FACULTY OF JURIDICAL SCIENCES

Lecture-4

KEYNESIAN THEORY

Keynesian economics is a macroeconomic economic theory of total spending in the economy and its effects on output, employment, and inflation. Keynesian economics was developed by the British economist John Maynard Keynes during the 1930s in an attempt to understand the Great Depression. Keynesian economics is considered a "demand-side" theory that focuses on changes in the economy over the short run. Keynes's theory was the first to sharply separate the study of economic behavior and markets based on individual incentives from the study of broad national economic aggregate variables and constructs.

Based on his theory, Keynes advocated for increased government expenditures and lower taxes to stimulate demand and pull the global economy out of the depression. Subsequently, Keynesian economics was used to refer to the concept that optimal economic performance could be achieved—and economic slumps prevented—by influencing aggregate demand through activist stabilization and economic intervention policies by the government.

- Keynesian economics focuses on using active government policy to manage aggregate demand in order to address or prevent economic recessions.
- Keynes developed his theories in response to the Great Depression, and was highly critical of previous economic theories, which he referred to as "classical economics".
- Activist fiscal and monetary policies are the primary tools recommended by Keynesian economists to manage the economy and fight unemployment.

Keynesian Economics and the Great Depression

Keynesian economics is sometimes referred to as "depression economics," as Keynes's *General Theory* was written during a time of deep depression not only in his native land of the United Kingdom but worldwide. The famous 1936 book was informed by Keynes's understanding of events arising during the Great Depression, which Keynes believed could not be explained by classical economic theory as he portrayed it in his book.

Other economists had argued that in the wake of any widespread downturn in the economy, businesses and investors taking advantage of lower input prices in pursuit of their own self-interest would return output and prices to a state of equilibrium, unless otherwise prevented from doing so. Keynes believed that the Great Depression seemed to counter this theory. Output was low and unemployment remained high during this time. The Great Depression inspired Keynes to think differently about the nature of the economy. From these theories, he established real-world applications that could have implications for a society in economic crisis.

Keynes rejected the idea that the economy would return to a natural state of equilibrium. Instead, he argued that once an economic downturn sets in, for whatever reason, the fear and gloom that it engenders among businesses and investors will tend to become self-fulfilling and can lead to a sustained period of depressed economic activity and unemployment. In response to this, Keynes advocated a countercyclical fiscal policy in which, during periods of economic woe, the government should undertake deficit spending to make up for the decline in investment and boost consumer spending in order to stabilize aggregate demand.

Keynes was highly critical of the British government at the time. The government greatly increased welfare spending and raised taxes to balance the national books. Keynes said this would not encourage people to spend their money, thereby leaving the economy unstipulated and unable to recover and return to a successful state. Instead, he proposed that the government spend more money and cut taxes to turn a budget deficit, which would increase consumer demand in the economy. This would, in turn, lead to an increase in overall economic activity and a reduction in unemployment.

Keynes also criticized the idea of excessive saving, unless it was for a specific purpose such as retirement or education. He saw it as dangerous for the economy because the more money sitting stagnant, the less money in the economy stimulating growth. This was another of Keynes's theories geared toward preventing deep economic depressions.

Many economists have criticized Keynes's approach. They argue that businesses responding to economic incentives will tend to return the economy to a state of equilibrium unless the government prevents them from doing so by interfering with prices and wages, making it appear as though the market is self-regulating. On the other hand, Keynes, who was writing while the world was mired in a period of deep economic depression, was not as optimistic about the natural equilibrium of the market. He believed the government was in a better position than market forces when it came to creating a robust economy.

Keynesian Economics and Fiscal Policy

The multiplier effect, developed by Keynes's student Richard Kahn, is one of the chief components of Keynesian countercyclical fiscal policy. According to Keynes's theory of fiscal stimulus, an injection of government spending eventually leads to added business activity and even more spending. This theory proposes that spending boosts aggregate output and generates more income. If workers are willing to spend their extra income, the resulting growth in the gross domestic product (GDP) could be even greater than the initial stimulus amount.

The magnitude of the Keynesian multiplier is directly related to the marginal propensity to consume. Its concept is simple. Spending from one consumer becomes income for a business that then spends on equipment, worker wages, energy, materials, purchased services, taxes and investor returns. That worker's income can then be spent and the cycle continues. Keynes and his followers believed individuals should save less and spend more, raising their marginal propensity to consume to effect full employment and economic growth.

In this theory, one dollar spent in fiscal stimulus eventually creates more than one dollar in growth. This appeared to be a coup for government economists, who could provide justification for politically popular spending projects on a national scale.

This theory was the dominant paradigm in academic economics for decades. Eventually, other economists, such as Milton Friedman and Murray Rothbard, showed that the Keynesian model misrepresented the relationship between savings, investment, and economic growth. Many economists still rely on multiplier-generated models, although most acknowledge that fiscal stimulus is far less effective than the original multiplier model suggests.

The fiscal multiplier commonly associated with the Keynesian theory is one of two broad multipliers in economics. The other multiplier is known as the money multiplier. This multiplier refers to the money-creation processes that result from a system of fractional reserve banking. The money multiplier is less controversial than its Keynesian fiscal counterpart.

Keynesian Economics and Monetary Policy

Keynesian economics focuses on demand-side solutions to recessionary periods. The intervention of government in economic processes is an important part of the Keynesian arsenal for battling unemployment, underemployment, and low economic demand. The emphasis on direct government intervention in the economy often places Keynesian theorists at odds with those who argue for limited government involvement in the markets.

Keynesian theorists argue that economies do not stabilize themselves very quickly and require active intervention that boosts short-term demand in the economy. Wages and employment, they argue, are slower to respond to the needs of the market and require governmental intervention to stay on track. Furthermore they argue, prices also do not react quickly, and only gradually change when monetary policy interventions are made, giving rise to a branch of Keynesian economics known as Monetarism.

If prices are slow to change, this makes it possible to use money supply as a tool and change interest rates to encourage borrowing and lending. Lowering interest rates is one way governments can meaningfully intervene in economic systems, thereby encouraging consumption and investment spending. Short-term demand increases initiated by interest rate cuts reinvigorate the economic system and restore employment and demand for services. The new economic activity then feeds continued growth and employment.

Without intervention, Keynesian theorists believe, this cycle is disrupted and market growth becomes more unstable and prone to excessive fluctuation. Keeping interest rates low is an attempt to stimulate the economic cycle by encouraging businesses and individuals to borrow more money. They then spend the money they borrow. This new spending stimulates the economy. Lowering interest rates, however, does not always lead directly to economic improvement.

Monetarist economists focus on managing the money supply and lower interest rates as a solution to economic woes, but they generally try to avoid the zero-bound problem. As interest rates approach zero, stimulating the economy by lowering interest rates becomes less effective because it reduces the incentive to invest rather than simply hold money in cash or close substitutes like short term Treasuries. Interest rate manipulation may no longer be enough to generate new economic activity if it cannot spur investment, and the attempt at generating economic recovery may stall completely. This is a type of liquidity trap.

When lowering interest rates fails to deliver results, Keynesian economists argue that other strategies must be employed, primarily fiscal policy. Other interventionist policies include direct control of the labor supply, changing tax rates to increase or decrease the money supply indirectly, changing monetary policy, or placing controls on the supply of goods and services until employment and demand are restored.