Introduction to Keynesian theory and Keynesian Economic Policies

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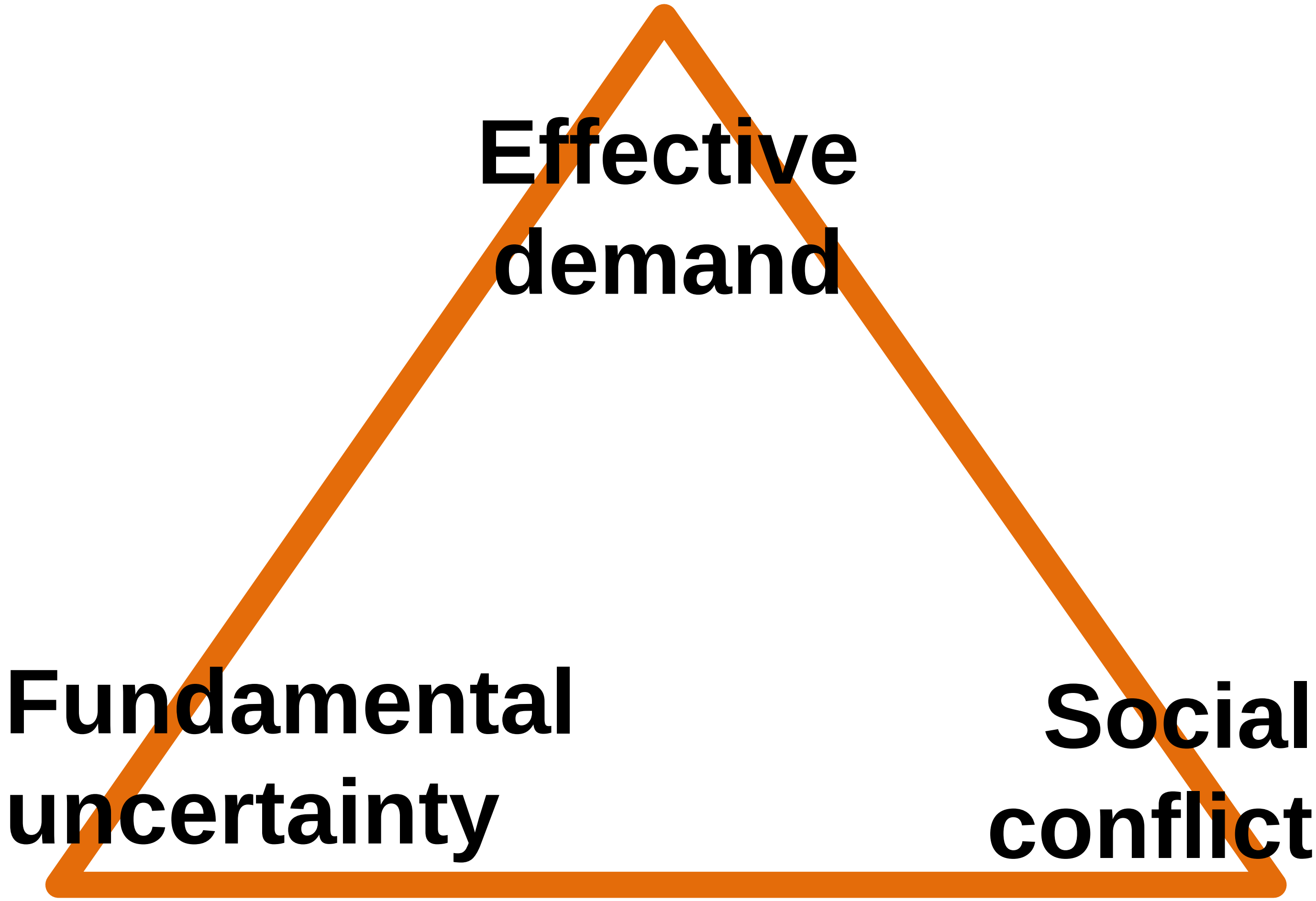
Outline

- foundations
  - Fundamental uncertainty
  - Social conflict
  - Effective demand
- Macroeconomics
  - Investment $\longrightarrow$ savings
  - Involuntary unemployment
  - Credit $\longrightarrow$ money
  - Financial instability
- Context: Synthesis and New Keynesians
- Economic Policy

Post Keynesian Economics



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 → 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 conflictions: 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
-

