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# Keynesian Economics through the Lens of Modern Macroeconomics

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**Abstract**

The paper tries to show an evolutionary aspect of macroeconomics from Keynesian economics onward and highlights the fact in spite of several changes in the macroeconomic thoughts, we cannot neglect the Keynesian economics in modern times.

**Keywords:** Great Depression, Keynesian economics, Neo classical economics, New Keynesian Economics, Post Keynesian Economics

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## Introduction

Keynesian economics is the approach to macroeconomics, grew out of John Maynard Keynes's famous trilogy, A Tract on Monetary Reform (1923), Treatise on Money (1930) and supremely his The General Theory of Employment, Interest and Money (1936). Keynes's work has inspired various formulations of macroeconomics to which: aggregate demand plays major role in determining output and employment, monetary and fiscal policy can affect the level of output and employment involuntary unemployment can persist,. Keynes had a number of predecessors. The major elements of his approach were anticipated by others, notably by Michal Kalecki.

## General Theory and Keynesian Arguments

Keynes, in his General Theory, argued that employment is determined by the aggregate demand for goods, which, in turn, is determined, in a closed economy, by consumption demand and investment demand. Consumption demand depends mainly on the level of real income while investment demand depends on the interest rate, which again is determined by the supply of and the demand for money, by business expectations--expectations about the price a producer expects to get in the short term and expectations about the returns to extra capital expenditure in the long term. Employment is determined, given expectations and monetary conditions, in such a way so that output produced equals to aggregate demand.

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The employment level determined in this way may be less than full employment level at which the demand and supply for labour (which depends on real wage) becomes equal. The aggregate supply side of the economy with given money wage and production function was also examined by Keynes. He argued that because of the concern of workers with their wages the wages are likely to be rigid downward when unemployment exists. Keynes therefore recommended expansionary monetary and fiscal policy to increase aggregate demand, employment and output to reduce unemployment.

Keynes's analysis is simply depicted with the Fig below**,** in which the axes measure income (Y), and expenditure (E). The line C is the consumption function that shows the relation between consumption and real income, and the line C+I+G is aggregate demand. Equilibrium output, $Y_E$, is determined where expenditure equal output. By increasing G or I through fiscal and monetary expansion increase in output and reduction in employment.

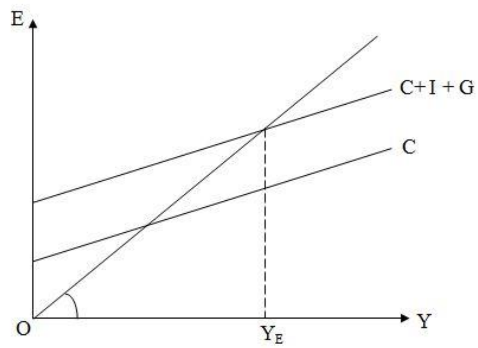


**Fig: 1**

Economists such as Franco Modigliani and John Hicks tried to relate it to pre-Keynesian classical theory in which the economy was assumed to be at full employment. A series of models likeIS-LM and aggregate demand-supply (AD-AS) models, were developed to produce what is known as the **neo-classical synthesis approach** to Keynesian economics**.** This approach implies that due to wage rigidity unemployment can exist in the short run , but not in the medium and long runs. In the medium and long runs the wage is flexible, the economy is at full employment, when unemployment exists, over the medium and long run the money wages falls.

In the 1960s,due to the success of Keynesian macroeconomic policiesmost advanced countries experience low unemployment for long periods and inflationary pressures began to mount.

**Alternative Approaches Negating Keynesian Revolution**

In view of the above, alternative approach to macroeconomics began to emerge. Three of them that adopted policies opposing Keynesian economics, are worth mentioning.

**First,**In1968monetarist approach was developed by Milton Friedman and others which returned to the pre-Keynesian idea of flexible wages in the short run, so that full employment always prevails, but allow the changes in aggregate demand. According to this approach, in spite of persistence of full employment due to the flexibility of wages, macro policy has a temporary effect on real variables due to the misperception of the workers.

