

A Change in Macroeconomic Thinking

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Thomas Kuhn, in his seminal work entitled "The Structure of Scientific Revolutions," notes that when the progression of reality transcends and otherwise appears incompatible with the paradigms devised to explain such events, new venues of thought will be proposed. If these newly proposed paradigms are popularly perceived to explain the happenings under consideration better than those in existence, they will eventually displace them, becoming the accepted tool of analysis. The 1930s was such a period. A severe economic depression debilitated much of the industrialized world, adversely affecting nearly every economic indicator measured, most notably leaving unemployment levels at historically high levels. Accepted classical notions of supply and demand and the ability of markets to clear apparently were describing the economic operations in some mystical utopia. Adam Smith's "invisible hand" for equilibrating the markets of the modern economy had never been so invisible. As was evident, there were grave deficiencies between the accepted economic paradigms of the classical school and events in the real world. At about this time, a talented and vocal economic philosopher by the name of John Maynard Keynes, son of the notable economist John Neville Keynes, was enjoying the heyday of his professional career. When the dust had settled, the institution of modern political economy for the next thirty years had been revolutionized.

John Maynard Keynes' most notable disagreement with the classical school occurred over what was perhaps the most conspicuous economic problem of the time--employment, or lack thereof. The classical

economists had essentially taken Say's Law (the notion that supply creates its own demand) as the standard by which they performed their macroeconomic analysis. The classical school believed that the economy must automatically adjust to a position of full employment, and that at this position the interest rate would ensure that aggregate savings equaled aggregate investment. Savings, the classicists argued, was positively related to the interest rate by encouraging people to forsake current consumption for a greater amount of future consumption. Investment is negatively related to the interest rate as it alters the opportunity cost to firms of investment at the margin. If investment increases, the interest rate would rise, causing people to transfer a portion of the income from consumption into savings. Thus, as the loanable funds market ensured a ready demand for goods and services by balancing investment and consumption, free markets and rapid interest rate responses more or less guaranteed full employment.

Keynes protested the facile naiveté of the classical model of savings and investment determination, showing that investors' "animal spirits" and their desire for short-term gain cause investment decisions to revolve around "anticipating what average opinion expects the average rate to be," far adrift of even any recognition of interest rate levels. Keynes also believed that consumption and saving are functions of aggregate income, rather than the real interest rate as the classical school had contended. Thus, he asserted that a rise in the interest rate will cause no change in consumption and savings. With this new model dependent upon the income level,

Keynes saw no guarantee that savings and investment would necessarily be equal at a level of economic activity that produced full employment. Keynes showed that after a given level of income, the aggregate supply of goods and services begins to outstrip aggregate demand, which includes both the demand for consumption and investment goods and services. In other words, the aggregate cost of producing that higher level of output would exceed the receipts obtainable from consumption and investment expenditures at that level. In such a case, unsold inventories would build up, forcing entrepreneurs to cut back production to the level at which aggregate demand and aggregate supply were equal. Thus, although the output level generated by consumption and investment is stable, it is not necessarily the full-employment level of national output.

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In addition to the self-regulating mechanism of responsive interest rates within the loanable funds market, the classical school relied upon flexible wages and prices to equilibrate the goods market. Given low aggregate demand as a result of, for instance, a sluggish loanable funds market, money, wages and prices would fail to ensure the economy returned to its position of full employment and full production. For example, if the real wage were at a level which resulted in unemployment,

unemployed workers would competitively bid the real wage down to a level which facilitated full employment. Classicists saw no need to question the willingness of workers to accept lower wages or entrepreneurs to automatically lower their prices in order to allow the economy to return to its optimal position.

