

Lecture 8.

John Maynard Keynes

John Maynard Keynes (1883-1946)

- No theory of business cycles in economics before Keynes
- One of the most important figures in the entire history of economics
- Revolutionized macroeconomic theory and practice of economic policy in the 20th century

John Maynard Keynes (1883-1946)

- Main work: *The General Theory of Employment, Interest and Money*, 1936
- Son of John Neville Keynes, British economist
- Educated at Cambridge
- Not only an economist, held several government posts; also engaged heavily in drama and literature

John Maynard Keynes (1883-1946)

- Invested in stocks privately – went from near bankruptcy in 1929 to the wealth of ca 13.5 million US dollars (current prices) in 1940s
- Policy-oriented economist
- Published two books on the economic consequences of peace and war
- Represented Britain at the peace conference after The First World War

John Maynard Keynes (1883-1946)

- In 1926 published *The end of laissez-faire*, in which he rejected Smith's vision of the invisible hand of markets.
- In 1944 contributed to the establishment of IMF and the World Bank
- In *General theory...* Keynes argued that classical and neoclassical macroeconomic theories are special cases in his more *general* framework.

Keynes's methodology in *General Theory*

- Avoided mathematics (worked in Marshallian tradition)
- Complex, ambiguous, imprecise work
- There are multiple interpretations of the *General theory*
- Here only a conventional account of it will be offered

Keynes vs. Neoclassical economics

- Neoclassical economics assumed that in the long-run equilibrium at macro level can be achieved only at full employment of resources, especially labour.
- Deviations from equilibrium (recessions) are possible (even likely) but they will be temporary and short-lived
- So in the long run unemployment is either voluntary (people don't want to work at market wage), or it is caused by government intervention (for example minimum wage legislation).

