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keynes circular flow
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Keynes

John Maynard Keynes an economist from Britain. Keynes economic theory was based on circular flow of money. His views and ideas greatly affected modern macroeconomics and social liberalism. In Keynes' theory, one person's spending goes towards another's earnings, and when that person spends her earnings she is, in effect, supporting another's earnings. This circle continues on and helps support a normal functioning economy.

However, the advent of the global financial crisis in 2007 has caused a resurgence in Keynesian thought. Keynesian economics has provided the theoretical underpinning for the plans of President Barack Obama of the United States, Prime Minister Gordon Brown of the United Kingdom, and other global leaders to ease the economic recession.

JMK was given low marks for his views on inflation.

His preoccupation with unemployment led him to ignore the issue of inflation completely.

Since his death in 1946 his name has been linked to such inflationists slogans as " full employment at any cost", and " money doesn't matter".

It is small wonder that he has been widely perceived as an inflationist and that our present inflation is often described as the legacy of Keynes.

Democracy in Deficit : The Political Legacy of Lord Keynes

Buchanan and Wagner

Lord Keynes himself must bear substantial responsibility for our apparently permanent and perhaps increasing inflation. Without Keynes inflation would not be clear and present danger to the free society that it has surely now become. The legacy or heritage of Lord Keynes is the intellectual legitimacy provided to deficit spending inflation and the growth of government.

In reality Keynes deplored inflation warned repeatedly of its evils and recommended restricted demand management policies to prevent it.

Keynes strong aversion to inflation is evident in even his earliest work. It appears in his *Indian Currency and Finance* (1913). There he emphatically rejects the argument that a depreciating currency is advantageous to trade contending that any advantages derived from inflation are only temporary and that they occur largely at the expense of the community and therefore do not profit the country as a whole.

In his *Economic Consequences of the Peace* (1919) he said Lenin is said to have declared that the best way to destroy the capitalist system was to debauch the currency. By continuing process of inflation governments can confiscate, secretly and unobserved an important part of the wealth of their citizens. By this method they not only confiscate but they confiscate arbitrarily and while the process impoverishes many it actually enriches some.

He then proceeds to specify at least four ways that rapid inflation works to weaken the social fabric and to undermine the foundations of the capitalist free market system. First, unforeseen inflation he says results in a capricious and totally arbitrary rearrangement of riches that violates the principles of <https://assignbuster.com/john-maynard-keynes-circular-flow-money-modern-macroeconomics-economics-essay/>

distributive justice. Besides its inequities inflation also renders business undertakings riskier and thereby turns the process of wealth getting into a gamble and a lottery. In generating risk and injustice, inflation strikes not only at security, but at confidence in the equity of the existing distribution of wealth.

Second inflation violates long term arrangements based on the assumed stability of the value of money. In so doing, inflation disturbs contracts and upsets all permanent relations between debtors and creditors which form the ultimate foundation of capitalism. Third inflation generates social discontent and directs it against businessmen whose windfall profits are wrongly perceived to be the cause rather than the consequence of inflation.

This discontent is exploited by governments which being many of them reckless as well as weak seek to direct on to a class known as profiteers the popular indignation against the more obvious consequences of their vicious methods.

In other words governments actually responsible for causing inflation seek to shift the blame onto businessmen who consequently lose confidence in their place in society and become the easy victims of intimidation by government of their own making and a press of which they are proprietors. By making business a scapegoat and target of vilification and control inflation reinforces anti business attitudes and weakens support for what Keynes called the active and constructive element in the whole capitalist society.

Finally inflation tends to breed such misguided remedies as price regulation and profiteer-hunting that may do more damage than the inflation itself.

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Keynes was especially critical of the tendency of governments to resort to price controls which in his view lead to resource misallocation and a reduced supply of goods thereby compounding inflationary pressures.

Regarding the dis-incentives to real out-put occasioned by controls he said that the preservation of a spurious value for the currency by the force of law expressed in the regulations of prices contains in itself however the seeds of final economic decay and soon dries up the source of ultimate supply.

For by freezing prices at what are likely to be disequilibrium levels controls constitute a system of compelling the exchange of commodities at what is not their real relative value and this not only relaxes production but finally leads to the waste and inefficiency of barter.

Keynes concern with the dangers of inflation influenced his policy advice in the post war boom of 1920 when an outburst of inflation threatened the British Economy.

