

# Overview of keynesian income and expenditure model economics essay



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## **Introduction:**

Keynesian economic theory has been named after a British, John Maynard Keynes (1883 – 1946). The foundation of his theory was on the basis of circular flow of money. Keynesian economics is one of the major schools of thought in the current era.

Keynesian theory was popularized during Great depression period (1920 – 1930). Keynes argues against the custom of excess hoarding, non consumption or none spending. Keynesian theory also supports the redistribution of wealth when and where it is needed because; the spending style of the lower middle class of economy is higher than there saving trends. This will support a growth in the economy. Another interesting idea of Keynesian theory is that, it identifies changes in the macroeconomic level which has great influence over the consumer behavior at micro economical level. Keynesian economics is also called as macroeconomics due to its vast and extensive study over the economics.

## **Over look into Keynesian Income and expenditure model:**

The Keynesian income-expenditure model explains the relationship between the expenditure and current national income. The Keynesian model considers that, the real GDP consist of four major factors:

Aggregate expenditure on consumption

Investment (I)

Government (G)

Net exports (NX)

Investment, government and net exports are autonomous expenditures where as aggregate expenditure on consumption is dependent on the real national income. He summarizes his argument into an equation.

### **Aggregate consumption = C + mpc (Y)**

In which " C" explains the independent consumption expenditure and " Y" is the current real income which corresponds to the value of existing real GDP. Whereas the " MCP" (marginal propensity to consume) when multiplies " Y", becomes part of change in real income available for consumption. The change in level of aggregate consumption has direct connection with the changes in " Y".

Hence aggregate expenditure can be expressed by following equation:

### **AE (Aggregate expenditure) = A + mpc(Y)**

In which " A" is Autonomous or independent expenditure which is the sum of (C+I+G+NX). " Y" is the real national income, match with levels of aggregate expenditure (AE).

There is a direct relation between independent income and aggregate expenditures on government G, Investment I and net exports NX.

Equilibrium real GDP in the income-expenditure model is found by setting current real national income

, Y, equal to current aggregate expenditure, AE.

$$Y = AE$$

Therefore

$$Y = A + mpc(Y)$$

### **Determination of stability of GDP – An income Expenditure Approach**

The above figure details that, variations in the Autonomous expenditure (A1, A2, A3) is identical to the shift in the Aggregate expenditure (AE1, AE2, AE3). The positive slope of AE explains the increasing value of Mpc. This slope also indicates that up changes in national income Y has positive influence over AE, consequently GDP according to Keynesian condition is  $Y = AE$ .

Graphical illustration of the Keynesian theory.

The above figures explain a practical picture of how the aggregate demand and supply works. Imagine an economy whose GDP is in the natural level (Y1) initially and has aggregated expenditure AE1 curve. Now consider the independent or autonomous expenditure declines (from A1 to A3). This decline causes a downward trend of the AE curve from AE1 to AE3. This decline in the autonomous expenditure also affects negatively the aggregate demand (AD1 to AD2), this reduction influences the fall in equilibrium of real GDP from Y1 to Y3 at the same price level, but the SAS (intersection) and AD2 comes towards lower level (P2) which explains a fall in price level. The AE level however will not come down along with the level to AE3 but instead of that it will fall only to AE2, thus forming a new equilibrium real GDP Y2 which lies below the natural level Y1. Keynes explains that there will not be any further decline in the price level from P2, due to high resistance for <https://assignbuster.com/overview-of-keynesian-income-and-expenditure-model-economics-essay/>

further reduction in their wages which also restricts the suppliers to take decision on further increase in the supplies. Until and unless a shift in the SAS curve,  $Y_2$  will remain constant and this will drastically affect the resources and employment. If workers cannot earn anything more they cannot make any purchase of goods and service, this will cause a stuck on position on the Aggregate expenditure curve  $AE_2$  and will also prevent the economy to reach its natural real GDP level. To boost this stage Keynes advises to use “prime the pump” concept.

“Prime the Pump” is the remedial measure suggested by Keynes to restart the idle economy back to its initial condition. Keynes believes that the real factor to drive the economy is aggregate demand. The concept can be compared to a starter fluid which is used in a car engine to ignite its move. Thus Prime the pump concept is also designed to maintain the motion of economic engine identically like a gasoline dose in a motor car . In Prime the pump concept, Keynes explains that the government should step in to increase the expanding by either increasing the money supply or by actually buying things on the market itself. This will slowly boost the confidence of the consumer, which will encourage him to restart the spending and to bring the economy back to its original position.

Government spending , taxation and borrowings has great influence over economic activity and growth , output , employment and aggregate demand . It is very important to understand that this fiscal policy can affect the aggregate demand and aggregate supply .

