FACULTY OF JURIDICAL SCIENCES

Lecture-5

POST-KEYNESIAN THEORY

Post-Keynesian Economics (PKE) is a school of economic thought which builds upon John Maynard Keynes's and Michal Kalecki's argument that effective demand is the key determinant of economic performance. PKE rejects the methodological individualism that underlies much of mainstream economics. Instead, PKE argues that fundamental uncertainty and social conflict require an analysis of human behavior based on social conventions and heuristics embedded in specific institutional contexts. Social interactions give rise to distinct systemic properties at the macroeconomic level. For example, if all individuals attempt to increase their saving simultaneously, total saving at the aggregate level may not increase because aggregate demand and output will decline (the paradox of thrift).

The principle of effective demand posits that economic activity is driven primarily by expenditure decisions. In particular, investment is held to be a key determinant of demand, output and employment. In contrast to the neoclassical (mainstream) approach, investment is not constrained by the availability of saving, but may be constrained by the availability of credit. Investment decisions are regarded as driven at least in part by 'animal spirits'. As such, economic activity cannot be reduced to the outcome of some optimizing behavior but instead depends upon expectations and sentiment, income distribution and financial conditions. Income distribution plays a prominent role in PKE because expenditure propensities differ between groups of individuals and firms. Consumption propensities vary by income level or income classes while investment propensities are affected by firm size and strength. Shifts in the distribution of income and wealth therefore affect aggregate demand.

PKE also has a distinctive take on monetary theory. This take focuses on holding money as protection against uncertainty (liquidity preference), money as a denominator of contracts, and the use of money as a means of payment. Money in a modern economy mostly consists of bank deposits which are created by commercial banks as a side effect of their lending decisions. The money supply is not therefore under the direct control of central banks or governments. The flexibility of the monetary and financial system allows for the dynamism of capitalist economies – since credit can be used to finance investment – but it can also give rise to financial instability and credit-driven bubbles. In times of uncertainty a rush to liquidity can result in higher interest rates and falling asset prices, and hence to financial instability.

PKE regards modern economies as systems of cash-flows, not systems of equilibria between real variables. Concepts such as the 'natural' rate of interest (and the associated 'natural' rate of unemployment) are therefore rejected – the rate of interest is not the equilibrium price of present versus future consumption but is the price of liquidity, a monetary variable with distributional effects which is strongly influenced by the decisions of the central bank.

Unlike neoclassical economics, PKE does not regard wage flexibility and labour market structural reforms as a route to full employment but instead sees employment as a reflection of demand conditions in the goods market. As such, capitalist economies have no automatic mechanism towards full employment. PKE rejects the view that wage cuts can be used as a way to reduce unemployment since such cuts will lead to reductions in consumption expenditures and thus to aggregate demand. PKE holds that this is the case not only in the short run but also over longer periods because of hysteresis mechanisms such as social wage norms and demand-driven productivity growth. The supply side cannot be considered in isolation but is likely to be affected by demand conditions. The economy is a path-dependent system.

PKE builds on the work of J.M. Keynes as well as other key figures such as Michal Kalecki, Joan Robinson and Nicholas Kaldor. The term PKE came into use from the 1970s onwards when the narrowing of mainstream economics led to the formation of PK academic journals and conferences. From the outset, PKE was opposed to the appropriation, in degenerate form, of Keynesian arguments by the mainstream. While there are similarities in short run analysis to the so-called New Keynesian Economics, there are also fundamental differences: PKE rejects the need for optimizing micro foundations and the concept of long-run supply-side equilibrium; it highlights the possibility of financial instability; and it regards involuntary unemployment as a normal feature of market economies that needs to be explained. PKE maintains that aggregate demand matters both in the short and in the long run.