‘The debates between Keynes and the “classical” economists are only of interest to economic historians; they are of no relevance to modern policymakers.’
Discuss.

In this essay I will be discussing the different views amongst the Keynes and the ‘classical’ economists. I will be identifying the main points in the debates between the two, and analysing them to see if they have any relevance to modern policymakers. To do this I will look at the different policies that were proposed by the two during the unemployment crisis in the 1930’s and then compare to see if they hold any importance in the current macroeconomics environment.

The term ‘classical’ is used in economics when one is referring to the works of the earlier economists such as Professor Pigou, Alfred Marshall, Thomas Malthus and John Stuart Mill, Adam Smith and David Ricardo.
The classical theory model was used to make government policies up until 1930’s, when the Keynes theories came in to practice. Earlier classical economists such as Adam Smith and David Ricardo stated that the economy will achieve its greatest benefits if individuals acted upon their ‘self-interest’ in making a profit.

'He intends only his own security, only his own gain. And he is in this led by an invisible hand to promote an end which was no part of his intention’
(Adam Smith, 1776). [i]

The above quote shows how Adam Smith described this by using his theory of the ‘invisible hand’ to back it up.

The classical model of the economy suggests that all markets are always at equilibrium. The labor market failing to reach equilibrium level cannot exist in the classical model because of the competitive exchange equilibrium. This way quantities and prices can adjust accordingly. The classical model is for a closed economy and the variable are employment, real and nominal wages, prices levels, interest rates and real output.

The early economist also believed that the economy was always at the equilibrium level or was working towards it. They claimed that the equilibrium in labour market is ensured by changes in wages. They also believed that the capital market would reach equilibrium stage when there were changes in the interest rate. In the case of disequilibrium using the classical model, higher interest rates means more savings and less investments and lower interest rates means less savings and more investments. A similar case would happen in the labour market, where if there was a rise or fall in the demand for labour then this would mean a rise and fall in wages, and therefore keeping the labour force at full employment level.
The classical model’s analysis of the economic behaviour can be summarised into ‘two fundamental theoretical building blocks’. These are aggregate market for labour and Say’s Law.

The aggregate market for labour can be further broken down into different assumptions or 'postulates'. One assumption is when the demand for labour is planned by 'profit-maximising' firms who operate as 'price-takers'. This is in the goods market and the labour market. The other assumption includes both the supply of labour needed to maximise the utility for households as well as the 'market-clearing' equilibrium. The two assumptions will only work if competition is imperfect and if the labour market clears.
The second 'building block' in the classical model is Say's Law. This suggests that supply can create its own demand. In the classical model it is necessary to have Say's Law if the labour market is to reach equilibrium. This can only happen if there is aggregate demand. In order for this to happen all the income in the economy must be spent and therefore this would lead to investment equalling savings. Loan-able funds theory is used to justify Say's Law. This is when firms and households allocate their incomes and financial sources according to the interest rate. [ii]

Professor Pigou is also said to be one of the main writers of the 'classical' model. Pigou's views stressed that any problems in the economy were to do with the supply side. The classical economists believe that all markets are competitive and that firms and households try to maximise their income and profits as much as they can. They also believe that workers try to maximise their leisure time (utility).

In comparison to the classical model, the Keynes economic model has different views and this has caused a lot of debate between then two. John Maynard Keynes is the founder of the Keynesian school of thought. His major contribution to the subject of economics is *The General Theory of Employment, Interest and Money* published in 1936. In this is criticises and questions the theories and ideas of the classical economists. This caused many debates between himself and the followers of the classical economists. Where the classical economists had many theories like the supply side theory and Say's Law, Keynes had the fiscal policy. This was the government intervention policy. Keynes believed that an economy which is run by monetary policies is vulnerable against market failures. He also argued that it was impossible for any economy to self correct itself when in trouble. This type of economy would just lead to a big economical and financial collapse. In his General Theory he totally disagrees with the classical economists. Author James Tobin had this to say about Keynes' views:

"denies the existence of self-correcting market mechanisms which would eliminate excess supplies of labor and other productive resources…in a competitive economy….He does not say merely that this process may take a very long time; he says that it does not work at all"
(Tobin, 1980a, p1-2)[iii]

The quote above explains how Keynes felt about the views of the classical economist. This sparked up further debates between them.

The 1920's and 30's saw the period of the Great Depression in America, Britain and most parts of Europe. This caused excessive poverty and homelessness. It also caused an unemployment crisis. The classical economists at this time were failing to explain why this was happening and why there were thousands of people without jobs. Their theory of the economy always being at equilibrium status was contradicting itself,

because if the economy was at equilibrium status then how did it reach that point when the rate of unemployment was excessively high. This is another topic of debate that sparks up between the classical economists and the Keynesians.

"The postulates of classical theory are applicable to a special case only and not the general case, the situation which it assumes being a limiting point of the possible positions of equilibrium."
(Keynes, 1936, p.6)[iv]

The above quote taken from "The General Theory of Employment, Interest and Money" by Keynes, is suggesting that classical theorists have come up with policies that work in special case economies and since we don't live in a special case economy, their ideas can't possibly work. The economy needed a policy that would apply to general cases in able to stabilise.
Again Pigou's theory of the supply-side of the economy was used to try to explain the reasons behind the crisis. The argument of the supply-side theory was that if workers were to offer firms extra labour for what the firms needed, than this would cause unemployment as the firms can only take on the amount of workforce they need and can afford. This would then increase the competition for employment as it suggested that workers would have been desperate to work. The only way jobs could be created for this extra labour supply would be if wages were lowered so that firms could afford to take on more staff. This would cause outrage with the existing staff and they would either leave employment a one firm to seek employment elsewhere for a better rate or they would reduce their hours. Either way it would create extra jobs, and so firms would demand labour. This way the extra labour supply would automatically decrease and equilibrium status would be achieved again. With these views the classical economists believed that 'involuntary unemployment was a theoretical impossibility'.[v]
The fiscal policy is a method that Keynesians prefer as they believe that government intervention is necessary in times of crisis like the Great Depression. Keynes argument was that governments must intervene as the investments from the private sector were not enough to save the economy. The Keynesians way of saving the economy was for the government to invest, in order to create jobs and raise the national income. In return individuals would have more to spend and would indeed spend more. This would cause a change in the aggregate demand which would then cause a 'multiplier effect'. The unused workforce who have gained employment and now have incomes would cause this affect.

In conclusion then, going back to the question 'The debates between Keynes and the "classical" economists are only of interest to economic historians; they are of no relevance to modern policymakers,' I have discussed the histories of both Keynesian policies and classical policies and I have discussed the debates. I found that though they have extremely different views about the economy, they can both work. Keynesian would work well in times of recession and unemployment crisis' and the classical can work for the inflation in the economy and for the supply-side. From this I have concluded that the debates and topics discussed are not just in the interest of economic historians but can actually be used by modern policymakers. They can take the theories from both these schools of thought and apply them as and where needed.

[i] Smith, Adam, (1776) - *An Inquiry into the Nature and Causes of the Wealth of Nations*, London

[ii] Gerrard Bill (Mar. 1995) The Economic Journal- Keynes, The Keynesians and the Classics: A Suggested Interpretation. vol 105 p445-458. Publishers royal Economic Society
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[iii] Tobin, James (1980a). Asset Accumulation and Economic Activity. Chicago: University Press.
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[iv] Keynes. J.M, (1936) The General Theory of Employment, Interest and Money.

[v] Fortin, Pierre. Graham, John, (May 2003) Keynes Resurrected. Working Paper No 20-21. UQAM Economics Department
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