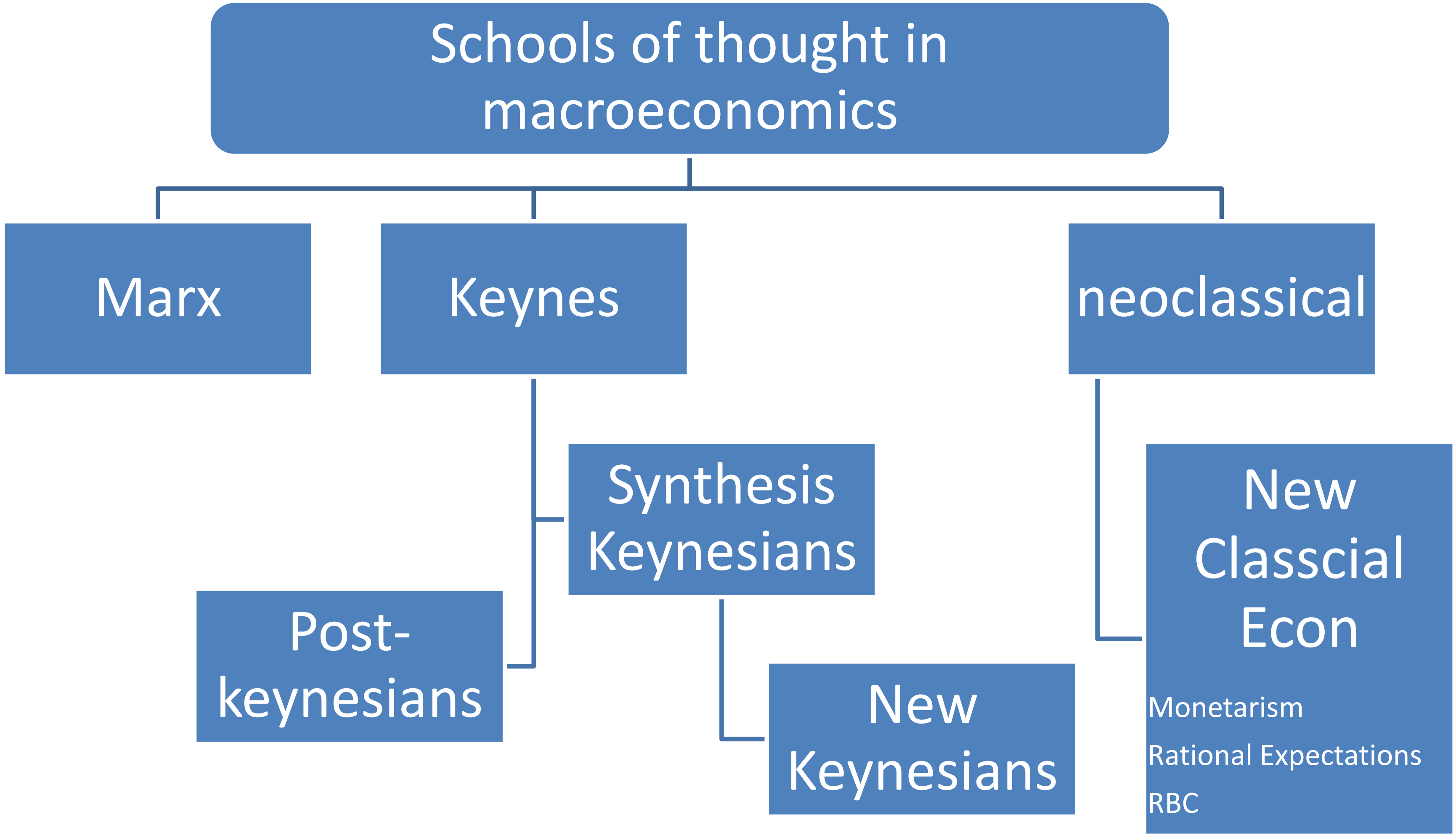
PK streams + further readings

- Sraffians
- Monetary Keynesians
  - Minsky
- Kaleckians

- Lavoie: Introduction to Post Keynesian Economics
- Hein & Stockhammer: New Guide to Keynesian Macroeconomics and Economic Policies
- King: History of Post Keynesian Economics
- Keynes, Kalecki

Neoclassical vs Keynesian theory

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


Schools of thought in macroeconomics
Marx
Keynes
neoclassical
Synthesis Keynesians
Post-keynesians
New Keynesians
New Classcial 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

PK and mainstream economic policy

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

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

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PK goods market: basic multipliers

- Standard Keynesian multiplier
- $C = c_1.Y + c_0$
- $I = I_0$
- In equilibirum
- $Y = C + I_0$
- $Y^* = 1/(1-c_1).(C_0+I_0)$

Different consumption propensities for profit income and wage income

- $C = c_W.W + C_R.R$ $\pi=R/Y$ (profit share)
- $C = c_W.(1-\pi).Y + c_R.\ \pi.Y$
- $Y = c_W.(1-\pi).Y + c_R.\ \pi.Y + c_0 + I_0$
- $Y^* = 1/(1- c_W +\pi[c_W - c_R]).(c_0 + I_0)$

- If workers don't save: $c_W = 0$
- $Y^* = 1/\pi(1-c_R).(c_0 + I_0)$
- $dY^*/d\ I_0 = 1/\pi(1-c_R)$
- $dY^*/d\pi = -1/\pi^2(1-c_R) < 0$

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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, π..profit share, D..debt, Y^W..world GDP, ex..exchange rate, P.. price level, p..inflation
- $dY^*/d\pi = h_1/(1-h_2)$
- $h_2 = dC/dY + dI/dY + dNX/dY$
- $h_1 = dC/d\pi + dI/d\pi + dNX/d\pi$
- neg + pos + pos = ??
  - If h1 > 0 profit-led demand
  - If h1 < 0 wage-led demand

Net Effects: ΔY/ΔWS

	Effects on private excess demand	
	EU 12 (openness 15%)	*Austria (openn. 50%)*
Consumption	0.37	0.36
Investment	-0.07	-0.15
Domestic sector	*0.30*	*0.21*
Net exports	-0.09	-0.39
Total effect	0.21	-0.18

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