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What is Keynesian Economics?

Taken from Investopedia *(Edited)*

Keynesian economics was developed by the British economist John Maynard Keynes during the 1930s in an attempt to understand the Great Depression. Keynes believed in increased government spending and lower taxes to stimulate demand and pull the global economy out of the depression. Keynesian economics refers to the concept that the highest economic performance can be achieved with active government intervention. Keynes also believed that economic slumps like recession and depression can be prevented (or at least lessened) by government intervention policy. Keynesian economic theory is considered a “demand-side” theory that focuses on changes to the economy in the short run.

Prior to Keynesian economics, classical economic thinking believed that regular swings in unemployment levels and economic production levels (sales of goods and services) will adjust back to the original equilibrium on their own - if left alone. Classical economic theory says that if sales are down, manufacturers will lower wages, and this will allow them to spend more money on producing more product. Producers will also naturally lower the price of the new surplus of product, and the market will correct to where it was.

In his book, "General Theory of Employment, Interest and Money," Keynes argued that employers will not add employees to produce more goods, if the goods cannot be sold because demand for them is weak. Similarly, poor business conditions may cause companies to reduce capital investment, rather than take advantage of lower costs to invest in new plants and equipment. This would also have the effect of further reducing overall spending and increase unemployment. In other words, wealthy factory owners will not spend their money if they don’t believe there is an existing demand for their product. In economic downturns like the Great Depression, unemployment went from 3.2% to 25% in just a couple of years. At this rate, there were not enough consumers with money to spend to purchase goods and services, so manufacturers cut back on production and jobs, causing more unemployment - and the cycle continued.

Keynes disagreed with the idea that the economy would return to a natural state of equilibrium all by itself. Instead, he pictured economies as being constantly contracting and expanding. This natural cycle is referred to as boom and bust. In response to this, Keynes advocated for a **countercyclical fiscal policy**. This meant that during the boom periods, the government should increase taxes or cut spending, and during periods of economic downturn, the government should use deficit spending.

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Keynes was highly critical of the British government at the time. The government cut welfare spending and raised taxes to balance the national books. This is the theory any one of us might use to manage personal finances. When times are tough and you don't have enough money you should spend less. That may be all well and good for individual consumers, but Keynes argued that this philosophy does not work at the level of a full economy, since it would not encourage people to spend their money.

If consumers didn't have the money to spend, or didn't feel comfortable spending the money they do have, then nothing would stimulate the economy and it would be unable to recover and return to a successful state. Instead, he proposed that the government spend more money when times are tight - to balance what consumers and businesses are not spending. This would put more money into the economy and lead to increased consumer demand in the economy. This would in turn lead to an increase in overall economic activity, the natural result of which would be deflation and a reduction in unemployment.

When discussing the concept that classical economists believed that the economy would recover in the long run, Keynes said that was fine, but reminded us that, "In the long run we are all dead." What he meant by this is that average citizens and businesses cannot necessarily afford to wait long periods of time for economic theory to return jobs and wages. They need money and food right now.

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Keynesian Economics and the Multiplier Effect

One of the chief components of the Keynesian economic model is the **multiplier effect**. According to Keynes' theory, an injection of government spending (adding money into the economy) eventually leads to added business activity and even more spending. If workers are willing to spend their extra income, the resulting growth in gross domestic product (GDP) could be even greater than the initial stimulus amount.

The concept is actually simple: Spending from one consumer becomes income for another worker. That worker's income can then be spent and the cycle continues. Keynes and his followers believed individuals should save less and spend more, raising their likelihood to consume. This would eventually lead back to full employment and economic growth. In this way, one dollar spent in fiscal stimulus eventually creates more than one dollar in growth. This appeared to be helpful for government economists, who could provide justification for politically popular spending projects on a national scale.

This theory was the dominant economic theory for decades. Eventually, other economists, such as Milton Friedman, showed that the Keynesian model misrepresented the relationship between savings, investment and economic growth. That said, many economists still rely on multiplier-generated models today, although most acknowledge that fiscal stimulus is far less effective than the original **multiplier** model suggests.

Keynesian economics focuses on demand-side solutions to recessionary periods. The intervention of government in economic processes is an important part of the Keynesian strategy for reducing unemployment. The emphasis on direct government intervention in the economy places Keynesian theorists at odds with those who argue for limited government involvement in the markets. Keynesian theory argues that economies simply do not stabilize themselves quickly enough and therefore require active intervention that boosts short-term demand in the economy. The new economic activity feeds a circular, cyclical growth that maintains continued growth and employment, which in turn, helps repay the borrowed stimulus money. When borrowing is encouraged, businesses and individuals often increase their spending. This new spending stimulates the economy.

Monetarism and Other Challenges to Keynesian Economic Theory

Unlike Keynesian economics, which believes that aggregate demand is is the key to economic growth, monetarism is the economic school of thought that says that the supply of money in an economy is the primary driver of economic growth. Monetary policy, an economic tool used in monetarism, is used to adjust interest rates to control the money supply. This theory was made most famous by economist Milton Friedman, who was a strong supporter of free-market economics and minimal government intervention. He, and other supporters of monetarism

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believed John Maynard Keynes's theory of controlling an economy through a policy of increased and decreased government spending is a poor decision. Excessive government intervention, they claimed, interferes with the workings of a free market economy and could lead to large deficits, increased sovereign debt, and higher interest rates, which would eventually force the economy into a state of destabilization.

Monetarism had its heyday in the early 1980s when economists, governments and investors eagerly jumped at every new money supply statistic. In the years that followed, however, monetarism fell out of favor with economists, and the link between different measures of money supply and inflation proved to be less clear than most monetarist theories had suggested. Many central banks today have stopped setting monetary targets and instead have adopted strict inflation targets.

Other critics of Keynesian economic theory point out that once the government gets involved in free-market economics it is hard to go back to an economy without the government spending. Companies and markets become dependent upon the government spending and support. Many people, including some economists, simply don't trust the government to make decisions as correctly as the free-market will.

Another key critique of Keynes's theories is that it relies on deficit spending. As the U.S. debt rages on, larger and larger, how can government justify borrowing more? Deficit hawks (politicians who would like to eliminate government debt) despise any economic theory which grows the debt - even if it supposedly does so only in the short run. One measure used to reduce budget deficits (not enough revenue to cover spending) is **austerity**. Contrary to Keynesian theory, **austerity** measures reduce government spending and increase taxes during tight economic times. The purpose of **austerity** measures is to force a reduction, or eliminate a government's budget deficit. These measures can be voluntary or imposed by an outside agency like the European Central Bank on member states with poor credit or an inability to qualify for new loans. These measures often take away the ability for governments to support those in need during a recession, however, and are not popular with the public.

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