Nowhere does Keynes express his concern for inflation more strongly than in the TRACT. There his chief fear is that inflation may retard capital formation and inhibit long term economic growth. He specifies at least three ways that this can happen. He notes first the inflationary disincentive to saving. By eroding the real value of past savings inflation diminishes the capacity of the investing class to save and destroy the atmosphere of confidence which is a condition of the willingness to save.

With a smaller portion of national income flowing into saving and investment the rate of capital accumulation falls. And since according to Keynes The

national capital must grow as fast as the national labour supply for the maintenance of the same standard of life it follows that a fall in capital growth below the required potential rate will lower the living standards. In short by discouraging saving and capital formation inflation may cause a fall in the aggregate capital/labour ratio and a corresponding drop in labour productivity and output per capita.

A second factor regarding capital accumulation is the undercharging of the depreciation during inflation and the consequent inadequate provision for the replacement of worn-out capital. This occurs because depreciation charges on capital equipment are computed on the basis of original cost rather than replacements costs.

These replacement costs rise with inflation. Thus when prices rise the depreciation charge calculated on the basis of the original cost are too small to replace the worn-out capital. The result may be an unintended depletion of the capital stock. In such condition said Keynes a country can even trench on existing capital or fail to make good its current depreciation. For it is one of the evils of a depreciating currency that it enables a community to live on its capital unawares.

The increasing money value of the community's capital goods obscures temporarily a diminution in the real quantity of stock. Yet a third adverse effect on capital formation, he noted, is the increased business risk resulting from inflation. For inflation adds to ordinary business risk the extra " risk directly arising out of instability in the value of money". To compensate for

this extra risk, businessmen add a risk premium to the rate at which they discount the future, and the higher discount rate discourages investment.

The discouraging effects of inflation on saving, investment, and growth were not the only inflationary evils described by Keynes in the Tract. Others included (1) the injustice and inequity resulting from inflationary redistributions of income and wealth, (2) the resort to spurious inflation remedies-e. g., price controls, excess profits taxes, profiteer-hunting and the like-remedies that constitute “ not the least part of the evils,” often doing more harm than the inflation they are designed to cure, and (3) the social resentment and discontent produced by inflation.

This resentment, when directed against the business class whose windfall profits are wrongly perceived as the cause rather than the consequence of inflation, works to discredit enterprise and to weaken support for the productive element of society-“ the prop of society and the builder of the future” He notes that unanticipated inflation may temporarily stimulate economic activity by raising profits and profit expectations. Profits rise, he said, because wages and other costs lag behind rising prices during inflation. And with nominal wages lagging behind prices, real wages fall, thus inducing producers to step up their employment of labor.

Likewise, the lagged adjustment of market interest rates to inflation and the consequent fall in the real cost of borrowing leads producers to expand their operations. Finally, inflation reduces the real burden of fixed charges, thereby giving a temporary fillip to profits and to economic activity. But

Keynes insisted that any such stimulus would most likely be small and short-lived.

Moreover it would constitute an undesirable “ overstimulation of industrial activity” requiring undue strain on capacity and a corresponding “ overexertion” of labor. For these reasons he judged the overall benefits to be minimal. Consequently, when Keynes weighed the benefits of inflation against the evils, he found the latter to far outweigh the former and accordingly came down heavily in favor of price stability.

He summarized his case for price stability best when he declared that, because “ inflation is unjust and deflation is inexpedient . . . , both are evils to be shunned. The individualistic capitalism of today, precisely because it entrusts saving to the individual investor and production to the individual employer, presumes a stable measuring-rod of value, and cannot be efficient-perhaps can-not survive-without one” It follows, he said, that the government should make price stability its primary policy goal. For, “ if we are to continue to draw the voluntary savings of the community into ‘ investments,’ we must make it a prime object of deliberate State policy that the standard of value, in terms of which they are expressed, should be kept stable”

Monetarist Aspects of the Tract

The analysis of inflation contained in the Tract has much in common with the position taken by today’s monetarists. Specifically, inflation is discussed within the context of an analytical-model that is remarkably monetarist in spirit, embodying such standard monetarist ingredients as (1) the quantity <https://assignbuster.com/john-maynard-keynes-circular-flow-money-modern-macroeconomics-economics-essay/>

theory of money, (2) the concept of inflation as a tax on real money balances, (3) the monetary approach to exchange rate determination, and (4) the Fisherian distinction between real and nominal interest rates. The paragraphs below summarize Keynes' views on these elements in order to demonstrate that he was not the stereotype nonmonetarist caricature of the textbooks.

