PO230 States and Markets: An Introduction to International Political Economy
Seminar Week 9. Keynesianism: Ideas and Practice

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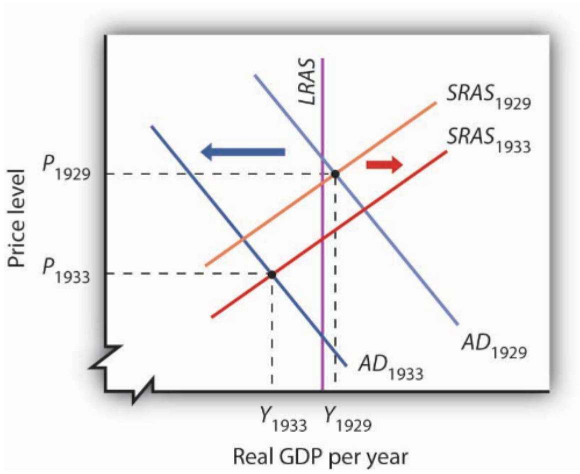
What is Keynes responding to?

The vicious cycle of depression- the lack of market led adjustments
- Lack of consumer demand. How does behaviour change in the face of uncertainty? Individual rationality bad for the community (aggregation).
  "Of the maxims of orthodox finance none, surely, is more anti-social than the fetish of liquidity… it forgets that there is no such thing as liquidity of investment for the community as a whole" (Keynes, 1936).
- Lack of lending for investments
- Lack of spending

What should a reboot look like? What happened in 1929?



Slumping aggregate demand brought the economy well below the full-employment level of output by 1933. The short-run aggregate supply curve increased as nominal wages fell. In this analysis, and in subsequent applications in this chapter of the model of aggregate demand and aggregate supply to macroeconomic events, we are ignoring shifts in the long-run aggregate supply curve in order to simplify the diagram.

Other factors contributed to the sharp reduction in aggregate demand. The stock market crash reduced the wealth of a small fraction of the population (just 5% of Americans owned stock at that time), but it certainly reduced the consumption of the general population. The stock market crash also reduced consumer confidence throughout the economy. The reduction in wealth and the reduction in confidence reduced consumption spending and shifted the aggregate demand curve to the left.

Fiscal policy also acted to reduce aggregate demand. As consumption and income fell, governments at all levels found their tax revenues falling. They responded by raising tax rates in an effort to balance their budgets. The federal government, for example, doubled income tax rates in 1932. Total government tax revenues as a percentage of GDP shot up from 10.8% in 1929 to 16.6% in 1933. Higher tax rates tended to reduce consumption and aggregate demand. (From https://open.lib.umn.edu/principleseconomics/chapter/32-1-the-great-depression-and-keynesian-economics/)

An alternative approach would be to do nothing. This would have caused wages to and prices to fall (making supply curve rise i.e. shift right). We do not know if such an approach might have worked as federal policies enacted in 1933 prevented wages and prices from falling further than they already had.

So what is the role of the state? Does the state know better than the market?

Say's law and Keynes
"When good are produced by firms in the economy, they pay reward to the factors of production. The households after receiving rewards of the factors of production spend the amount on the purchase of goods and services. From this it follows that each product produced in the economy, creates demand equal to the value in the market."

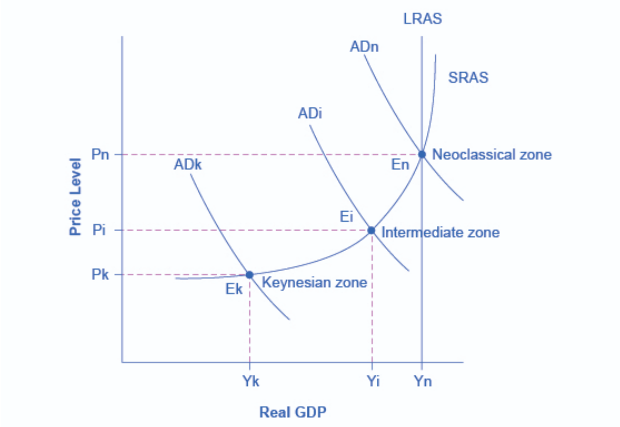
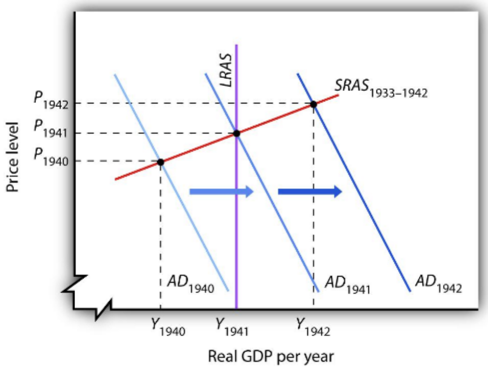


Image credit: *Figure 1* in "Keynes' Law and Say's Law in the AD/AS Model" by OpenStaxCollege, CC BY 4.0

The Keynesian zone occurs at low levels of output on the SRAS curve where it is fairly flat, so movements in aggregate demand will affect output but have little effect on the price level. **Say's Law** states that supply creates its own demand; changes in aggregate demand have no effect on real gross domestic product or employment, only on the price level.
Say's Law can be shown on the vertical neoclassical zone of the aggregate supply curve. The neoclassical zone occurs at the right of the SRAS curve where it is fairly vertical, so movements in aggregate demand will affect the price level but have little impact on output.

Some economists believe that the economy is strongly predisposed to be in one zone or another. Hard-line Keynesian economists believe that economies are in the Keynesian zone most of the time; they view the neoclassical zone as a theoretical abstraction. On the other hand, hard-line neoclassical economists argue that economies are in the neoclassical zone most of the time and that the Keynesian zone is a distraction. **Is it all a matter of belief?**

What happened next?
Why did economics shift away from Keynesianism?



Increased U.S. government purchases, prompted by the beginning of World War II, ended the Great Depression. By 1942, increasing aggregate demand had pushed real GDP beyond potential output.

Why might Keynes' ideas that markets are often in disequilibria be politically dangerous?

What is Keynes's critique of neo-liberal orthodoxy?

The orthodoxy suggests that:

a. Pure competition exists
b. Wages and prices are flexible
c. Self interest

d. No government interference

Critique of Say's Law

- Savings may not equal investment
- Cutting wages will not cure recession.
- Markets are not self-correcting
- The limitation of effective demand prevents the full use of potential resources.

How does the international economy need to be configured to enable 'domestic' Keynesian economic policies?