Chapter Twenty-one: The Keynesian School - Keynes (pg 427 - 444)

Formally began in 1936 – "A General Theory of Employment, Interest and Money"

- Keynes himself drew heavily from Marshal
  - Marginalism
  - Subjective Valuation
  - Static Equilibrium Analysis
- Also followed from Fisher and Wicksell (early monetary theory)

Historic Background

- WWI had led to massive government intervention in economies
  - Even Laissez-faire England and the U.S.
  - The NBER (Mitchell) had begun collecting macro data in 1920
- Large scale industrial production meant more planning
  - Railroads, trains, schedules
    - So this meant gathering more macro-data by industry as well
- And these industries were vulnerable to business cycle fluctuations
  - And the public was thus demanding an answer to unemployment

- Also, fear of "secular stagnation"
  - A belief that long term economic growth rates were declining
  - No new parts of the world to colonize, no "geographic growth"
  - As income and savings rose, production outran consumption
    - Over-capacity, over production, "gluts"
  - A decline in vigorous price competition
    - So capital was being replaced more slowly
      - (declining investment)
    - The return of Say and Malthus…..

- And then the Great Depression
  - Starting in 1929, a downturn that never got better…..
  - Many people (esp in U.S.) were advocating Keynesian policies
    - But they had no general theory, just specific proposals
      - Have the Fed ease credit…
      - High minimum wages to boost demand
      - A multiplier from government spending

Major Tenants of the Keynesian School

- Macro-economic emphasis: total or aggregate consumption, savings, etc.
  - Less concern about what a firm did, what is important is what
    - They are all doing
- Demand Orientation
  - Effective Demand (aggregate expenditures)
    - What we now think of as $Y = C + I + G + (X – M)$
  - Output can be above or below expenditures,
    - Which leads to increases/decreases in inventories

Output vs. potential (full employment) output

Instability in the Economy

Planned spending and investment is erratic, subject to sudden changes

This means the economy is subject to booms and busts

Changes in investment plans cause LARGER changes in National income and output

Changes in the saving market regulated by changes in output, Not changes in interest rates

Expectations and Animal Interests

Wage and Price Rigidity

Wages are sticky downwards (can't be lowered)

Union contracts, minimum wage laws, implicit contracts

People just don't like wage reductions

Prices are also sticky downwards (not so much Keynes)

Only under severe conditions will wages/prices adjust

It takes a lot to get deflation going

Keynes on Wages (insert graphical analyses)

Active fiscal and monetary policies

Government should promote full employment, price stability and economic growth

Can do so with countercyclical policies

Whom did the Keynesian School Benefit or Seek to Benefit?

Well, everybody…

Recessions hurt everybody, so they should be combated

And government already was doing so, Keynes gave them a map

Individual sectors of the economy liked it because…..

Farmers liked….

Workers (unions) liked….

Industrialists liked….

Government liked…..

Ohh, and tax cuts as well

How was it valid, useful or correct for its time?

Keynes geared theory to policy-making.

WWI, the great depression, WWII, the creation of the welfare state

Laissez-faire was no longer working or appropriate

And the Public was demanding answers

Keynes brought the economist into public life….

Keynes showed alternate ways of reducing nominal wages

Politically, neoclassical lower wages was a non-starter

And according to Keynes, it was also bad policy

A firm can increase sales by cutting wages…

But an economy can't….

Falling wages led to falling prices

Which meant real debts increased, transferring wealth to renters

Who had a lower MPC, to much savings now

Even those who opposed his policy prescriptions

Benefited from his analytic tools

Which Tenets of Keynsianism became lasting Contributions?

Contemporary economics is neo-classical micro and
Keynesian macro

The consumption function and the savings function
The marginal propensity to consume

Transaction, precautionary, speculative demand for money
IS-LM, aggr. Supply and Demand, etc.

John Maynard Keynes (1883-1946)

Born of intellectuals
Schooled by Marshal and Pigou

At 28, editor of Economic Journal, managed its investments

Kings college did as well

Keynes was a very skilled investor (twice)

Usually in currencies

A leading member of the "Bloomsbury Group" between 1905-1930
Represented Britian's treasury at Versialles

"The Economic Consequences of the Peace" 1919

Germany and the reparations crises

"The end of Laisse-faire", 1926

Micro rationality is NOT macro rationality

"The General Theory", 1936

More later

Back at treasury in 1940, throughout WWII

Represented Britain at Bretton woods

Dominated economic thought by the time of his death

Personality, personal life, etc…

The Keynesian system

Consumption and Savings……

The consumption function

C = f(Y)

The marginal propensity to consume…

MPC = $\frac{\Delta C}{\Delta Y}$

Which implies the savings function

S = f(Y)

And thus the marginal propensity to save…

MPC = $\frac{\Delta S}{\Delta Y}$

And this gives us the famous consumption function, often called "the Keynes cross"

Insert graph….

