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Introduction to Macroeconomics
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Keynesian Policy

Keynesianism is an economic thought, building upon the ideas of John Maynard Keynes. Keynesian economics is a theory of total spending in an economy and of its effects on output and inflation. This economic approach is characterized by a focus on aggregate demand, the amount firms and households plan to spend at each level of income, rather than supply. J. M. Keynes' book, *General Theory*, has proved to be probably the most significant social science study of the 20th century. It quickly and permanently changed the way the world looked at the economy and the role of the government. However, in practice, this economical view had proved itself to have its advantages as well as its disadvantages.

One of the key propositions of Keynesianism is that there is no natural tendency for capitalist market economies to correct economic stocks and maintain equilibrium at full employment. Before Keynes it was well known that there was a regular pattern of "boom and slump", but it was assumed that economies quickly righted themselves without government intervention. Keynes denied this. He stressed the role of government is "to run counter-cyclical budgets, rather than the permanent fiscal prudence advocated by others".

We cannot say that Keynesians advocate government spending, taxes, and the money supply every few months to keep the economy at full employment. Almost all economists, including most Keynesians, now believe that the government cannot know soon enough to adjust successfully. Three intervals make it unlikely that modification will work. First, there is an interval between the time that a change in policy is required and the time that the government distinguishes it. Second, there is an interval between when the government recognizes that a change in policy is required and when it takes action. The third interval comes between the time that policy is changed and when the changes affect the economy. Yet, many Keynesians still believe that these stabilization policies are not only defensible, but sensible.

In the twenties Keynes was a believer in the quantity theory of money (today called monetarism). In 1923 he wrote *Tract on Monetary Reform*, and later he published *Treatise on Money*, both on monetary policy. His major policy view was that the way to stabilize the economy was to stabilize the price level, and to do that the government's central bank must lower interest rates when prices tend to rise and when prices tend to fall.

The two fundamental postulates of Keynesian theories that critics condemn are: 1) Unemployment is caused by insufficient aggregate demand; and 2) The proper means to eliminate unemployment is for the government to increase aggregate demand through discretionary monetary and fiscal policies.

The early critics observed that Keynesians had not fully explained the micro foundations of their models, and that this fault of error led to dangerous long-run consequences. Unemployment is not caused by insufficient aggregate demand' it is caused by excessive wage rates. "Increasing aggregate demand only effects employment if, due to nominal wage rigidity, the real wage falls relative to prices".

Other critics of Keynesianism doubt that money illusion is possible or relevant Keynesians include, all economists agree that some positive amount of unemployment is the natural and inevitable result of freedom of contract, due to quits, dismissals, search, and other frictions. Moreover, all economists agree that a change in real factors ca affect the rates at which workers find and lose jobs; hence, there will always be some fluctuations in employment. Another group of critics have a distinctly different orientation. They argue that there are better means to cure unemployment than active fiscal and monetary policies. For example, they argue that active intervention makes the economy unstable, since policy can change with the opinions of politicians and the central bank. No one can know policy in advance, so they may take actions which are unwise in light of the policy that actually happens.

The two most important features of Keynesianism are: first that it introduces the notion of aggregate demand as the sum of consumption, investment, and government spending. Second, it shows that full employment could be maintained only with the help of government spending. Economists still argue about what Keynes thought caused high unemployment. Some think that Keynes attributed unemployment to wages that take a

long time to fall. But Keynes actually wanted wages not to fall, and advocated in the *General Theory* that wages be kept stable. A general cut in wages, he argued, would decrease income, consumption, and aggregate demand. This would offset any benefits to output that the lower price of labor might have contributed.

According to Keynesian theory, changes in aggregate demand, whether anticipated or unanticipated, have their greatest short-run impact on real output and employment, not on prices. The idea is portrayed in Philips curves that show inflation changing only slowly when unemployment changes. Keynesians believe that the short run lasts long enough to matter. They often quote Keynes's famous statement "in the long run, we are all dead" to make the point.

Anticipated monetary policy can produce real effects on output and employment only if some prices are rigid-if nominal wages do not adjust instantly. Otherwise, an injection of new money would change all prices by the same percentage. So Keynesian models generally either assumer or try to explain rigid prices or wages. Rationalizing rigid prices is hard to do because, according to standard microeconomic theory, real supplies and demands do not change if all nominal prices rise or fall proportionally. But Keynesians believe that, because prices are somewhat rigid, fluctuations in any component of spending-consumption, investment, or government expenditure- cause output to fluctuate. If government spending increases, for example, and all other components of spending remain constant, then output will increase.

Keynesians believe that prices and, especially, wages respond slowly to changes in supply and demand, resulting in shortages and surpluses, especially of labor. Even though monetarists are more confident than Keynesians in the ability of markets to adjust to changes in supply and demand, many monetarists accept the Keynesian position on this matter.

Keynesians don't think that the typical level of unemployment is ideal-party because unemployment is subject to change to the caprice of aggregate demand, and party because they believe that prices adjust only gradually. In fact, Keynesians typically see unemployment as both too high on average and too variable. Although they know that rigorous theoretical justification for these positions is hard to come by. Keynesians also

feel certain that periods of recession or depression are economic maladies, not efficient market responses to unattractive opportunities.

Many, but not all, Keynesians advocate activist stabilization policy to reduce the amplitude of the business cycle, with the rank among the most important of all economic problems.

Finally, and even less unanimously, many Keynesians are more concerned about combating unemployment than about conquering inflation. They have concluded from the evidence that the costs of low inflation are small. However, there are plenty of anti-inflation Keynesians. Most of the worlds current and past central bankers, for example, merit this title whether they like it or not. Needless to say, views on the relative importance of unemployment and inflation heavily influence the policy advice that economists give and that policymakers accept. Keynesians typically advocate more aggressively expansionist policies than non-Keynesians.

Keynesians' belief in aggressive government action to stabilize the economy is based on value judgment and on the beliefs that a) macroeconomic fluctuations significantly reduce economic well-being, b) the government is knowledgeable and capable enough to improve upon the free market, and c) unemployment is a more important problem than inflation.

In conclusion, Keynesian economics is basically a theory of total spending in the economy and of its effects on output and inflation.