



CH10

REACTIONS TO KEYNES



THE LONG RUN

1) First, net investment

I adds to **the capital stock of the economy**, K , that is, $I = \Delta K$, and thus increases the economy's **productive capacity** or **potential output**. We can call this the “**capacity effect of investment**.”

2) Second, **gross investment** is one of the vehicles by which **new economic knowledge** enters the economic system—**new and better machines, computers, and so on**. (The other vehicle is “**human capital**”)

Evsey Domar (1914–1997) and Roy Harrod (1900–1978)

Towards a Dynamic Economics (1948).

Demand

I

Imagine that **NET INVESTMENT**, year after year, remains constant. In this case **EFFECTIVE DEMAND**, given by the multiplier, would also remain the same over time. However, **THE CAPITAL STOCK** would increase every year by $I = \Delta K$ and together with it productive capacity.

DEMAND > INVESTMENT

DEMAND < INVESTMENT

ECONOMIC GROWTH AND PUBLIC DEBT

Domar emphasized that in **judging public debt**, it is not its absolute level that is crucial but **the ratio of that level to the GDP—the government debt ratio**. The situation becomes **unsustainable** when **the latter** is rising over time.

This is the case when **the real rate of interest** to be paid on the debt (the nominal rate minus the expected increase in the price level) **exceeds the growth rate of real GDP and that of taxes**.

A growing public debt in absolute terms, Domar concluded, is perfectly compatible with a constant or even falling debt ratio, and **the growing interest burden** will not, in the given circumstances, devour the growing tax revenues.

CYCLE AND TREND

Many contributions were devoted to the relationship between **economic cycles** and **the long-term trend of the economy**.

In the 1930s, picking up on Marx and Mikhail Tugan-Baranowsky (1865–1919) rather than Keynes, Kalecki developed **several models** to explain both **the cyclical character of development and the growth trend**.

MULTIPLIER AND ACCELERATOR

Paul A. Samuelson

- **problem of cycle and trend**
- **“multiplier-accelerator model.”**
- **effective demand**
- **steady growth, cycles with constant amplitudes**

AUTONOMOUS INVESTMENT

John Hicks

Contribution to the Theory of the Trade Cycle

The upper turning point of a cycle—when a **boom** ends in a **crisis**, which triggers **the downturn**— can be easily explained (as it was by Kalecki) in terms of a “**ceiling**” hit by the economy (full employment of labor, excess capacity utilization, rising wages, and falling profits).

The main reason for this, said Hicks, was that **investment is not only “induced” by changes in demand for given products (as in Harrod) but is partly “autonomous” in the sense that it does not depend on demand in given markets but is caused by expectations regarding demand in emerging markets.**

In short, by means of **autonomous investment** new goods and new methods and means of production are channeled into the economy.

IS-LM MODEL AND THE NEOCLASSICAL SYNTHESIS

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- The construction of two relationships. One reflects **all possible equilibria on the goods market**, characterized by an equality between **savings (S)** and **investment (I)**; the other reflects all possible **equilibria on the money market**, characterized by an equilibrium between **the demand for liquidity (L)** and **the central bank's supply of money (M)**. The former relationship is known as the **IS** curve and the latter as the **LM** curve.
- In order for the money demand from the speculative motive to be equal to the remaining money supply, the interest rate must rise along with national income. This is the **so-called LM curve**: along this curve, equilibrium prevails on the money market.

CYCLE AND TREND



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1899-1970

Essays in the Theory of Economic Fluctuations (1939)

Political Business Cycle” (1940)

MULTIPLIER AND ACCELERATOR

- Paul A. Samuelson

Industry and Trade (1919)



