies to ensure full employment and stability. In recessions, they advocate higher spending, tax cuts, and lower interest rates. To fight inflation, they recommend spending cuts, tax hikes, or tighter money supply.

Whom Did the Keynesian School Benefit or Seek to Benefit?

- **Full Employment Benefits:** Promoted full employment, benefiting society overall.
- **Labor Support:** Labor unions supported Keynesian goals due to rising demand, better wages, and job security.
- **Business Gains:** Businesses benefited from government contracts and stimulus measures.
- **Banking Sector Support:** Banks profited from investing excess reserves in secure government bonds and enjoyed financial stability.
- **Reformers & Intellectuals:** Found more job opportunities in government and supported Keynesian-driven reforms.
- **Farmers' Alignment:** Favored easy money policies and government agricultural support; used early concepts similar to the multiplier effect.
- **Consumer Approval:** Consumers supported tax cuts in the 1960s–70s, aligning with Keynesian goals of stimulating demand.

How Was the Keynesian School Valid, Useful, or Correct in Its Time?

- **Policy Focus:** Keynes aligned economic theory with practical policymaking, especially during crises like wars and depressions.
- **Explanation & Solutions:** Keynes explained economic fluctuations and offered tools to reduce their impact, increasing economists' influence on policy.
- **Rejection of Wage Cuts:** He opposed across-the-board wage cuts as a solution to unemployment, arguing they reduce demand, worsen debt burdens, and harm investment.
- **Wages as Demand:** Wages are both a cost and a source of demand; cutting them across the economy reduces overall consumption and deepens depression. Wage cuts were also politically impractical and likely to provoke labor unrest.
- **Alternative Policies Preferred:** Keynes promoted demand-side policies (e.g., government spending) to achieve full employment without wage reductions.
- **Broad Influence:** Even critics used Keynesian tools; his ideas advanced national income accounting, econometrics, and empirical economic analysis.

Which Tenets of the Keynesian School Became Lasting Contributions?

Mainstream Influence: Keynesian ideas are foundational to modern macroeconomics and widely taught. Despite some criticisms and outdated views, Keynesian methods and frameworks still dominate macroeconomic analysis.

Synthesis with Neoclassicism: Contemporary economics blends neoclassical microeconomics with Keynesian macroeconomics.

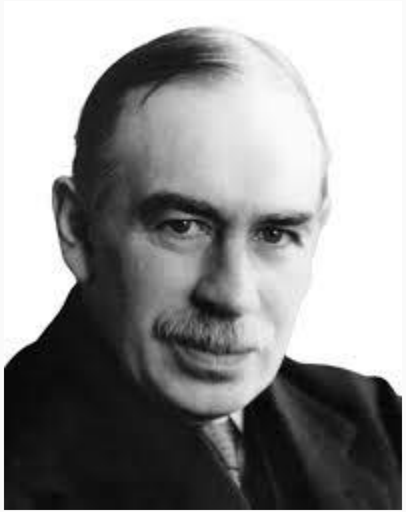
Key Concepts Adopted:

- Consumption and saving functions
- Marginal propensities to consume and save
- Marginal efficiency of capital
- Transaction, precautionary, and speculative motives for money demand
- The multiplier
- Ex ante and ex post saving and investment
- Fiscal and monetary policy
- IS-LM analysis

Policy Limitations: Earlier beliefs in the economy's ability to be "fine-tuned" for non inflationary full employment have been largely discredited.

John Maynard Keynes

John Maynard Keynes (1883–1946) was a renowned British economist, influential in both academic and practical economic spheres. Born into an intellectual family, he was educated at Cambridge, where he studied under Alfred Marshall and A.C. Pigou. Keynes quickly rose to prominence, becoming editor of the Economic Journal at 28 and successfully managing investments for Cambridge's King's College and the Royal Economic Society. He played key roles in public life—as a member of the Bank of England's governing body, a director in private firms, and a key government advisor. A prolific writer and influential thinker, he opposed the harsh terms of the Treaty of Versailles in The Economic Consequences of the Peace (1919). He returned to government during World War II to manage war finance and helped shape postwar economic institutions like the IMF and the World Bank. Keynes was also a member of the Bloomsbury Group, an elite circle of intellectuals and artists, and a supporter of the arts. His 1926 book The End of Laissez-Faire criticized unregulated capitalism, highlighting the role of uncertainty and risk in modern economies. Elevated to the peerage in 1942, Keynes left a lasting legacy in economics, particularly for his revolutionary ideas in macroeconomic theory and policy.



John Maynard Keynes: economic ideas

Consumption function

Keynes proposed a "fundamental psychological law" stating that as income increases, consumption also increases, but by a smaller amount.

This leads to a positive relationship between consumption (C) and income (Y), with the marginal propensity to consume (MPC = $\Delta C/\Delta Y$) being greater than zero but less than one.

As a result, saving (S) also rises with income, with the marginal propensity to save (MPS = $\Delta S/\Delta Y$) also between zero and one. These relationships are illustrated by the upward-sloping consumption function.