Quantity Theory of Money

The Keynes of the Tract was an unequivocal adherent of the quantity theory. "This theory," he said, "is fundamental. Its correspondence with fact is not open to question" [7; p. 61]. His own version of the theory as elucidated in the Tract is essentially the same as the modern monetarist version and embodies the following monetarist elements : (1) a money supply and demand theory of price level determination, (2) the notion of money stock exogeneity, implying money-to-price causality, (3) the concept of the demand for money as a stable function of a few key variables, and (4) a focus on the special role of price expectations in the money demand function. Regarding the money supply and demand theory of the price level, he said that "two elements" determine general prices and the value of money. "First, the quantity, present and prospective, of [money] in circulation. Second, the amount of purchasing power which it suits the public to hold in that shape" [7; p. xviii]. Elsewhere in the Tract he says that the price level "depends on the currency policy of the government and the currency habits of the people, in accordance with the quantity theory of money"

Finally, Keynes employed the quantity theory in his policy analysis, arguing (1) that inflation is caused by an excess supply of money, (2) that such monetary excess could stem from falls in money demand as well as from rises in money supply, (3) that the central bank possesses the power to prevent the latter and counteract the former, and (4) that it should employ this power to stabilize prices.

For price stability he recommended deliberate countercyclical movements in the money supply to offset or nullify the procyclical impact of changes in money demand on prices. He thought that real money demand fluctuated with the state of business confidence, falling in booms, rising in slumps, and thereby amplifying cyclical movements of prices. "The characteristic of the 'credit cycle'," he said, "consists in a tendency of [real cash balances] to diminish during the boom and increase during the depression" [7; p. 67].

To counteract these he advocated deliberate monetary contraction in booms and monetary expansion in slumps. "The time to deflate the supply of cash," he said, "is when real balances are falling . . . and . . . the time to inflate the supply of cash is when real balances are rising, and not, as seems to be our present practice, the other way round" [7; p. 149].

In so stating, he rejected the monetarist case for a fixed monetary growth rate rule (which he argued "is bound to lead to unsteadiness of the price level" when money demand fluctuates) in favor of discretionary monetary management [7; p. 69]. "In the modern world of paper currency and bank credit," he declared, "there is no escape from a 'managed' currency" [7; p. 136].

Note, however, that while he rejected the monetarist case for rules instead of discretion in the conduct of monetary policy, he did voice the modern monetarist complaint that discretionary monetary movements frequently tend to be procyclical rather than countercyclical.

That is, he complained that the British monetary authorities had perversely engineered monetary expansions in booms when money demand was falling and monetary contraction in slumps when money demand was rising thereby aggravating rather than mitigating inflation and deflation. These -policy errors notwithstanding, however, he remained a strong advocate of discretionary monetary intervention in the pursuit of price stability.

The second monetarist ingredient that Keynes enunciates in the Tract is the concept of inflation as a tax on real money balances. As noted by the late Harry Johnson, this inflation tax analysis constitutes an essential part of the quantity theory approach to inflation. Consistent with that approach, Keynes argues that inflation is “ a method of taxation” which the government uses to “ secure the command over real resources, resources just as real as those obtained by [ordinary] taxation” [7; p. 37]. “ What is raised by printing notes,” he writes, “ is just as much taken from the public as is a beer duty or an income tax” [7; p. 52].

Regarding the inflation tax he says that “ a government can live by this means when it can live by no other. It is the form of taxation which the public find hardest to evade and even the weakest government can enforce, when it can’ enforce nothing else” [7; p. 37]. In discussing the inflation tax, Keynes stresses that it is a tax on cash balances.

The burden of the tax, he says, falls on cashholders, i. e., on the holders of the original . . . notes, whose notes [after inflation] are worth . . . less than they were before. The inflation has amounted to a tax . . . on all holders of notes in proportion to their holdings. The burden' of the tax is well spread, cannot be evaded, costs nothing to collect, and falls, in a rough sort of way, in proportion to the wealth of the victim.

No wonder its superficial advantages have attracted Ministers of Finance [7; p. 39]. He next explains how inflationary money creation transfers real resources from cashholders to the government. He notes that a given, say, 25 percent inflation rate requires an equivalent rate of rise of cash holdings just to maintain real money balances at desired levels. To accomplish this, cashholders cut expenditures on goods and services and add the unspent proceeds to money balances.