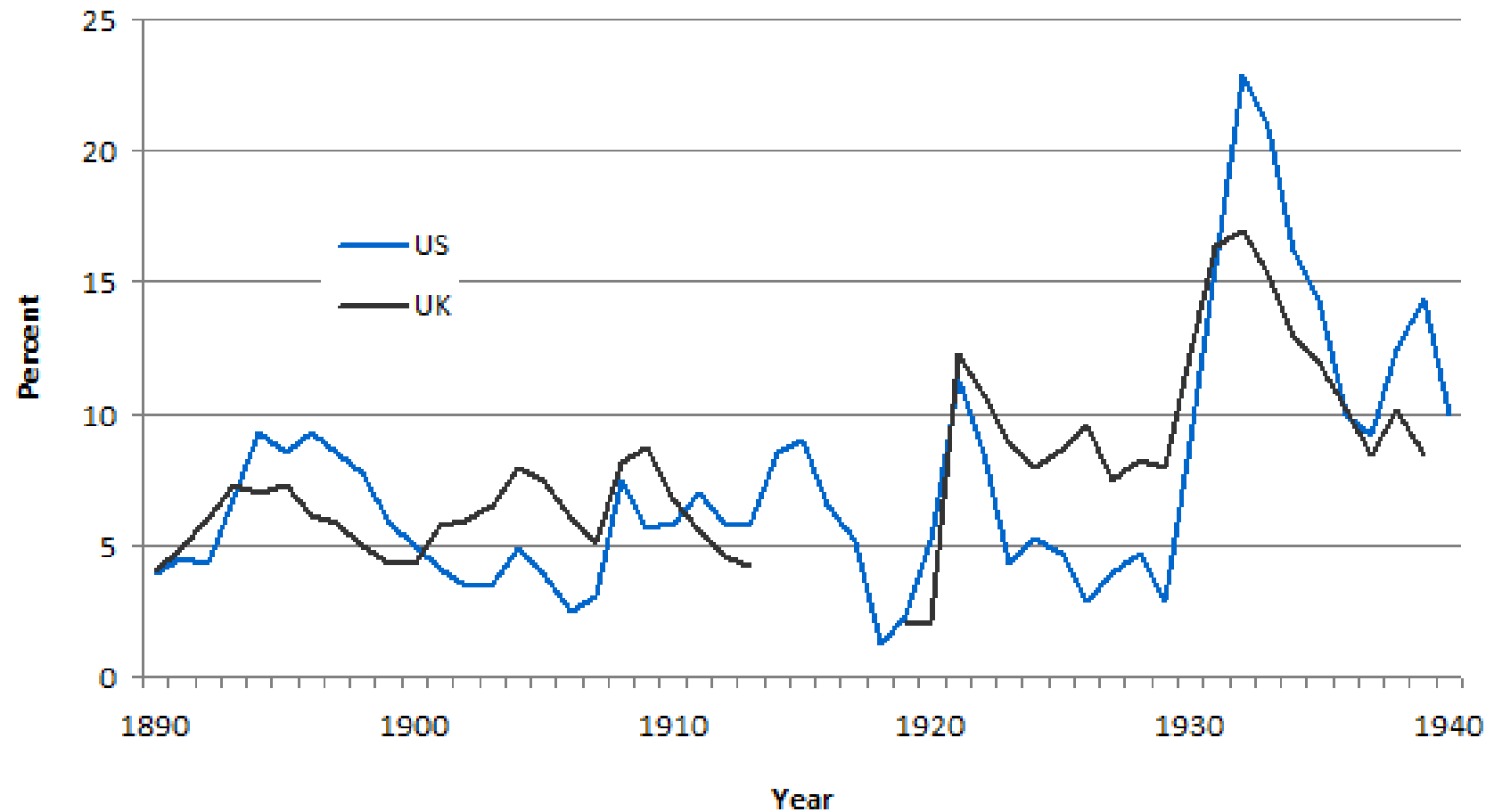
Keynes vs. Neoclassical economics

- For Keynes, equilibrium at less than full employment can exist for a long period. Full employment of resources (esp. labour) is very special and not very likely case.
- Keynes rejected the view that capitalism is a stable and self-adjusting economic system (with respect to unemployment at least).
- He thought that (neo)classical economics was unable to explain such facts as high and long-lasting unemployment, business cycles, severe depressions etc.

The Great Depression of 1930s

- Worst economic slump in history
- Unemployment rate rose in the US from 3% in 1929 to 25% in 1933
- US production level dropped by about 30% in 1929-1930
- Occurred in all industrialized countries
- Lasted for about a decade

Unemployment in the US and the UK during the Great Depression



(Neo)Classical Macroeconomics

- Economic perturbations are short-lived
- Markets operate relatively quickly and restore full employment equilibrium
- Government intervention is neither necessary nor desirable – could only generate greater instability
- Assumptions:
 - Economic agents are rational and maximize (profits or utility)
 - Markets are perfectly competitive (agents are price-takers)
 - Agents have perfect knowledge and stable expectations

(Neo)Classical Macroeconomics

1. Output (national income) is determined by real factors (stock of capital, quantity of labour, technology)
 2. Quantity theory of money (monetary policy affects only level of prices and not the real output)
 3. Say's Law operates – supply creates its own demand; production creates income and purchasing power; so demand is always sufficient to purchase all output which is produced
- In other words, there is an automatic tendency for full employment of resources (esp. labour)

Keynes's economics

- Keynes constructed a new basis for macroeconomic theory
- He rejected classical concept of Say's Law – supply creates its own demand.
- Keynes argued that it is not production which generates demand, but it is rather that production adjusts to demand.
(Turned classical theory upside down)
- Production and employment (Y and L) are determined by the so called effective demand, that is the sum of investment and consumption expenditures by firms and households: $E = I + C$
- The last statement is Keynes's principle of effective demand:
 $E \rightarrow Y$, and $L=f(Y)$

Keynes's effective demand

- Most powerful implication of this principle is that the level of production determined by effective demand is at equilibrium point, but this equilibrium does not have necessarily to be at full employment of resources (e.g. labour).
- This occurs when effective demand is too small.
- In such a situation we face involuntary unemployment – people want to be employed at the market wage rate, but can not find jobs.
- But why effective demand can be insufficient to generate full employment of labour? What is the reason for inefficiency of capitalism in terms of unemployment?

Why effective demand can be insufficient?

