Chapter 9, Economic Instability (Keynes’ Critique of the Self-Regulating Economy)

I. Keynes’ Problems with Classical Theory
   A. Say’s Law (“Supply creates its own demand”) implied that there could never be demand deficiencies, because individuals produce goods only to fulfill their consumption desires. Furthermore, if consumption fell off and savings increased, then interest rates would fall and increased investment would make up for the decreased consumption.

   --- Keyes maintained that there was nothing sacred about a particular level of total expenditures. If consumption fell and savings increased by $X, investment might increase by less (or by more) than $X. Savings and investment were dependent on more than just the one variable, the interest rate. He thought savings was more a function of income than of the interest rate, and that investment was a function of “animal spirits”, and that investment was particularly driven by business expectations (of profit and general economic activity).

   B. Wage rates are flexible downward if cyclical unemployment is present.

   --- Keyes maintained that wages were inflexible downward, that employees and their labor unions naturally resisted wage rate cuts. Keynes’ followers (Neo-Keynesians) have also added long-term labor contracts and “efficiency wage models” as further reasons for why wages are inflexible downward. This latter point simply means that wages and productivity are positively related -- pay a worker more and the worker will work better. A wage cut is a recipe for disaster (see the Henry Ford example, p. 211).

   C. Prices are flexible downward if surpluses are present.

   --- Keyes maintained that there were “noncompetitive” elements in the economy (such as monopolistic or oligopolistic firms) that prevented prices from falling.

   D. Is it simply a question of time, that the economy will adjust sometime.....!

   --- Keyes maintained that the world was mired in a Great Depression, and that there was no foreseeable end in sight. His major work, The General Theory of Employment, Income and Money was published in 1936.

II. The Keynesian Framework (assumes constant prices, no international or monetary sector)

   A. Total Expenditures (TE) = Consumption + Investment + Government purchases

      1. Consumption as a function of Disposable Income: 
         \[ C = C_0 + MPC \cdot Y_d \]
         a. \( C_0 \) is “autonomous consumption”, in contrast to “induced” consumption.
         b. \( Y_d \) is disposable income: income net of taxes.
         c. MPC is the “marginal propensity to consume”, \( \frac{\Delta C}{\Delta Y_d} \)

      2. Consumption will increase with increases in \( C_0, MPC, \) or \( Y_d \).

      3. Savings is equal to Disposable Income less Consumption: 
         \[ S = Y_d - C \]
         a. \( MPC + MPS = 1 \)
         b. Savings is also a function of Disposable Income:
            If \( S = Y_d - C \) and \( C = C_0 + MPC \cdot Y_d \), then
            \[ S = Y_d - C \implies S = Y_d - (C_0 + MPC \cdot Y_d) \implies S = C_0 + (1 - MPC) \cdot Y_d \]

   B. Total Expenditures as a function of Disposable Income

      1. \( TE = C + I + G \)

      2. \( C \) is a positively-sloped function of \( Y_d \), and \( I \) and \( G \) are invariant wrt changes in \( Y_d \).
         Then \( TE \) is a positively-sloped function of \( Y_d \), with a vertical intercept of \( C_0 + I + G \).
C. Total Expenditures (TE) and Total Production (TP = RGDP)
   1. Three possible states of the economy
      a. TE = TP, equilibrium
      b. TE > TP, disequilibrium: inventory reduction
      c. TE < TP, disequilibrium: inventory build-up
      d. Firms make “optimal inventory” decisions and automatically move to TE=TP.
      e. Diagrammatic (Exhibit 6, p. 218)
         1) TE as a positively sloped function
         2) TP measured as the 45° line (horizontal values reflected to vertical values)
   2. The Recessionary Gap, revisited
      a. It is possible to be at TE = TP equilibrium at less than full employment RGDP, with no tendency to change. Why? Wages and prices are rigid downward.
      b. With no self-correcting system in place, there is a role for government policy.
D. The Multiplier
   1. Autonomous (independent of changes in RGDP) vs. induced spending
   2. An increase in an autonomous spending item (C, I, G) leads to an increase in RGDP that is greater than the original autonomous spending increase.
      a. The original increase is “multiplied” throughout the economy
         1) Begin with increase in autonomous spending.
         2) This autonomous increase INDUCES an increase in consumption.
         3) The increased consumption induces a second round consumption increase.
         4) And a third round, etc. until the increase becomes negligible....
      b. Value of the multiplier (m) = 1 / (1 - MPC)
      c. The change in RGDP is equal to the autonomous increase times the multiplier.
   3. In reality, multipliers are not so large
      a. There must be underutilized resources.
      b. Consumers must spend the full MPC increase.
      c. The process will take time.
   4. The multiplier works in reverse also: Autonomous decreases ==> decreased RGDP.
E. In AS/AD framework, Keynesian AS is horizontal.
   1. Prices are constant.
   2. Idle resources must be available.
   3. No price movements with increased AD.
F. Can/will the private sector bring about a closure of the Recessionary Gap?