## **Fiscal policy and Keynesian theory:**

Fiscal policy has been treated as an instrument of managing demand where government spending, budget balance and direct and indirect taxation can be used to sooth out some of the unpredictable external economic shocks for example there is a fiscal stimulus in UK economy (2001 – 2005) which applied through increasing the government spending on transport, health and education and this fiscal stimulus later terminated by slowing down the rates.

Keynesian theory explains that fiscal policy has great influence over aggregate demand, employment and output at the time when the economy is operating at a below national output capacity level also, the economy needs an external stimulus. Keynesian also argues that the government has a reasonable role in making use of fiscal policy measures and to administer and maintain the level of aggregate demand.

## **The great depression – a review:**

In the US, 1920s is the period which has been dominated by republican presidents who believed in the conservative economic philosophy of leave it alone or 'laissez-faire'. This was the time when people had complete freedom to operate in any market without the interference of government rules or any taxes. This adversely affected the regulatory situation and led to monopoly markets, practice of too much saving or under-consumption resulting in high rates of unemployment, which were the by-product of laissez-fair. The federal government was not ready to increase the money supply that worsened the entire situation. . Share market, Agriculture,

mining and energy were the major sectors drastically affected by the <https://assignbuster.com/overview-of-keynesian-income-and-expenditure-model-economics-essay/>

depression. During this decade, half of the Americans lived at or below average survival condition.

Laissez-faire approach created an economy with inequality in wealth. Poor became poorer and rich richer. The American labor and business sectors faced equal dilemma where monetary policy became inefficient during the great depression. Fall in the asset price was another reason for institution failures.

Keynesian model explains that in a normal economy, the level of employment will be high and supply will be equal to one's earnings. In the model he also describes that spending and earning goes in a circle and one's spending supports another's earnings . Thus earning and spending becomes a part of the money flow and helps to function the economy normally. But any sort of disturbance in the normal flow of money will shake the confidence of the people. This insecure reaction will result in hoarding money in order to overcome fiscal deficit . But according to Keynesian; this panic reaction will worsen the entire situation which can put the economy on a standstill.

As an economist Keynes studied that incentives are the best effort to overcome the people's hoarding tendency. Keynes also suggested that injecting money or ' deficit spends' into the economy is the best option to awake a poor economy which faces absence of regular investment.

## **How US attacked great depression with Keynesian methods for putting control over unemployment and inflation**

The federal reserve bank started buying US debts from commercial banks in return of their government securities . This support helped the commercial banks to increase their capacity to generate the amount of money they could lend.

The government also used measurements to ease the credit requirements, which helped the banks to increase the amount generated through banking system. Expanding money supply is the tactic used by the bank to stimulate the spending capacity which opened chances for more jobs. But these tactics increased risky chances for inflation in the economy where money loses its value. Considerable discretion policy or control in the money supply will be used to balance the money supply . Considerable discretion is the process where the federal reserves balances the economy perfectly . Any fault in balancing will result in severe unemployment or inflation

### **Practical importance:**

Keynes is the first one who destroyed grace of Laissez- fair and he proved that interference of state into the economic affairs under certain circumstance will help the public as well as the economy.

He explained the importance of deficit budget and how it can be used for increasing the amount of income output and help to reduce the intensity of unemployment in an economy. He highlighted the importance of achievement of full employment both in a planned and unplanned economy.



## **Critical evaluation of Keynesian theory**

Keynesian theory has its own defects even though it opened a new gateway to the revolutionized economic thinking.

Keynesian theory failed to give genuine and complete solution for unemployment and he was not able to give a comprehensive plan to achieve full employment .

He failed to explain suggestion for monopoly and monopolistic competition as well as to phenomenon of a perfect competition.

Keynes failed in giving long term solutions for the dynamic economy.

Keynes was not able to provide statistical evidence for the relationship between effective demand and the volume of employment.

He concentrated only in short period problems and paid less or no attention to long time problems

Keynes neglected the acceleration concept such as extension of multiplier concept

An economy will get completed only with micro and macro economic factors but, Keynes completely neglected the micro economic problems.

Keynes theory is criticized because of its non dynamic character as well as it failed to analysis the business cycle; therefore his studies are considered to be static or motion less theory.

Keynes did not explain the international trade and its impact on income and employment.

Keynes' theories failed to find applicability in a developing or underdeveloped economy because it requires huge investment to solve unemployment issues.

## **Conclusion**

Even after so many short comings Keynesian approaches remains as one of the most outstanding theories which were able to analyze economic problems and Keynes showed courage to challenge the Laissez-fair theory which prevailed during his time. His ideas were undoubtedly cemented during the most crucial US economic crisis. Keynesian theories also played a major role to solve the problems of market failure and that of a collapsed economy. Keynesian approaches remained one of the best until the end of 1960's when it was confronted by Friedman and monetarists and later Keynesian ideas were replaced by classical macroeconomics. However, Keynesian approaches have been considered one of the most outstanding gifts in the history of economics. Economic practitioners still use Keynesian ideas and concepts as a guideline to analyze economic problems.