AUTONOMOUS INVESTMENT

- John Hicks

*Contribution to the Theory of the Trade Cycle
(1950)*

IS-LM MODEL AND THE NEOCLASSICAL SYNTHESIS

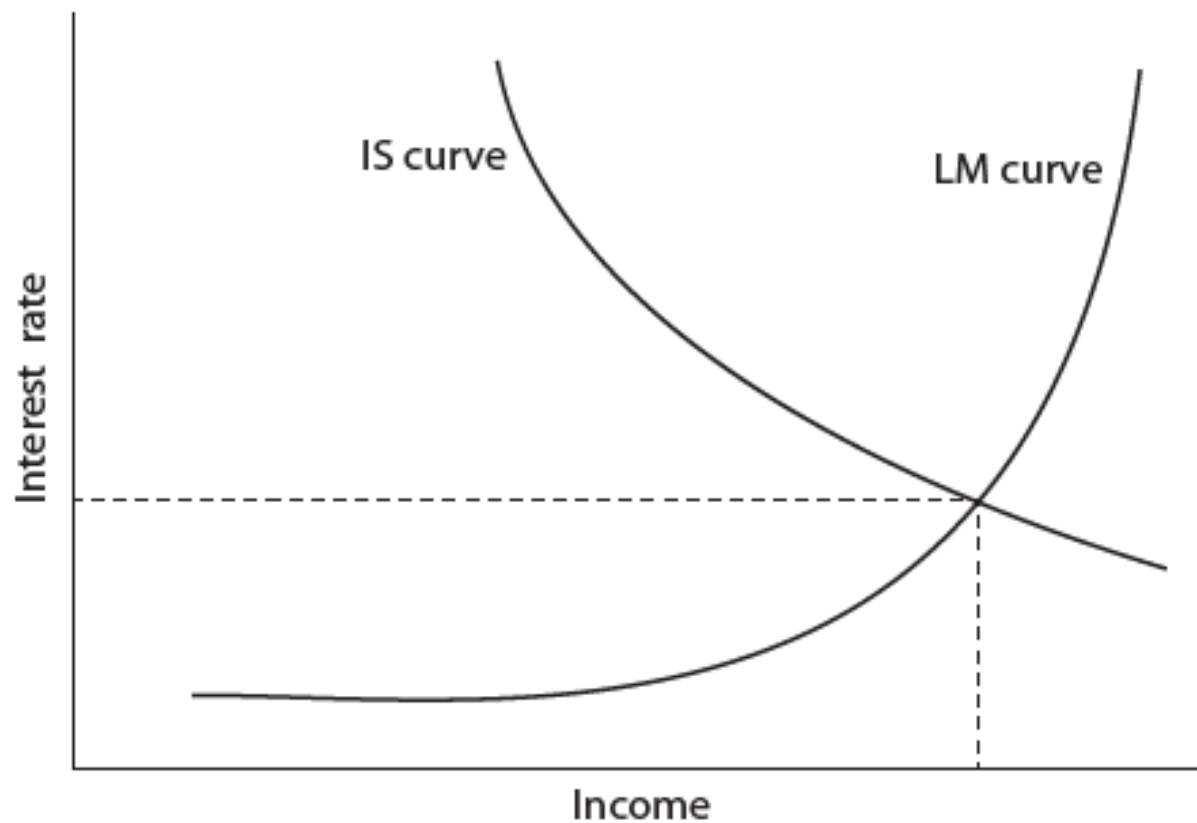


FIGURE 10.1 The *IS-LM* model

Franco Modigliani (1918–2003)

“Liquidity preference and the theory of interest and money” (1944).

Joan Robinson (1903-1983)

POST-KEYNESIAN THEORY

- **Pierangelo Garegnani (1933–2011)**
- **Joan Robinson**
- **Nicholas Kaldor**
- **Luigi Pasinetti**
- **George Shackle (1903–1992)**
- **Hyman Minsky**
- **Paul Davidson**

What unites **the post-Keynesians**?

Their rejection of the following neoclassical tenets:

- Say's law and the assertion of a **tendency toward full employment**;
- the idea that **money is draped like a “veil” over the real economy**, on which it has no influence;
- the thesis that **savings determine investment** rather than the other way round;
- and the **marginal productivity theory of income distribution**.

More...

- NEOCLASSICAL-KEYNESIAN SYNTHESIS
- MONETARISM
- NEW CLASSICAL MACROECONOMICS
- NEW KEYNESIAN MACROECONOMICS
- NEW NEOCLASSICAL SYNTHESIS