Module 4

Lecture 28

Topics

4.2 Keynesian Economics

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4.2.1 Overview

- Keynesian economics is based on the book \The General Theory of Employment, Interest and Money" written by John M Keynes published in 1936.

- The book was written in the backdrop of great depression the first global economic crisis of the industrial society.

- The great depression saw widespread unemployment in the western world which raised some serious questions about the classical macroeconomics.

- Classical macroeconomics relied on the unfettered market mechanism to resolve the problem of unemployment. Any involuntary unemployment according to the classics is a short run phenomenon in nature and any policy to correct the situation would lead to worse economic outcome

- The large scale unemployment of 1930s could not be ignored by calling it a short run phenomenon.

- Keynes wrote, \In the long run we are all dead".

- Keynes explained unemployment as a systematic problem and prescribed policies to get away with it.

- Keynes' fundamental contribution was his systematic focus on demand side of a macroeconomics which was ignored by all the major economists that preceded him.

4.2.2 Role of Demand

- In classical formulation, aggregate demand has no role in determining unemployment.

- This idea is formalized by a theorem known as `Say's Law' which states that Supply creates its own demand. This means that goods produced by an agent creates equal amount of income and aggregate demand for goods. According to this law there can be `glut' which will be disposed only in the short run.

- Because demand played no role in national income determination classical macro-economics, demand management policies such as fiscal and monetary policies was not part of classical prescription to cure recession.

- The biggest contribution of Keynes was to analyze the role of aggregate demand in national income determination.

- Once demand is shown to play a role in aggregate income determination, use of fiscal or monetary policies to cure recession logically follows.

- Classical paradigm is characterized by market clearing condition so that in equilibrium demand is always equal to supply.

- In this paradigm any discrepancy between demand and supply is corrected by price movement -- price goes up in case of excess demand and goes down in case of excess supply to clear the market. Similar adjustment in rate of interest happens if savings (supply of funds) is not equal to investment (demand for funds).

- Keynes maintained that rate of interest may have a floor below which it may not drop leaving the credit market in excess supply condition

- Keynes wrote that investment depends on the “animal spirit of man" and therefore there is no a priori reason that aggregate demand, of which investment constitutes a major part, is always equal to the aggregate supply.

4.2.3 Model

- Keynes did not use any analytical model in The General Theory. The IS-LM model which is the most popular (though a little out of fashion now) version of The General Theory was developed by J.R. Hicks.

- IS-LM model characterizes the economy with money market and goods market. The equation representing the equilibrium condition is given by

$$S(Y-T)+T=I(r)+G \qquad (1)$$

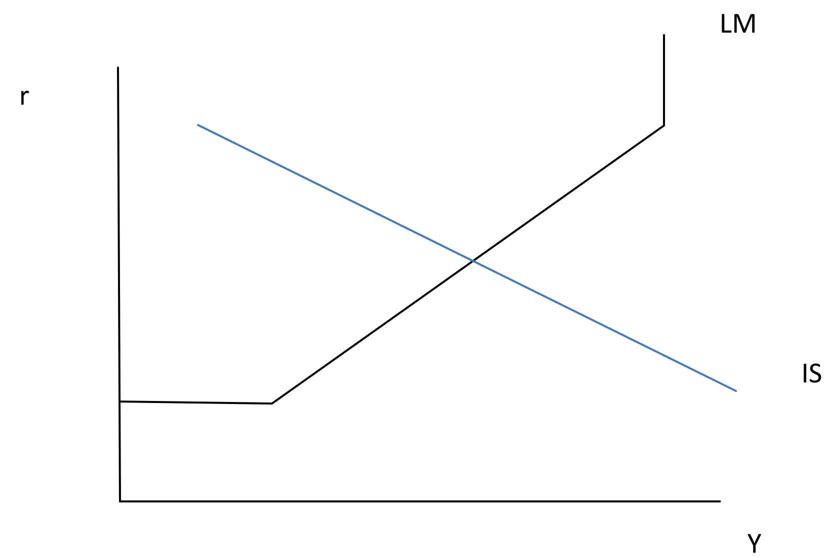
and

$$\overline{M}=L(Y,r) \qquad (2)$$

- The first equation is known as Investment Savings (IS) curve and the next one as Liquidity of Money (LM) curve.

- The intersection of these two curves denotes the equilibrium $Y$and r.

- IS curve is downward sloping and LM curve is upward sloping. Let us explain the reasons here. IS curve is a relationship between saving and investment. Increasing Y would mean S>I creating an excess supply of investment. In response to this rate of interest – the opportunity cost of investment falls, giving rise to investment. The LM curve on the other hand characterizes the money market equilibrium. However, it is assumed that there is a floor to the rate of interest. This means that at r = r_{min}LM curve becomes infinitely elastic. Similarly, above r = r_{max} , the LM curve becomes perfectly inelastic i.e. vertical. Hence the shape of IS and LM curves look like the next diagram.



4.2.4 Policy Prescription

- The biggest difference between the classical and the Keynesian school is their view on the effectiveness of fiscal and monetary policies.

- According to the classical view fiscal and monetary policy can only worsen the situation.

- Keynesian view on the other hand strongly argued for government intervention to cure recession.

- The mechanism that plays a key role in the fiscal and monetary policy effectiveness in Keynesian exposition is known as the multiplier process.
- The multiplier mechanism ensures that one rupee spent on government expenditure creates more than one rupee worth of national income.

- The simplest exposition of the multiplier mechanism goes like this: Suppose government spends Rs. 100 on a project which goes to people who work in that project. Suppose that people spend half of their income and saves half. Hence, those people working in that project spends Rs. 50 and saves Rs.50. Again the new spending creates income for people who sell goods to them. Hence income goes on by Rs.50 in the second round. This goes on forever and the total income generated this way amount to

$$\Delta Y = 100 + 50 + 25 + 12.5 + \cdots = \frac{100}{1-\frac{1}{2}} = 200$$

- Note that the final rise in national income is much higher than the initial rise in government spending.

- This result shows that the to cure an economy from recession there is no need to change the capitalist nature of the economy through government expenditure { national income will rise in the multiple of government expenditure.

- Similarly, if government expands money supply that would reduce interest rate and induce investment thereby increasing national income.

- How do we reconcile between these two views?

- Usually the Keynesian view is seen as a short run view where the supply curve is positively sloped -- aggregate output increases with an increase in prices. Hence, if price is increased by some policy variable output will increase (unemployment will decrease) too. This negative relation between unemployment and inflation is known as the Philips curve.

- On the other hand the classical view can be seen as a long run view when the economy has utilized all its resources implying a vertical supply curve. In this case any change in demand will lead to change in price without any change in aggregate output.

- However, Keynes dismissed the projection of long run as a more stable situation saying that in the long run we are all dead".

- However, there are Keynesians who see that Classical view that markets rests in equilibrium is fundamentally flawed. They see that investment is driven by animal instinct defying any rational structure which converges to a stable nationwide equilibrium. They adopt disequilibrium to characterize an economy and does not result in any reconciliation.