Investment

Defined by Keynes as the purchase of capital goods

Financial investment is savings, economic investment is investment
Keynes made a strong distinction between finance and capital
Why invest? Business is investing in a right to prospective returns…
The size of the expected income stream depends on
The productivity of the piece of capital
The price you can sell additional output at, and
The additional costs (wages, etc.) of making the capital work
Also, the supply price (replacement cost) of the asset.
The supply price is the price that would induce capital maker
To make one more piece of capital for sale
The Marginal Efficiency of Capital, its present cost vs.
Its discounted over time value, should be equal

Mathematically, $K = R_1/(1 + r) + \ldots.. R_n/(1+r)^n$

The marginal efficiency of capital will equal the interest rate….

Insert graph keynes2.jpg here….. Investment Expenditures

The above graph shows all investment in descending order of value, the most valued investments on the left, subsequent investments produce a smaller stream of expected income. Where the MEC is equal to the interest rate, it make no more sense to keep investing. But…….

This does NOT set the interest rate.
Interest is NOT the reward for abstinence (Senior), or
The reward for waiting (Marshal).

When people hoard cash, they earn no interest. So savings is the reward for forgoing liquidity

Liquidity preferences. Money serves three purposes
Medium of Exchange
Store of Value
Unit of Account

We hold money for three reasons
The transaction motive (increases with income)
The precautionary motive (may increase with income)
The speculative motive (forward looking)

These motives translate into a downwards sloping demand for money

But the money supply is fixed (by the central bank)
So the M curve is horizontal. The amount of money we hold is determined by the interest rate, for any given demand.

Note in the above; when the interest rate goes down, it does NOT mean that savings goes down, per the classical/neoclassical school. It means that business investment goes up.

So investment depends on the marginal efficiency of capital, which defines our investment curve, and the market interest rate, which depends on liquidity preferences and the supply of money.

Equilibrium income and employment

Keynes assumed a high correlation between national income and employment

Plausible in the short run, maybe not in the long run

(unless wages adjust) – LR vs. SR stickyness

"in the long run, we are all dead"

In its simplest form,

Y = C + I, thus S = Y – C

Which can be reduced to an equilibrium of I = S

The Samuelson representation is given graphically as "the Keynes Cross"….

What happens with a change in equilibrium?

Imagine a change in the desire to investment (animal spirits…) what will happen?

Policy implications

A large government was necessary to deal with Recessions

Reduce interest rates to promote investment – note interest can't go below 0

Liquidity trap or "lower bound problem"

So monetary policy is unlikely to solve the problem

So instead, the Government can directly stimulate investment

By spending more

The government should socialize investment,

The VOLUME of employment, not the TYPE of employment

Keynes still believed markets were efficient in how they allocated goods/investment, just that they could lead to sub-optimal amounts of them.

Chapter 22…..

Hansen and Hicks
- IS/LM models
- Secular Stagnation thesis and Post War history

Abba Lerner the "Keynesian Steering Wheel" (also the socialist calculation debate)

Paul Samuelson
- Published everything.
- Mathematized everything.
- The dominant post WWII economist for 40 years or so

Contributions…
- Multiplier Accelerator Interactions (how to calculate the multiplier)
- The Algebra of Income Determination
- The Phillips Curve and its introduction to the U.S.

- Also…
  - Comparative statistics
  - Revealed Preference theory
  - Efficient markets theory
  - Factor Price-equalization theory
  - Public Expenditures Theory (optimal amount of public good)

Post Keynsians and Neo-Keynesians
- Post Keynesians believe that wages/profits are allocated, not "earned"
  - A neo-ricardian view of the distribution of the surplus

- New Keynesians – Wage a price inflexibility
  - Many, many models of market imperfections
    - Menu costs
    - Formal and implicit contracts
    - Efficiency wages
    - Insider-outsider theories