Keynes, however, did. He argued that laborers supplied labor with respect to the nominal wage, and thus lived under a “money illusion,” which impelled them to refuse to take cuts in their nominal wages. Long-term labor contracts also served the purpose of precluding cuts in nominal wages. As a consequence, structural or involuntary unemployment would become the norm following a reduction in aggregate demand. Firms faced with lower revenues would be unable to reduce costs by lowering wage rates, leading either to layoffs or a distinct absence of new employees. Since there is no tendency for the employment rate to shift from this point, equilibrium in the labor market would be established at a level below full employment. In fact, equilibrium could be established at any utilization of labor, not just at the level of full employment as classicists had contended. Keynes reinforced his argument against the classicists’ conviction that the wage-price adjustment mechanism would ensure full employment by showing that even if workers willingly accepted a diminution of their wages, the wage-price adjustment mechanism would still be incapable of effecting full employment. Because a firm’s profit margin is determined by prices and wages, the employment capabilities of firms are dependent on the real wage. It is this that must decrease if full employment is to be achieved. Due to the fact that widespread wage reductions would lower aggregate demand, Keynes argued via the classicists’ own wage-price adjustment mechanism—as lower aggregate demand translates into

excess supply of goods and services, wage reductions must precipitate a commensurate fall in prices. And as a price fall would accompany the wage cut, real wages would remain constant, leaving employment levels unchanged.

Left to its own devices, Keynes felt that there was no way a free market system, even with downwardly flexible wages and prices, could guarantee full employment. In fact, Keynes showed that an exogenous reduction in aggregate demand would cause production and employment levels to stabilize below their optimal levels. This unemployment and underproduction could be relieved by increasing aggregate demand, or one of its components (consumption or investment) by the difference between the levels of aggregate supply and demand at full production. As alluded to earlier, Keynes viewed private investment decisions with a heavy dose of skepticism, believing they were volatile, motivated by capricious psychological factors and desire for short-term financial gain, more or less making them analogous to the decisions made by gamblers in a casino. As a result, Keynes didn't hold much hope that private investment funds would provide the stimulus of aggregate demand.

Keynes also rejected the somewhat popular tool of monetary policy, believing it was unable to affect the increase in aggregate demand necessary to restore full employment levels and, in turn, rejecting the accompanying conclusions drawn by neoclassicists from their quantity theory of money. Neoclassicists argued that the money supply could be adjusted to produce changes when there are unemployed resources in the economy. Keynes, however, disagreed over one apparently minor but ultimately critical point; he felt that in addition to transactions and precautionary purposes, individuals hold money in order to speculate in the bond market. When interest

rates are high, individuals prefer to hold bonds, but as the interest rate falls bond prices rise, rendering the holding of bonds less and less attractive and the selling of them more and more attractive. Thus, as the interest rate falls, more and more people choose to hold their assets in the form of money. Keynesians argue that the interest rate may eventually fall to so low a positive level as to encourage everybody to hold the more liquid asset of money instead of the now unsafe bonds for speculative purposes. According to Keynes, this renders monetary policy completely ineffective in the face of depression or unemployment since changes in the money supply cannot alter the interest rates which are used to influence spending, income and employment.

Keynes, therefore, felt that a strong fiscal policy--as opposed to sole reliance on monetary policy--was the only reliable means to achieve economic stabilization. Keynes argued that the government should use its powers to tax and spend in order to influence the business cycle by providing direct injections of public investment into the income stream. As investment expenditures affect income not by the amount of the spending change, but by some multiple determined by the marginal propensity to consume, spending increases will result in manifold rises in the level of production. Such spending increases could be financed by tax increases (although this would reduce consumption, the multiplicative effects of an increase in government spending outweigh those of a tax increase, so the overall effect on the economy would be positive), by the sale of bonds to the Federal Reserve or by some other means. Keynes looked for a full-scale program of discretionary fiscal policy and the strengthening of built-in macroeconomic stabilizers such as progressive taxation.

Within a few years, these notions had permeated virtually every economic

institution in the Western world, from the offices of economic advisers and policy makers to the classrooms of institutions of higher learning. This led to the inaction of higher marginal tax rates, burgeoning expenditure programs, welfare benefits and public work projects, and ultimately bequeathing a bitter legacy of astronomical

debt to future the power brokers of nations who adopted the Keynesian model. For three decades, from the conclusion of the second World War to the oil crises of the 1970s, Keynesian notions formed much of the basis for governmental intervention in the economy. Macroeconomics would never be the same.

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