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Business, Management

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Keynes and the Keynesian Economics Theory Name: Institution: John M. Keynes and the Keynesian Economics Theory John Maynad Keynes was an economist of British nationality. He is one of the main contributors to the school of thought in the formulation of theories that relate to economics affecting modern practice in economics. His are the ideas that form the basis in the concept of Keynesian economics. The most prominent theory he formulated was the Keynesian economics theory that involves the fiscal stimulus policy and the monetary policy. Keynesian theory emphasized the importance of government intervention in the country's economy to regulate the economy positively and has seen significant usage in the US economy. The approach was different from the previous free market approach to economics supporting the idea that the free market would lead to the creation of jobs in the short term.

In the free market, forces of demand and supply are responsible for control of the cost of goods and services in the market and their distribution. In the Keynesian school of thought, aggregate demand is not only influenced by the forces of demand and supply but also by external factors such as government factors in terms of fiscal and monetary policies (Blinder, 2008). Aggregate demand in this case refers to the total demand for available goods in the economy at a specific price level in a given period. Fiscal policy according to the Keynesian theory involves making use of government taxation and regulation of government spending to control a country's

economy. It also deals with government borrowing in order to create equilibrium in a country's economy.

This influences the level of taxation in a nation as well as distribution in resource allocation across the different sectors of the government. According to Keynesian economics theory, increasing government spending and lowering the rates of taxation can lead to increased aggregate demand and attainment of high employment levels in the economy. After that, the tax rates and government spending can be regulated to maintain a balance in the economy. Fiscal policies affect the distribution of income in an economy hence balancing the economy of a country.

In regulating the economy, three different fiscal stances are opted by a government in the different economic situations. The neutral fiscal policy maintains the country's economy at equilibrium. All the tax revenue collected takes care of government spending. When an economy is in recession, a government borrows to add onto the tax revenue collected to cater for government spending.

Contractionary fiscal policy takes place where the government uses less than the collected amount in tax revenue in spending, where the surplus pays off debts. Fiscal policy under Keynesian economics is used in conjunction with monetary policy to maintain stability of the economy. Monetary policy refers to monetary authorities in a government such as the central bank controling the circulation of money in a nation (Blinder, 2008). This is done through regulation of interest rates and controlling the amount released to

commercial banks for circulation into the market. This is done in an effort to lower unemployment rates and stabilize prices in the market. In times of recession, the government lowers interest rates to make borrowing easier for businesses.

In this way, by expansion of businesses, employment opportunities are created lowering unemployment levels. This is known as expansionary monetary policy. When there is too much money in circulation leading to inflation, contractionary monetary policy is implemented to prevent deterioration of value of assets or the country’s currency value. Monetary policy, through control of the amount of money in circulation and the interest rates, controls price levels in the country. The Keynesian theory is important as it puts into perspective short term effects of changes in aggregate demand. This is observed in the employment levels as well as output levels. Hence, by use of monetary policies, certain prices can be maintained and regulated at a rigid level by the government to prevent fluctuations, hence where the fiscal policies are changed; the effect aimed at is achieved (Blinder, 2008).

For instance, if the prices of goods are kept at a certain constant and the government spending rises without increasing taxation levels, output levels will rise. With these increasing output levels, due to the multiplier effect, the initial government spending injected into the economy will multiply in value (Barro & Redlick, 2011). Hence, the final value of output will be more times the initial investment leading to increased money circulation in the market. Keynesians do not view recessions as efficient market responses to the

changing pattern in economics but view it as unnecessary and avoidable. They also view the level of unemployment in the economy as too high since price adjustment is meant to cushion against sudden rises or drops in aggregate demand. This ensures employment levels remain level. The current situation in the US reflects the Keynesian economics theory principles.

For instance, the level of flexibility in prices and salaries is kept at a minimum to ensure that the greatest level of return is achieved for every increase in input or investment (Blinder, 2008). Keynesian economics played a pivotal role in American economics especially in the 2008-2009 recessions, where use of this approach helped create millions of jobs. However, the government stimulus program would produce future problems that were bigger than the initial problem.

This is because the multiplier effect of the stimulus package was working at a low figure of close to zero hence its effectiveness was low. This means that the gained increased employment would not lead to increase in output at the same magnitude leading to greater crisis in the long term. The fact that the government does not have its own income creation and the money comes from taxation brings about the issue of debt recovery. This will result in raised taxation in the future leading to increased inflation in the long run, which will led to the repetition of a similar situation in the future. Over time, especially in the 1970’s, prolonged use of the Keynesian theory brought about devastating results. By the government using fiscal and monetary policies to regulate the market, there comes into play the problem of

macroeconomic instability. Although to some extent increased stimulus deficit did lower unemployment levels, it did not attain the achieved level with unemployment still being at high percentages in the nation.

This shows that fiscal and monetary policies alone cannot provide a comprehensive solution as is expressed by the Keynesian theory. Among the reasons why this theory fails are that it creates fear and uncertainty among the people; hence, instead of spending more, they begin saving more in fear of the future economy. Therefore, with the introduction of fiscal policies this can only worsen the situation as the country gets into deeper debts and with the volatility in the economy, people will be more apprehensive about getting into more debt (Barro & Redlick, 2011). An illustration is the American economy where during the recession, stock levels dropped, as people were uncertain about the future of the market regardless of deficit spending by the government. Investors chose to invest in safe assets that even if they did not have an increase in interest, would ensure return of their investments. This includes the American debt. If Keynes was alive, he would agree with the current economic plan for the US. However, there would be some issues in how he would have the financial crisis handled.

For instance, in the deficit spending by the government, he would encourage increasing spending to areas that would have a higher multiplier effect such as infrastructure and industrialization (Taylor, 2011). The growth of income from these areas is injected into areas with less income creation such as healthcare and environmental regulation. The government, on the contrary, chose to tackle the areas of healthcare and other regulatory expansion first.

The use of the approach by Keynes could have brought about faster recovery of the economy, encouraging people to spend rather than to save more. The US government also placed too high expectations on the power of the multiplier effect in the Keynesian theory to solve the credit crunch situation in the nation. The Keynesian theory is a fundamental aspect in crisis solutions such as financial crisis in countries. However, the government should work towards maintaining a balanced economy and maintaining proper monetary policies.

Additionally, it should minimize spending at all times for better financial crisis management when it arises. References Barro, R. J. & Redlick, C. J.

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