Example of essay on keynes' criticism on the classical school

Finance, Investment

Introduction

Business cycle and monetary theory are great aspects studied in macroeconomics. Economists were concerned with the changing nature of macroeconomics and most of them tried to elucidate specifically what goes on and the reasons for the existence of economic cycles. Due to this, several schools of thought and theories were developed. However, each economist was trying to outdo each other and criticizing one another's work was quite common. The classical school which perceived economics to be a science of wealth was highly criticized by John Keynes. This paper shall critically evaluate the Keynes' criticism on the classical school of thought and say's law in which Say argued that supply creates its own demand. Monetary theory of production and Keynes theory of liquidity shall also be discussed and linked to his criticism on the classical school. Finally, economists have observed that uncertainty is important in Keynes theory of investment. The role played by uncertainty in Keynes's theory of investment shall also be analyzed in detail.

Evaluation of the Keynes's critique of the law of " classical school" and the Doctrine school of Say's Law

Keynes sought to distinguish his theories from the classical theory of economics, arguing that the classical theory was wrong. The main principle of his critique argues that markets would not spontaneously result to full-employment equilibrium as opposed to classical economics. Keynes argued that economy could attain the equilibrium at any unemployment level. This nullifies the classical principle of non-intervention (Keynes, 1963). In an effort to attain economy that is efficient, it is significant to prod it in sense that the effective government intervention should be established to manage the level of demand. Keynes argument that say's law does not hold is true. Full employment is a scenario that can never exist in any economy despite the efforts to do away with unemployment. This is the reason why even developed economies still experience unemployment though on a small scale.

According to the one of the classical school assumption, " the utility of the wage when given volume of labor is employed is equal to the marginal disutility of that amount of employment." Keynes argued that this postulate could result into the labor market imperfection, and it was not theoretically fundamentally (Ludwig, 2003). He held that this assumption could not accord to the real life situation of the workers. In empirical terms, it implies that workers respond in an asymmetric way to the reduction of the real wage, depending on whether they were motivated by the increment in the general price level or money wage reduction (Keynes, 1963).

Keynes argued that the workers would tend to withdraw from the labor market if the money wages were reduced, hence fall of real wage. However, the workers would not behave the same way if the equivalent real wage cut was as a result of the cut in price level. In other words, it is observed in the general case that workers do not necessarily withdraw themselves from the labor market as a result of the real wage reduction. The withdrawal is therefore determined by what motivates the reduction.

According to the classical model, there exists an interaction between labor supply and demand as being facilitated by movements in the real wage

(Ludwig, 2003). However, in the real world the money wage is an economic concept that is agreed in the labor market. Therefore, workers are motivated to apply for jobs that are specifying the money wage to be offered, rather than the real wage. Therefore, Keynes held that the classical economists had fundamentally misinterpreted how economy actually works. In particular, he believed that if a money wage cut occurred, it would tend to lower general prices because marginal cost would not decrease (Ludwig, 2003). For instance, if the money wage reduces by 5 percent and the price level decreases by the same percent, the real wage would remain unchanged.

Liquidity preference

In Keynes theory of interest, interest is purely a monetary phenomenon since the rate of interest is calculated in monetary terms. It is monetary since the rate of interest is determined by the supply and demand of money. He defined interest as the reward for parting with liquid money for a specified time. He defined interest as the reward for parting with liquid money for a specified time. Keynes argued that interest is not the price for waiting. A man saves money, but gets nothing like interest from the investments made from the savings. Any liquidity surrendered should be rewarded by way of interest. Interests should attract individuals to invest. However, failure to get the expected rewards slays the investment drive and individuals end up holding money rather than allowing it to circulate in the economy.

Interest is therefore the reward for parting with liquid control over cash for a specific period or we can say that interest is the payment one receives for parting with the advantage of liquid control of money balance. Keynes came up with three distinctive motives of demand for money or holding money (Atkeson, 2009)

- Demand for money

There are three main components of holding money:

- Transactive motive: this is holding cash balances for day-to-day transactions. It relates to household desire and firms to keep a certain amount of cash in hand in order to bridge the interval between receipt of income and expenditure. This motives are influenced by:

- Time gap between receipts
- Size of income
- Spending habit

It is mathematically written as L1= F(y); where

L1 is the transaction demand for money

F(y) is function of income

- Precautionary motive: it is the desire to hold cash balances for unforeseen contingencies. This includes illness, accidents and unemployment among others. Businesses also hold cash for unfavorable conditions (Atkeson, 2009). Keynes holds that precautionary and Transactive motives are relatively interest in elastic but highly income elastic. Money held under these motives (M1) is a function of (L1) of the income (Y) and expressed as M1= L1(Y).

