Introduction to Keynesian theory and Keynesian Economic Policies in Europe

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Outline

• Fundamental uncertainty
• Social conflict
• Effective demand
• Investment → savings
• Involuntary unemployment
• Credit → money
• Financial instability
• Keynesian policy package
• European economic policy package
Post Keynesian Economics

Effective demand

Fundamental uncertainty

Social conflict
Fundamental uncertainty

• ‘we simply don’t know’
  • That’s a statement about the world, not about human cognitive abilities

• People can’t be ‘rational’, instead
  • They rely on conventions = look what other people are doing (social norms, anchoring, institutions)
  • Assume that the future is similar to the past (adaptive expectations)
  • Conventions can change rapidly (herd behaviour)

• Money as a means to deal with uncertainty → liquidity preference
  • Possibility of liquidity crises and panic

• Investment demand driven by animal spirits
  • Can’t make a ‘rational’ decision about long time horizon
Social conflict

- Distributional conflict
- PK models: often 3 classes: workers, capital, rentiers
  - Capital hires labour; firing threat as disciplinary advise
  - Capitalists make investment decisions
  - Rentiers advance capital and receive interest + dividend payments
  - Have different income propensities
- Institutions regulate and mediate conflicts
- Inflation as the outcome of unresolved distributional conflicts
Effective demand

• \( I(Y) = S(Y) \)
• Investment \( \rightarrow \) savings via multiplier process
• Inv not constrained by saving, but possibly by the availability of finance
• Investment expenditures are the single most important determinant of fluctuations in GDP
• Have strong non-rational component
• Private goods market equilibrium will in general not be at full employment equilibrium
Involuntary unemployment

- Labour market is not self-adjusting; cannot serve as the anchor of the economy
- Wage contract are nominal contracts
- Wage cuts $\rightarrow$ reduction in consumption demand
  - $\rightarrow$ downward pressure on prices
  - $\rightarrow$ possibility of debt-deflation spiral
- Real wage cut: workers have higher MPC than capitalist
  - $\rightarrow$ real wage cut will be contractionary unless investment is very sensitive to the profit margin
- No self adjustment towards full employment
- Labour market dragged along with goods market; strong hysteresis
Money & finance

• Endogenous money: credit $\rightarrow$ money
• CB sets the interest (base) rate
• Private financial institution mark up according to their liquidity preference (risk premium)
• Financial market prone to instability b/e forward looking (fundamental uncertainty)
  • Debt cycles a la Minsky
• Inflation as the outcome of unresolved distributional confictions: if capital, labour and finance can’t agree on their income shares
# Neoclassical vs Keynesian theory

<table>
<thead>
<tr>
<th></th>
<th>Neoclassical theory</th>
<th>Keynesian theory</th>
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<tbody>
<tr>
<td><strong>Key concepts</strong></td>
<td>Rational behaviour, equilibrium</td>
<td>Effective demand, ‘animal spirits’</td>
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<tr>
<td><strong>Behaviour</strong></td>
<td>Rational behaviour by selfish individuals</td>
<td>‘animal spirits’ (non-rational behaviour) and conventional</td>
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<tr>
<td><strong>Markets</strong></td>
<td>Market clearing ← prices adjustment</td>
<td>Some markets don’t clear</td>
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<tr>
<td><strong>Money</strong></td>
<td>Classical dichotomy (money is neutral)</td>
<td>‘money matters’ (has real effects)</td>
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<tr>
<td><strong>unemployment</strong></td>
<td>Voluntary or due to rigidities</td>
<td>Involuntary, due to lack of demand on goods markets</td>
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<tr>
<td><strong>policy</strong></td>
<td>Laissez faire: markets are self-regulating and gov’t should not intervene</td>
<td>market economies are unstable and result in unemployment → gov’t should intervene</td>
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</tbody>
</table>
Schools of thought in macroeconomics

- Marx
- Keynes
- Post-Keynesians
- Synthesis Keynesians
- New Keynesians
- Neoclassical
  - New Classical Econ
    - Monetarism
    - Rational Expectations
    - RBC
New Keynesians

• in 1980s (Mankiw, Blanchard, Stiglitz, Fisher)
• reaction to New Classicals - accept microfoundations and often rational expectations
• but assumes (or derives) imperfect markets –
  • menu costs,
  • NAIRU, insider outsider models
  • credit rationing / asymmetric information
• 1990s: “New Consensus Model” (New Keynesian-Neoclassical Synthesis): again short run/long run dichotomy, but with strict microfoundations
• 2008-? Crisis
EMU policy package

- No central fiscal policy
- Restrained national fiscal policy (SGP)
- No bail out clause
- Monetary policy: inflation targeting
- EU/EC has encouraged financial integration (FSAP)
- Labour market flexibility

- In the crisis: deflationary adjustment (‘internal devaluation‘) in the deficit countries.
EMU. criticism

- Is monetary union a good idea to begin with?
- Post-Keynesians (Arestis, Sawyer), Euro-memo (Huffschmied), H. Flassbeck
- Relies exclusively on labour market flexibility in case of asymmetric shocks
- Deflationary bias: the CA deficit countries have pressure to adjust
- No coordination of wage policy: increasing imbalances + race to the bottom
- No plan B for crisis scenario
A PK reform of the Euro system

• More fiscal integration: A European welfare state
  • progressive taxes (e.g. Profit tax) to finance social expenditures
  • automatic transfer from prosperous to poor regions without bail out and increasing debt

• Wage policy
  • Consider equity and (asymmetrically) trade balances
  • European system of coordinated wage bargaining
  • *Higher wages in trade surplus countries!*

• Speed bumps for finance
  • FTT, asset-based reserve requirements
  • To counteract the asset price-credit loop
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<th>Policy Area</th>
<th>European Policy Mix</th>
<th>Post Keynesian Policy Mix</th>
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<tr>
<td>EU fiscal policy</td>
<td>Hardly existing</td>
<td>Countercyclical fiscal policy; strong central fiscal policy</td>
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<tr>
<td></td>
<td>No bail out clause</td>
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<tr>
<td>National fiscal policy</td>
<td>Restrained fiscal policy: balanced budget in constitutions</td>
<td>Needs to be coordinated</td>
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<tr>
<td>Monetary policy</td>
<td>Inflation targeting</td>
<td>Has to support growth; need higher inflation target to allow rebalancing</td>
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<td>Labour market</td>
<td>Encourage ‘labour market flexibility’</td>
<td>Institution building</td>
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<tr>
<td>Financial market</td>
<td>Has encouraged financial integration and liberalisation</td>
<td>Regulated finance; emulate national financial markets (transaction tax; asset-specific reserve requirements)</td>
</tr>
<tr>
<td>Effective crisis strategy</td>
<td>‘internal devaluation’</td>
<td>Inflationary adjustment in surplus countries</td>
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