- Keynes focused on investment spending.
- Investments, for Keynes, depend on the interest rate and MEC (marginal efficiency of capital).
- MEC is expected (by businesspeople) rate of return on capital (expected profits)
- MEC estimates are based on expectations about the future, which are influenced by psychological, irrational factors.
- Those expectations are volatile, change quickly and irrationally.
- This way he rejects the (neo)classical assumption of (perfect) rationality of economic agents (here business owners)

Keynes on investment decisions

- Investors' moods, irrational waves of optimism or pessimism, states of confidence and 'animal spirits' govern investors' decisions.
- By animal spirits Keynes meant intuitive, unconscious mental actions, irrational actions, not based on economic calculation.
- Investment decisions governed by animal spirits are therefore not fully rational.
- And therefore, effective demand, in a part, also depends on uncontrollable, and extremely unstable factor – animal spirits.
- Investment decisions are not rational → unstable investments → unstable effective demand → unstable levels of production and employment (**that is why business cycles occur**)

Keynes on (in)stability of free markets

- So, there is a possibility of crises (increasing unemployment) because of a rapid fall in investments
- But why there is no automatic tendency to recover to full employment as postulated by classical theory ?
 - Classics: if r goes up – savings (S) go up, consumption decreases;
when r goes down - savings go down, consumption increases
- According to classics, $I=S$, so interest rate (kamatláb) must have fallen (because investments are down) and consumption has to rise -> E does not change -> no recession
- But in Keynes's system:
 1. Consumption does not depend on the interest rate (but on income)
 2. Interest rate is determined outside savings and investments market
- Therefore a fall in investments cannot decrease an interest rate and encourage consumption

Keynes on the neutrality of money

- Classical theory: QTM implies that money is neutral with respect to real variables (e.g. national income, unemployment etc.)
 - $M * V = P * Y$, (with $Y=f(K, L)$, V - velocity of money)
 - A rise in M leads to a proportionate rise in P , no real effects
- In Keynes's system:
Increase in money supply ($M/P \uparrow$) $\rightarrow r \downarrow \rightarrow I \uparrow \rightarrow E \uparrow \rightarrow$
 $\rightarrow Y \uparrow$ and $L \uparrow$
- So, money is non-neutral for Keynes – income and employment can be increased through this mechanism
- Potentially, expansionary monetary policy can bring back the full employment of resources in the economy

How unemployment can be automatically cured in Keynes's theory?

- If there is a crisis and growing involuntary unemployment, then theoretically the following mechanism automatically restores full employment of resources:

Employers cut down nominal wages ($w \downarrow$) $\rightarrow P \downarrow \rightarrow$
 $(M/P) \uparrow \rightarrow r \downarrow \rightarrow I \uparrow \rightarrow E \uparrow \rightarrow Y \uparrow$ and $L \uparrow$

- This mechanism is known as 'Keynes effect' – shows how market forces could bring back macroeconomic equilibrium with full employment in Keynes's theory

