Introduction to Keynesian theory and Keynesian Economic Policies

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Outline

• foundations
  • Fundamental uncertainty
  • Social conflict
  • Effective demand
• Macroeconomics
  • Investment → savings
  • Involuntary unemployment
  • Credit → money
  • Financial instability
• Context: Synthesis and New Keynesians
• Economic Policy
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
- Note: workers and uncertainty? job insecurity
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 → reduction in consumption demand
  • → downward pressure on prices
  • → possibility of debt-deflation spiral
• Real wage cut: workers have higher MPC than capitalist
  • → 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 conflicts: if capital, labour and finance can’t agree on their income shares
PK: development and streams

• 1950s + 60s: Keynes in the long run – distribution and growth; Capital Controversies; critique of Synthesis; Cambridge

• 70s + after: formation of PK school (journals); spreading out
  • Conflict inflation; endogenous money
  • Financial instability (Minsky)
  • Shift towards short/medium run analysis (Kaleckian models): distribution and demand, wage-led growth
  • More on economic policy, more empirical
PK streams + further readings

- Sraffians
- Monetary Keynesians
  - Minsky
- Kaleckians

- Lavoie: Introduction to Post Keynesian Economics
- King: History of Post Keynesian Economics
- Keynes, Kalecki
# Neoclassical vs Keynesian theory

<table>
<thead>
<tr>
<th>Key concepts</th>
<th>Neoclassical theory</th>
<th>Keynesian theory</th>
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<tbody>
<tr>
<td>Behaviour</td>
<td>Rational behaviour by selfish individuals</td>
<td>‘animal spirits’ (non-rational behaviour) and conventional</td>
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<tr>
<td>Markets</td>
<td>Market clearing ← prices adjustment</td>
<td>Some markets don’t clear</td>
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<tr>
<td>Money</td>
<td>Classical dichotomy (money is neutral)</td>
<td>‘money matters’ (has real effects)</td>
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<tr>
<td>unemployment</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>policy</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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Schools of thought in macroeconomics

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

• in 1980s (Mankiw, Blanchard, Stiglitz, Fisher)
• reaction to New Classical - 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
PK and mainstream economic policy

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<th>Mainstream Policy Mix</th>
<th>Post Keynesian Policy Mix</th>
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<tr>
<td><strong>Overall aim</strong></td>
<td>Efficiency (minimal interference in markets)</td>
<td>Full employment</td>
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<tr>
<td><strong>fiscal policy</strong></td>
<td>Balanced budgets (‘sound fiscal policy’)</td>
<td>Countercyclical fiscal policy to ensure <em>full employment</em></td>
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<td><strong>Monetary policy</strong></td>
<td>Inflation targeting</td>
<td>Has to support growth;</td>
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<td></td>
<td></td>
<td>In recession with debt hangover: higher inflation allows rebalancing</td>
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<tr>
<td><strong>Labour market</strong></td>
<td>Encourage ‘labour market flexibility’</td>
<td>Institution building</td>
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<tr>
<td></td>
<td>Wage as a cost factor</td>
<td>Wages as source of demand</td>
</tr>
<tr>
<td><strong>Financial market</strong></td>
<td>financial liberalisation, trusts efficiency of financial markets</td>
<td>Regulate finance</td>
</tr>
</tbody>
</table>
Reading suggestions

• Keynes: General Theory of Employment, Interest and Money
• Kalecki: Theory of Economic Dynamics
• Robinson: Accumulation of Capital
• Minsky: Stabilizing an Unstable Economy

• Lavoie: Introduction to Post Keynesian Economics
• Hein & Stockhammer: New Guide to Keynesian Macroeconomics and Economic Policies
• King: History of Post Keynesian Economics
Appendix
PK goods market: basic multipliers

- Standard Keynesian multiplier
- \( C = c_1 Y + c_0 \)
- \( I = I_0 \)
- In equilibrium
- \( Y = C + I_0 \)
- \( Y^* = \frac{1}{1-c_1} (C_0 + I_0) \)
Different consumption propensities for profit income and wage income

• \( C = c_W \cdot W + C_R \cdot R \) \( \pi = R/Y \) (profit share)
• \( C = c_W \cdot (1-\pi) \cdot Y + c_R \cdot \pi \cdot Y \)
• \( Y = c_W \cdot (1-\pi) \cdot Y + c_R \cdot \pi \cdot Y + c_0 + I_0 \)
• \( Y^* = 1/(1 - c_W + \pi(c_W - c_R)) \cdot (c_0 + I_0) \)

• If workers don’t save: \( c_W = 0 \)
• \( Y^* = 1/\pi (1-c_R) \cdot (c_0 + I_0) \)
• \( dY^*/d I_0 = 1/\pi (1-c_R) \)
• \( dY^*/d\pi = -1/\pi^2 (1-c_R) < 0 \)
Wage-led versus profit-led demand

- $Y = C + I + NX$
- Increase in profit share
  - Negative effect on consumption
  - Positive effect on investment
  - Positive effect on net export (for an individual country)
- $Y = C(Y, \pi) + I(Y, i, \pi) + NX(Y, \pi; Y^W, ex)$
  - $Y$ income, $i$. Interest rate, $\pi$.profit share, $D$.debt, $Y^W$.world GDP, $ex$.exchange rate, $P$. price level, $p$.inflation
- $\frac{dY^*}{d\pi} = \frac{h_1}{1-h_2}$
- $h_2 = \frac{dC/dY + dl/dY + dNX/dY}{dC/d\pi + dl/d\pi + dNX/d\pi}$
- $h_1 = \frac{dC/d\pi + dl/d\pi + dNX/d\pi}{h_1}$
- Negative + Positive + Positive = ??
- If $h_1 > 0$ profit-led demand
- If $h_1 < 0$ wage-led demand
# Net Effects: $\Delta Y/\Delta WS$

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<th>EU 12 (openness 15%)</th>
<th>Austria (openn. 50%)</th>
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<tr>
<td>Consumption</td>
<td>0.37</td>
<td>0.36</td>
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<tr>
<td>Investment</td>
<td>-0.07</td>
<td>-0.15</td>
</tr>
<tr>
<td>Domestic sector</td>
<td>0.30</td>
<td>0.21</td>
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<tr>
<td>Net exports</td>
<td>-0.09</td>
<td>-0.39</td>
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<tr>
<td>Total effect</td>
<td>0.21</td>
<td>-0.18</td>
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