MBHS Economics Club

Modern Economic Thought Notes

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(Some of) The Maths behind Keynes

- Keynes proposed the consumption function to relate disposable income (Y_d) to consumption (C):
  $C = a + b * Y_d$ where
  - a is autonomous consumption, the amount a person will consume even if they have no disposable income (think food, water, shelter, etc.)
  - and b is the marginal propensity to consume, the rate of change of consumption with a change in disposable income
    - Keynes believed b to be a constant (i.e. for every extra dollar I earn i spend b dollars more)
- Keynes assumed that $0 < b < 1$. This makes some sense, since b is the slope of the consumption function, meaning that for every dollar extra you have of disposable income, your consumption increases by b dollars. It would be odd to assume that if you got one more dollar from your job, then you would then spend more than one dollar.
- The Fiscal Multiplier, the ratio of a change in national income to the change in government spending that causes it, is derived from this idea.
  - For example, if b is ½, and person p_0 gets $100, then they will spend 50 dollars, which goes to p_1. p_1 will then spend 50 * ½ = $25 to p_2. p_2 will then spend 25 * ½ = $12.5 on p_3. This means that if the government spends $100 on p_0 then the net economic impact is $200.
- The way that Keynes measured this was via nominal and real value.
  - Nominal value is the value expressed in historical monetary terms.
  - Real value is value adjusted for inflation.
  - Keynes argued that real value was the only real measure of value, hence inflation was not important so long as it was smaller than the rate of economic growth.
- He further asserted that price responds to changes in supply and demand relatively slowly, ensuring that inflation caused by fiscal policy would almost always be minimal compared to growth.
  - To explain inflation not being caused by government intervention, Keynes provided the idea of Cost Push inflation, whereby the increase in price of some essential commodity (e.g. oil) drives up the costs of other goods (e.g. plastics, gas, kerosene, asphalt, hydrogen, shoes, nail polish, cement, hand lotion, tar, paraffin, etc.) leading to an increases in the price level
  - This is how inflation is generally calculated today, by taking a list of good, and tracking the price from year to year or from month to month.
- Besides driving economic growth, keynesian theories, being formulated during the great depression, also aimed to minimize unemployment. A method of doing so lays in the phillips curve, which stated that unemployment is inversely proportional to inflation. So, driving inflation up reduces unemployment, and Keynes, under his previous arguments, viewed government policies as a way to reduce unemployment.

- Finally, he argued that monetary policy was weak, at least in comparison to fiscal policy, and should not be implemented by governments. (Note that this was Keynes's original argument; few modern keynesian economists agree with this logic.)

Challenging Keynes

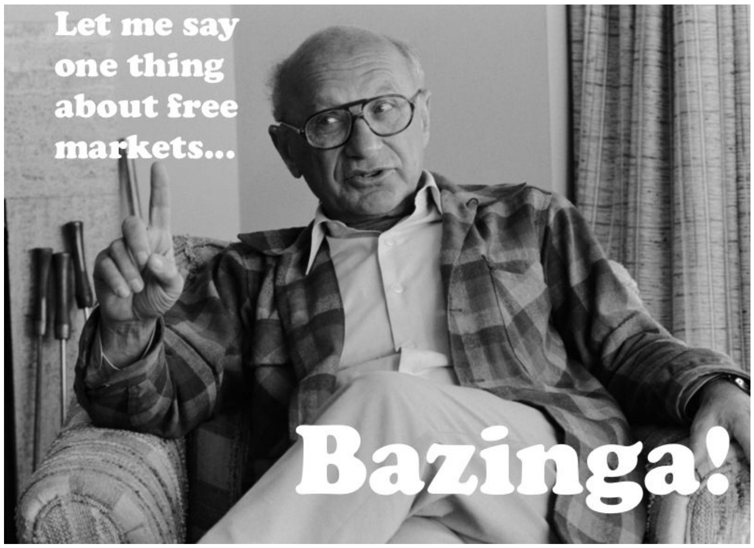

Fig 1: He actually said this. Is perhaps greatest defense of free markets. Ever.

- **Permanent Income Hypothesis**
  - Contrary to Keynes's theory, Friedman Argued that people spent money not only based on their current income, but based on the income they perceived they would have in the future, or permanent income.
  - This was a result of his applying microeconomic principles to macroeconomics, which was how he created most of his work.
  - Unlike Keynes, he never gave a distinct formula for this, and instead stated that there were many working models and that they all came to the same conclusion: Keynes was wrong.
- **"Natural" rate of unemployment**
  - There will always be unemployment, no matter how healthy the economy is.
    - Due to a variety of factors, including willingness to work (some people are just lazy) and qualifications/skills.
    - This was argued primarily on the basis that, ignoring cyclical unemployment, structural and frictional unemployment created a minimum rate of unemployment.