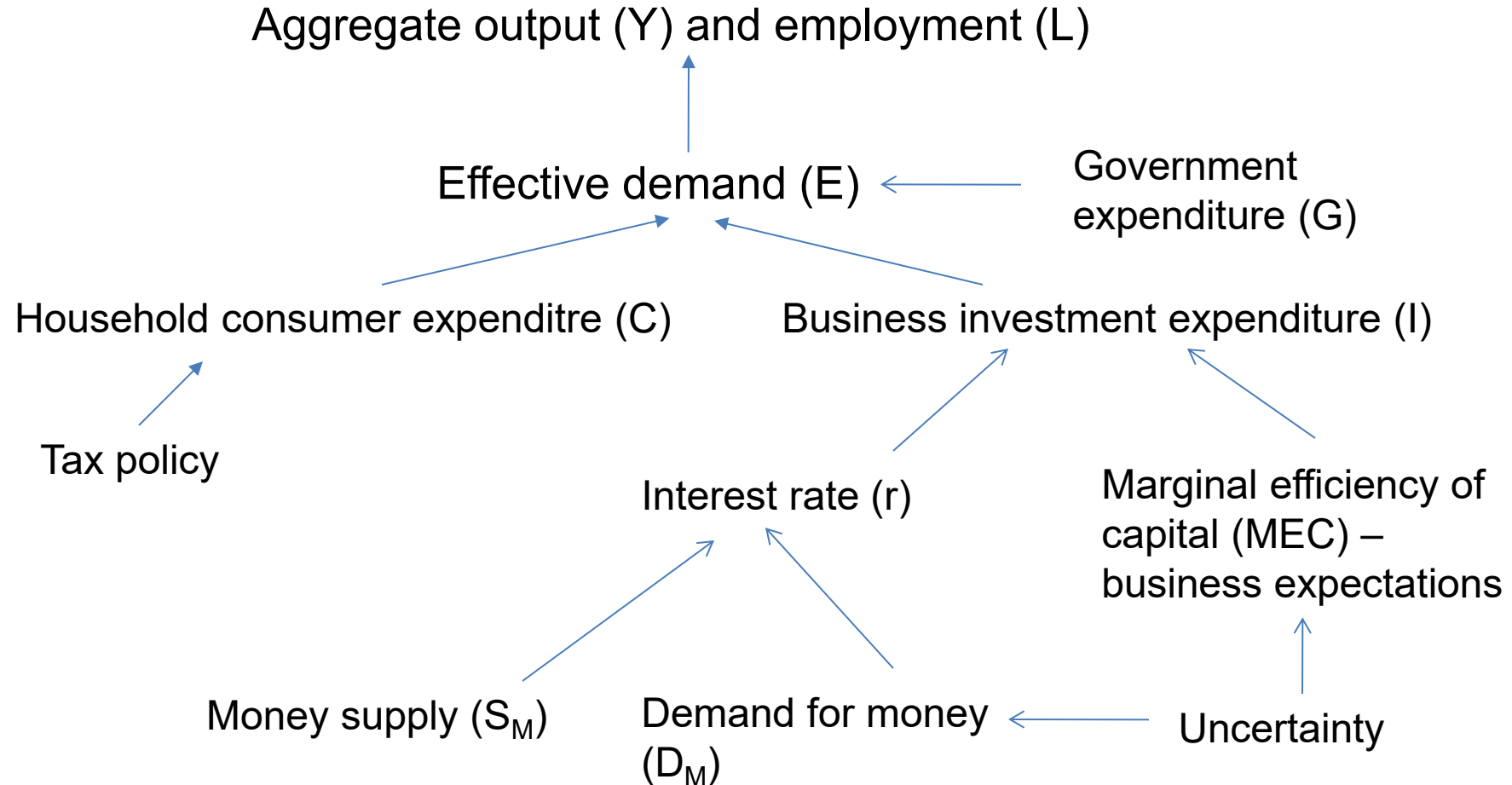
When Keynes effect does not work?

- But, of course, Keynes wanted to show that markets fail to provide full employment of resources
- So, he had to show that 'Keynes effect' sometimes (or rather often) is unable to deliver its promise
- Keynes introduced two reasons why 'Keynes effect' might fail:
 - 'liquidity trap'
 - Interest-inelastic demand for investments

How to achieve full employment when Keynes effect fails?

- In presence of any of those two situations, market forces will be too weak or inefficient – aggregate demand (E) will not be sufficient to produce full employment
- The only solution is stimulate E ($E = C + I$):
 - (a) directly through encouraging investment (I) *by increased government expenditure (G)*; so in fact: $E = C + I + G$
 - (b) indirectly by lowering taxes that stimulate consumer spending (C) through rising households incomes

Determination of output and employment in Keynes's system



Economic policy according to Keynes

- In *General Theory* presented extreme opposition to laissez-faire policy
- Advocated extensive, active and permanent government interventionism
- Specific policy obligations of governments in Keynes' vision:
 1. control the level of interest rates, tending to lower it in order to increase investments
 2. socialization of investment (to stabilize levels of employment and production).
 - Probably meant some kind of public (or public-private) investments in the economy in times of recessions
 3. use fiscal policy to lower economic inequalities (in incomes and wealth)
 - „the euthanasia of the rentier"

Economic policy according to Keynes

- Keynes was accused of being socialist, but himself thought that he was rather conservative.
- Not aimed at radical changes, only wanted to get rid of two biggest evils of capitalism for him: unemployment and inequality.
- Thought that his proposals would leave the biggest advantages of capitalism – like personal liberty, private property – intact.
- Thought that the continuation of laissez-faire policy would lead to revolt, socialism or totalitarian state.
- Rejected socialist and totalitarian visions of economic system.