Refer to the graphical presentation

John Maynard Keynes: economic ideas

Investment

- **Economic vs. Financial Investment:** Keynes defined economic investment as purchasing capital goods, distinct from financial investments like stocks and bonds, which represent savings storage.
- **Investment Decision Factors:** Investment depends on expected future profits from new capital, influenced by productivity, selling price, and costs.
- **Marginal Efficiency of Capital (MEC):**
  - The discount rate that equates the present value of expected returns to the capital's supply price.
  - Represents the expected rate of profit from investment.
  - Investment continues until MEC equals the interest rate.
- **Fluctuating MEC:**
  - MEC varies with expectations of future profits.
  - More investment in a type of capital lowers its MEC due to competition and rising supply prices.
- **Investment Demand Curve:** Shows an inverse relationship between interest rates and investment amounts.
- **Interest Rate Role:**
  - Keynes rejected classical ideas that interest rates balance saving and investment automatically.
  - Interest is a reward for giving up liquidity, not for saving per se.
  - Interest rates depend on liquidity preference and money supply.
- **Savings Dependence:** Saving is more influenced by income levels than interest rates.

John Maynard Keynes: economic ideas

Liquidity preference

Three Motives for Holding Money:

- **Transaction motive:** Need cash for daily purchases.
- **Precautionary motive:** Hold cash for emergencies.
- **Speculative motive:** Hold cash waiting for interest rates to rise or prices to fall to avoid losses.

Liquidity Preference Curve:

- Downward sloping; people hold more cash when interest rates are low, expecting rates to rise.
- When interest rates rise, bond prices fall, causing losses for bondholders who then hold more bonds and less cash.

Money Supply:

- Controlled by the central bank via open market operations, reserve requirements, and discount rates.
- Money supply is assumed fixed with respect to interest rate (vertical supply curve).

Refer to the graphical presentation

John Maynard Keynes: economic ideas

Liquidity preference

Interest Rate Equilibrium:

- Determined by where liquidity preference (money demand) meets money supply.
- Increasing money supply lowers interest rates unless liquidity preference rises more.

Effect on Savings and Investment:

- Lower interest rates do not reduce saving but encourage more investment spending.
- Increased investment raises national income and saving if below full employment.

Overall Investment Depends On:

1. Marginal efficiency of capital (investment demand curve).
2. Market interest rate (set by money demand and supply interaction).

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John Maynard Keynes: economic ideas

Equilibrium income and employment

Keynes linked national income closely with employment in the short run, assuming technological change can be ignored.

Aggregate expenditures (consumption + investment) determine equilibrium national income:

- Equilibrium condition: **Y = C + I**
- Saving equals investment at equilibrium: **S = I**

The Keynesian cross model shows equilibrium where aggregate expenditure equals income (45° line).

A depression can occur if investment declines due to pessimistic expectations, shifting the investment demand curve left. Reduced investment lowers aggregate expenditures, causing output, income, and employment to fall.

The multiplier effect means a change in investment leads to a larger change in income. Example: With a marginal propensity to consume (MPC) of 0.6 and a $10 billion investment drop, total income falls by $25 billion.

The multiplier formula:

k=1/MPS   where MPS is the marginal propensity to save. The multiplier amplifies initial spending changes through successive rounds of consumption adjustments.

Refer to the graphical presentation

John Maynard Keynes: economic ideas

Policies to promote full employment and stability

Full Employment Goal: Keynes proposed a major government role to stabilize the economy and maintain full employment.

Monetary Policy Limits: Lowering interest rates can stimulate investment, but only to a point. In a **liquidity trap**, when interest rates are very low, further monetary expansion becomes ineffective as people hoard money instead of investing.

Expansionary Fiscal Policy: Keynes favored **government spending** as a direct way to increase aggregate expenditures and boost income. Fiscal policy can raise national income through the **multiplier effect**.

Government Borrowing: If private saving exceeds private investment, government should **borrow the excess** and spend it on public investment.

Challenge of Rising Savings: Wealthier societies tend to save more, making it harder to sustain full employment through private investment alone.

Socializing Investment: Keynes called for the **state to determine total investment** (private + public) needed for full employment—not to control the entire economy.

Selective Government Role: Government should regulate the **volume** of employment, but not interfere with the **composition** or structure of production in the economy.

John Maynard Keynes: criticisms

Overemphasis on Short Run:

- Keynes’s focus on the short run led him to exaggerate the threat of **secular stagnation** (a prolonged period of low investment and growth).
- He underestimated the role of **technological progress** and its potential to stimulate new, profitable investment opportunities.

Historical Oversimplification:

- Keynes made **sweeping generalizations** about economic problems across history, suggesting that investment inducement was always weaker than the propensity to save.
- He applied 20th-century problems to earlier eras (e.g., ancient Egypt, the Middle Ages) in a **provincial and static** manner.

Toleration of Wasteful Spending:

- Keynes was **willing to accept wasteful government spending** if it meant increasing aggregate demand.
- He preferred **useful public works**, but considered **useless projects** better than no spending—especially when politically necessary to avoid competition with private enterprise.

John Maynard Keynes: criticisms

Defense of Luxury Consumption:

- Keynes was sympathetic to **private luxury spending** as a driver of economic activity.
- He supported Bernard de Mandeville's idea from *The Fable of the Bees* that **private vices could generate public benefits**.

Rhetorical Overreach for Persuasion:

- Like many thinkers, Keynes **sometimes overstated his claims** to drive home his points.
- Despite criticisms, his ideas **successfully reshaped macroeconomic thinking**, becoming the foundation of **mainstream policy** in industrialized nations.