- Therefore, spending tons of money on creating jobs is extremely inefficient.

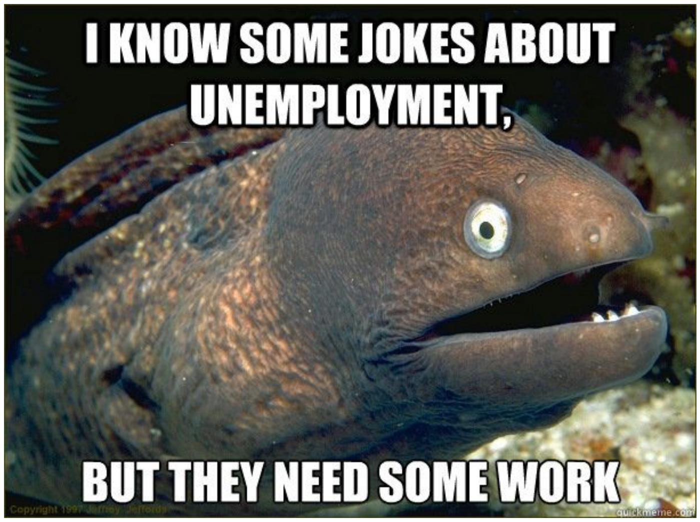

Fig 2: In Friedman's view, trying to decrease unemployment via fiscal policy was a joke.

- **Stagflation**
  - Can occur because of:
    - Unfavourable supply shock, which will raise prices while also slowing the economy by making production more costly, less profitable
    - Bad monetary policies (excessive monetary supply growth, excessive regulation of goods and labor markets
  - Versus depressions and recessions
    - Depressions and recessions normally include stagflation.
    - However, both depressions and recessions have negative growth, whereas periods of stagflation experience zero or very little growth.

  - **Stagflation Of the 70s**
    - Causes:
      - **OPEC oil embargo of 1973-74 (Cost-Push Theory)**
        - In October 1973, Israel fought a less than three week war against a coalition of Arab countries, including Egypt, Syria, Jordan, and Saudi Arabia -- and won.
        - More than that, some of the Western countries -- including the U.S. -- supported Israel, although it was mostly their fight.

    - Humiliated, the Arab countries -- many of which produced oil and were in the Organisation of Petroleum Exporting Countries (OPEC) -- imposed an oil embargo (we won’t sell you oil) on the U.S. and other countries that supported Israel.
    - The embargo lasted until March 1974, and had a terrible effect on many Western economies.
        - In the U.S., a stock market crash occurred and people had to ration oil.
        - High oil prices drove many Americans to abandon American automobiles that consumed a lot of gasoline (i.e. Ford, GM, etc.) for more fuel-efficient cars that overwhelmingly came from -- **[“guess where?”]** -- Japan.
        - And this is how Japan took over American auto markets.
- **Nixon Shock (Friedman’s hypothesis)**
    - Government spending trying to minimize unemployment was inefficient and caused inflation.

Monetarism

- Defined as a set of economic policies focusing on the effect of monetary policy on macroeconomics, with the central goal of encouraging price stability through a tightly regulated monetary supply.
- Both Thatcher and Reagan implemented this in the 1970s and 1980s, with the advice of Friedman
- Creates large number of businesses, due to increases in investment, due to falling interest rates
    - Many are not sustainable
    - Tight monetary policy encourages speculation, leads to significant heightening of monetary cycle
- After 9/11, interest rates were significantly lowered, banks were willing to give out toxic loans
- Austrian school of thought believes that the policies lead to excessive liquidity
- ECB
    - Tighter controls over inflation and spending targets
    - Followed credit easing in late 1980s through 1990 to fund German reunification
    - Blamed for the weakening of European currencies during that time

- Today, Monetarianism is questioned
- Many events inexplicable in monetarism terms have occurred, such as
    - The disconnection of the money supply growth from inflation in the 1990s
    - the failure of pure monetary policy to stimulate the economy during the period before the housing bubble bursting
- Some treat monetarism as a special case of Keynesian theory
- Bernanke argues that monetary policy could respond to 0% interest rates by printing more money
- Progressive Paul Krugman argues this would also have a devolutionary effect, like 2001-2004 sustained low interest