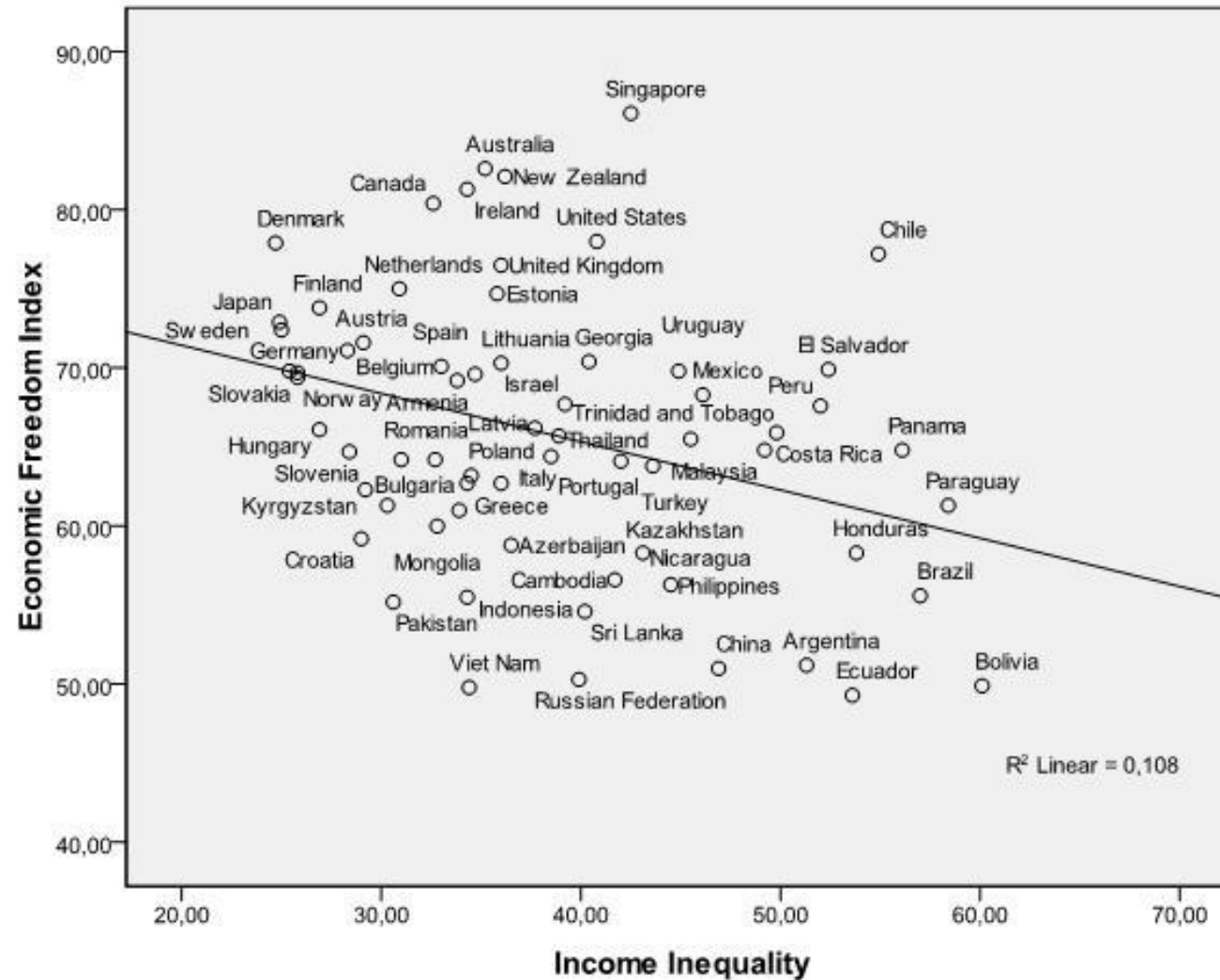
Economic policy according to Keynes

- Argued that personal freedom and private property associated with capitalism produce in general economic efficiency, innovative economy, variety of life etc.
- In general, Keynes can be called a proponent of a third way between capitalism and socialism, an advocate of refined capitalism (without involuntary unemployment and big inequalities)
- Was against laissez-faire policy, but was rather liberal, not radical or socialist.