- Speculative Motive: this relate to holding cash to take advantage of future changes in the interest rates or bond prices. If bond prices are expected to rise, people will buy bonds to sell when the price later actually rises. If bond prices are expected to decline, people will sell bonds to avoid losses.

- Supply of money

It refers to the total; amount of money circulating in the country. Supply of money is fixed by the monetary authorities and therefore takes a perfectly inelastic curve.

Determination of the Rate of Interest:

Rate of interest is determined where money demand and supply are equal.

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- QM represents the supply of money
- L represent the total demand for money
- E2 the equilibrium
- OR rate of interest.
- At the point E1, the money supply OM > OM1.
- The rate of interest decline from OR1 to OR
- At OR2 level of interest rate, the demand for money OM2 > OM.
- The rate of interest OR2 start rising until it reaches the equilibrium rate OR.

MONETARY THEORY OF PRODUCTION

Fiscal and monetary policies

Fiscal policy is changes in the taxing and spending of the government in order to expand or contract the level of aggregate demand. an expansionary fiscal policy involves lowering the taxes and increasing expenditure while a contradictionary policy increases taxes and lowers government spending. According to Keynes, a recession requires a deficit spending and overheated expansion call for a budget surplus.

1. Discretionary fiscal policy: it is done through government budget process.

This is where the government regulates its spending and taxation according to inflation (Vayanos, 2012).

2. Automatic stabilizers: it is built into the structure of federal taxes and spending. Progressive tax and welfare systems act to increase aggregate demand in recession and decrease it bin overheated expansion.

Monetary policy: the central bank is discretionary. It changes interest rate and money supply to expand or contract aggregate demand. In recession, the CB lowers the interest rate and increases money supply. In the overheated expansion, the opposite happens (Vayanos, 2012).

Keynes’s theory of liquidity preferences and his monetary theory of production

Keynes’s theory of liquidity preferences and his monetary theory of production have an ongoing relevance and it is applied to monetary theories as well as policy. In the liquidity preferences theory, Keynes believes it serves to replace the flawed savings theories, which had attempted to put emphasis on the exact forces of productivity and thrift. In this way, he differs with the neoclassical theories interpretation. In simple terms, Keynes believes in money but not in savings; he says that monetary value can steer economic activities thus leading to monetary production economies. Contrary with neoclassical theories, Keynes bases his argument that finances rules the roost and the economy must be adapted towards the theory (Atkeson, 2009). There is a requirement for individuals to know how monetary control can be put into practice so that real performance can be accepted. The analysis of Keynes is considered to be based on practical issues like expectations management and policy credibility; the examples can be connected to the heterodox endogenous money approach as well as the modern Wicksellian orthodoxy. These approaches have a tendency to lean in the illusion of money neutrality.

In monetary theory of production, Keynes claims that there exists a fundamental distinction between barter system and the modern monetary economy. In a very complex decentralized market, barter system will prosper in a condition where there is a set of social relations whereas the monetary economy is supported by an abstract account of money. This perspective seems to contradict with the orthodox theory, which believes that money has an upper hand to the barter system. In a real exchange economy, money is a medium of exchange and this makes Keynes argument to appear more complex (Atkeson, 2009).

The neutrality of money is boosted by the conditions that can arise due to emergence of crises. Money neutrality goes hand in hand with the real exchange economy to turn into a pure commodity economy where the value is determined by the C-M-C formula. Under the conditions presented, there emerges the need to validate the market laws. A monetary economy has the major aim of profit realization in form of money and it's guided by the M-C-M formula. The above insight made Keynes to develop his monetary production theory. The insight had an agenda of transforming the logic that lies in the classical postulates and put aside the dogma that corresponds in the Say's law.

In accordance to Keynes discussion, the liquidity preference concept argues that sales and purchases never coincide. When time is introduced, the economic agents increase their chances to hoard and the seller does not purchase after selling (Vayanos, 2012). In such a scenario, money serves two purposes; as a means of circulation as well as a storage of value. An inescapable problem that is tied to uncertainty is that there exists a profound connection between money and time. When you handle money as value storage, it automatically breaks the logic that lies under Say's law. Davidson claims that, " Money only matters in a world of uncertainty."

The connection between money and uncertainty is very pivotal in the Keynesian view of a modern economy in that investment depends on the future prospects in the expected return rate. Uncertainty is regarded as the unique Keynes concept and it is very different compared to the neoclassical theory that focuses on calculable and probabilistic risk (Vayanos, 2012).

References

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