The **second** also maintains the assumptions of flexible, labour- market clearing wages, but assumes that economic agents do not make systematic expectational errors as it is done in the earlier monetarist approach, and assumes rational expectations. This **new classical approach** developed by Robert Lucas and others in 1983 pointed out that with agents having rational expectations fiscal and monetary policy are not effective in the short-run, unless the policies' changes are random and unanticipated.

The third one, the **Real business cycle approach,** gives explanations to business cycle fluctuations in terms of technology shocks affecting investment demand and interest rate and bring out the inter-temporal substitution of labour to give explanation to the changes in employment. Finn Kydland and Edward Prescott introduced three revolutionary ideas in their 1982 paper, "Time to build and Aggregate Fluctuations." The *first* idea is that business cycles can be studied using dynamic general equilibrium models. *Second* idea is that these models feature atomistic agents operating in competitive markets and form rational expectations about the future. The *third* idea is that it is possible to unify business cycle and growth theory by insisting that business cycle models must be consistent with the empirical regularities of long-run growth. Kydland and Prescott's (1982) work, referred to as 'real business cycle' models, emphasizes on the role of real shocks, particularly technology shocks, in driving business fluctuations. But real business cycle models became a point of departure for many theories where technology shocks do not play a central role.

In this way, Keynesian economics lost ground to this new classical approach because of its alleged problem in providing proper micro-foundation of macroeconomics. The neo-classical synthesis of Keynesian approach explained unemployment in terms of wage rigidity. However, it did not relate the analysis in optimizing its micro-foundations. An early branch of new Keynesian approach merely introduced fixed prices and wages into the standard micro-founded general equilibrium model, examining disequilibrium situation.

Another branch addressed the monetarist and rational expectations approaches, introducing wage price stickiness ( such as staggered or sticky wage adjustment) into the models with rational expectations that it is the complete wage flexibility that produced the policy ineffectiveness result.

The ultimate **new Keynesian branch** finally provided optimizing micro-foundations to wage, price, and interest rate rigidity. Efficiency wages and wage bargaining, imperfect competition, 'menu' costs of price changes, asymmetric information in credit markets are used to explain these rigidities. Some models which distinguish roles of insiders and outsiders in wage determination implies that aggregate demand changes can have long term effects on output due to what is called hysteresis effects. A few new Keynesian models imply involuntary unemployment in equilibrium while others do not.

The main theme of both the neoclassical synthesis and new Keynesian approach is the rigidity of prices and wages. Wage rigidity is an important element in Keynesian theory. Keynes believes that wage flexibility is no guarantee for full employment. The **post-Keynesian approach**, on the other hand, emphasized that flexible wages may exacerbate rather than solve unemployment. This **approach** emphasize the implications of decision making under uncertainty, monetary institutions, and the effect of income distribution on aggregate demand. This approach states that when wages and prices falls due to existence of unemployment, the interest rate and real balance effect need not work to increase aggregate demand.

## Conclusion:

It is generally believed that Keynesian economics is valid for short run macroeconomics and ignored long-run growth. However, if wage flexibility does not automatically take the economy to full employment, and over the medium run the government is unable to do the same Keynesian economics may be relevant for the long-run as well if technology respond to aggregate demand and output. Post –Keynesians and other heterodox economists have, in fact, followed Joan Robinson in applying Keynesian economics in studying long-run growth.

In his Nobel Memorial Lecture, Akerlof (2002) defended Keynesian economics and said that the behavioral assumptions of the new classical models are so 'primitive' that they outright denied several important macroeconomic phenomena. These include denying the existence of involuntary unemployment, denying that monetary policy has definite impact on real variables such as output and employment. Akerlof agrees with Lucas that the orthodox Keynesian models of the neoclassical synthesis era are in need of coherent micro-foundations. Akerlof believes that future progress in macroeconomics depends on building 'a behavioral macroeconomics' in the spirit of Keynes.

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