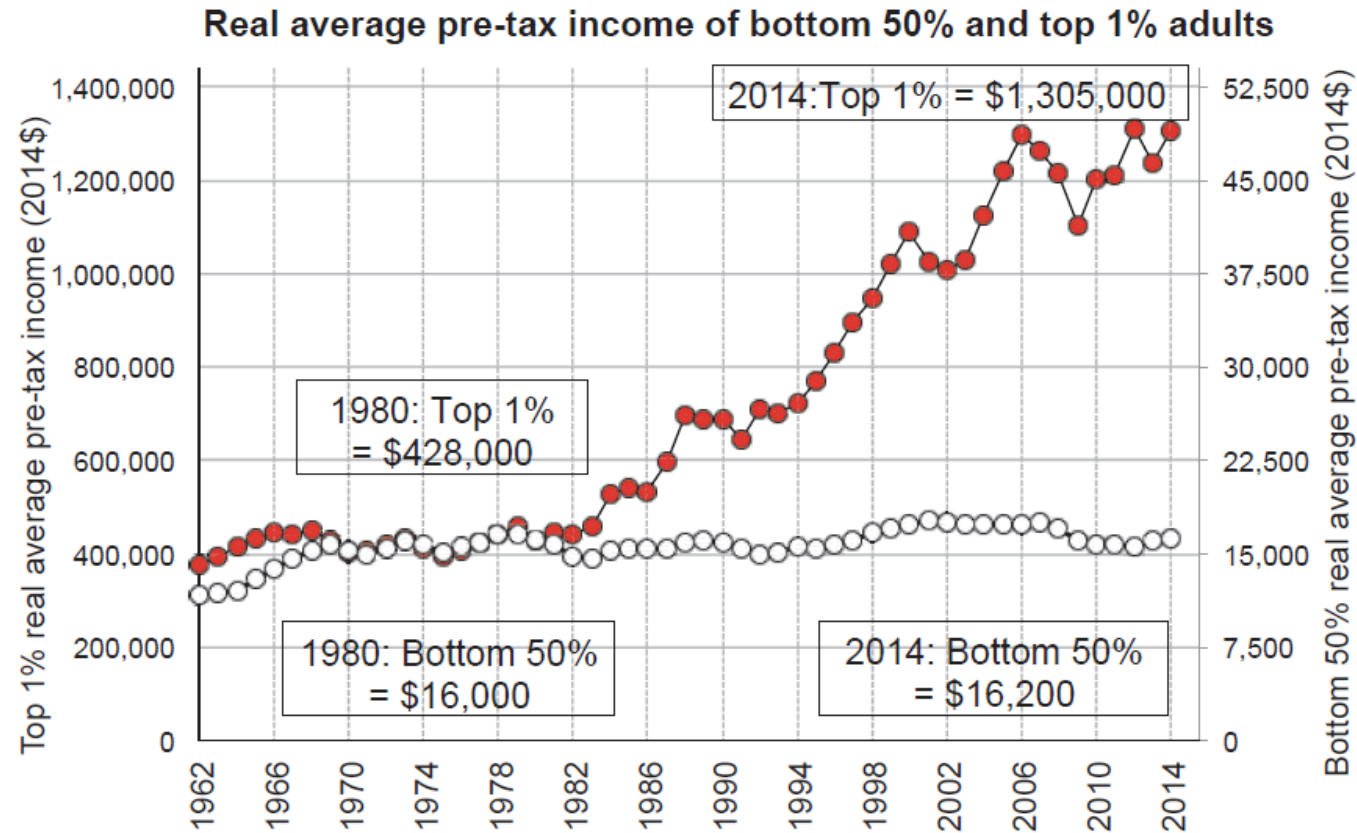
2018 *Economic Freedom of the World Index*^[1]

Rank ↕	Country ^[2] ↕	Score ↕
1	 Hong Kong	90.2
2	 Singapore	88.8
3	 New Zealand	84.2
4	 Switzerland	81.7
5	 Australia	80.9
6	 Ireland	80.4
7	 Estonia	78.8
8	 United Kingdom	78.0
9	 Canada	77.7
10	 United Arab Emirates	77.6
11	 Iceland	77.0
12	 Denmark	76.6
13	 Taiwan	76.6
14	 Luxembourg	76.4
15	 Sweden	76.3
16	 Georgia	76.2
17	 Netherlands	76.2
18	 United States	75.7
19	 Lithuania	75.3
20	 Chile	75.2
21	 Mauritius	75.1
22	 Malaysia	74.5
23	 Norway	74.3
24	 Czech Republic	74.2
25	 Germany	74.2
26	 Finland	74.1
27	 South Korea	73.8

Source: <http://economynepal.com/concerned-about-the-wealth-gap-spread-economic-freedom/>

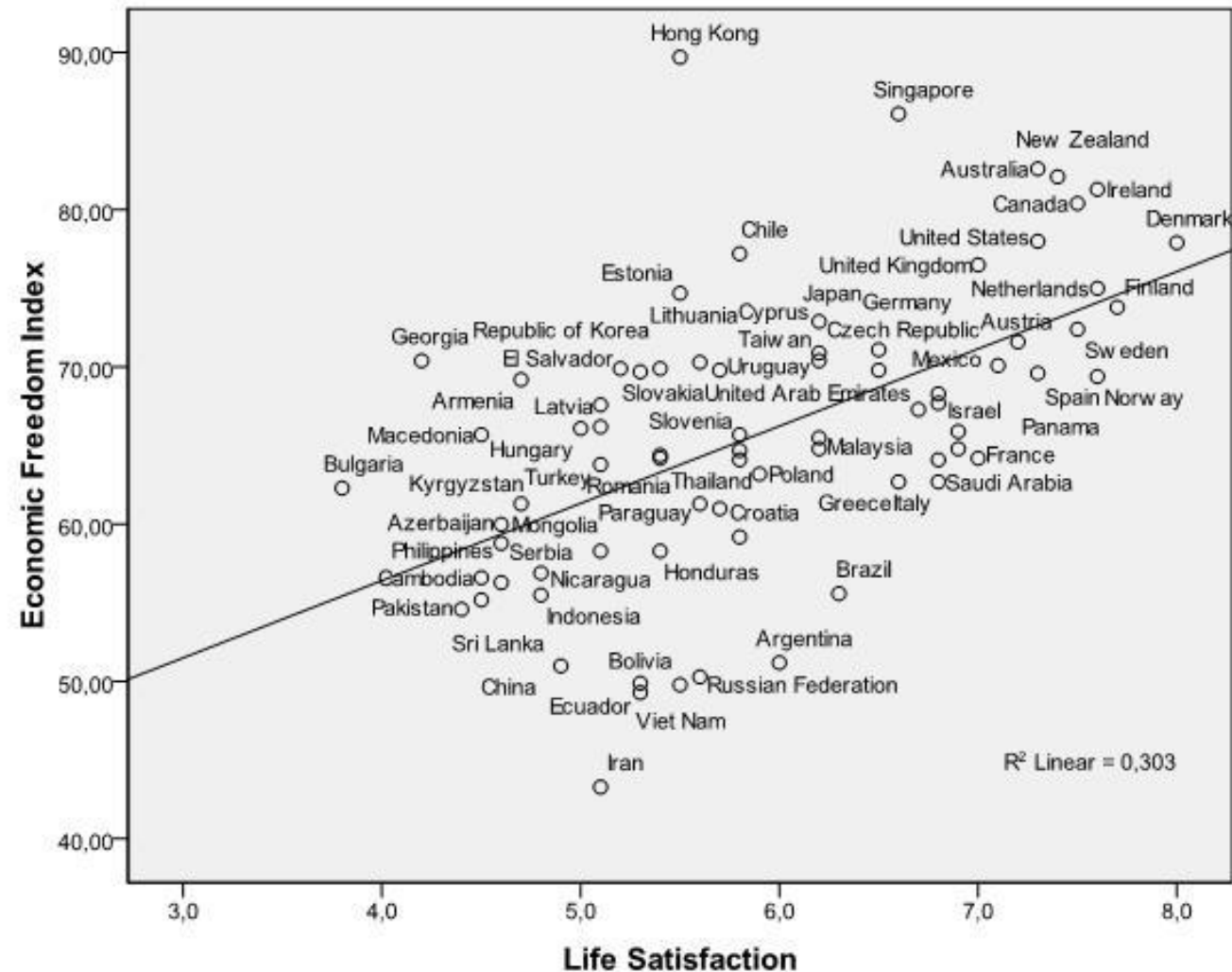


Piketty, T., Saez, E., & Zucman, G. (2016). Distributional national accounts: Methods and estimates for the united states (No. w22945). National Bureau of Economic Research.



Source: Appendix Tables II-B7 and II-B10

<https://www.theatlantic.com/international/archive/2010/04/free-tolerant-and-happy/39127/>



Lecture 9

[Teachers Workshop Introduction to the European Union presentation slides Feb 18 2022](#)

[Achievements and benefits | European Union](#)

Practice 9

Case studies

- [How Strong Is India's Economy?](#)
- [India - total population 2020-2030 | Statista](#)
- [Why Singapore is One of the World's Richest Countries](#)
- [Singapore Department of Statistics \(DOS\) | SingStat Website](#)