The reduced private outlay for goods and services releases resources which the government acquires with newly issued money that is then added to private cash balances. In this way inflation enables the government to appropriate real resources from cashholders just as surely as if it had taken part of their earlier money balances and spent the proceeds on goods and services.

How much the government gets depends upon the quantity of real balances the public wishes to hold when the inflation rate is 2.5 percent. Assuming the public desires real balances totaling \$36 million, the government's tax take is 25 percent of that sum or \$9 million. Or, as Keynes himself put it in discussing the effects of the hypothetical 25 percent inflation tax on real

balances of \$36 million, “ by ‘ the process of printing the additional notes the government has transferred to itself an amount equal to \$9 million, just as successfully as if it had raised this sum in taxation” [7 ; p. 39].

Keynes’ discussion of the inflation tax includes a sophisticated analysis of the optimal rate of inflation from the point of view of maximizing tax revenue. In this connection he makes four points. First, from the formula that tax yield equals tax rate times tax base, it follows that the yield of the inflation tax is the multiplicative product of the inflation rate (tax rate) and real cash balances (tax base), respectively.

Second, the tax base is not invariant to the tax rate but falls when the latter rises. That is, when the government raises the tax rate the tax base tends to shrink as people seek to avoid the inflation tax by changing their habits and economizing on real money holdings. Were this not so, said Keynes, “ there would be no limit to the sums which the government could extract from the public by means of inflation” [7; p. 42].

Third, because the tax base shrinks with rises in the tax rate, the government will realize more revenue from a tax rate rise only if it causes a less-than-proportionate fall in the base. “ A’ government has to remember,” he said, “ that even if a tax is not prohibitive it may be unprofitable, and that a medium, rather than an extreme, imposition will yield the greatest gain” [7 ; p. 43].

Fourth, it follows that there is one inflation rate that maximizes tax revenue and that occurs where’ the percentage increase in the tax rate equals the

percentage shrinkage in the tax base, i. e., where the elasticity of real
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money demand with respect to the inflation rate is unity. Here is the concept of the tax-maximizing rate of inflation, that plays such a key role in the modern monetarist analysis of inflationary finance.

A Treatise on Money (1930)

If the Tract is famous for its quantity theory-inflation tax analysis, the Treatise is equally famous for its celebrated “ fundamental equations of prices” and the corresponding distinction between income inflation and profit inflation. 8 Constituting the central analytical core of the Treatise, the fundamental equations express price level increases as the sum of two components, namely (1) increases in profit per unit of output, and (2) increases in unit costs of production (chiefly labor costs).

Of these two components of price change-namely changes in profit and changes in costs, respectively-Keynes labels the former “ profit inflation” and the latter “ income inflation.” Profit inflation occurs when prices are outrunning costs, leaving a large and growing margin for profit. By contrast, income inflation occurs when wages are rising as fast as prices thereby preventing profit growth.

It should be noted that Keynes’ income inflation does not correspond to what today is called cost-push inflation, i. e., an exogenous rise in wages and hence prices caused, for example, by the exercise of trade union monopoly power. Rather it is the induced endogenous result of an increased demand for labor and other resources generated by prior profit inflation. 9 For, according to Keynes, most income inflations do not stem from autonomous

("spontaneous") increases in wages caused by "the powers and activities of trade unions" [8, p. 151].

Instead they stem from profit-induced rises in the demand for (and hence prices of) labor and other factor resources. That is, a profit inflation stimulates firms to expand output and hence their demand for factors of production. This leads, to a bidding up of factor prices that raises production costs and generates income inflation.

This process continues until wages and other factor prices rise sufficiently to eliminate excess profits. 10 Seen this way, income inflations possess three distinctive features. They occur at the expense of profit inflations, eventually annihilating the latter. They need not cause a rise in prices since they are largely offset by compensating falls in profit inflation.

Finally, they are a crucial part of the process that transforms inflation-engendered profits into costs and thereby terminates the temporary stimulus to economic activity. Having developed the distinction between profit and income inflation, Keynes used it to analyze the effect of inflation on output and economic growth. Regarding these effects he reached two main conclusions.

For a recent exposition of the "fundamental equations" and the corresponding concepts of income and profit inflation, see Patinkin [11; pp. 33-8]. What follows draws heavily from Patinkin. This point is stressed by Patinkin [11; p. 37]. 10 See Keynes [8; pp. 241-2] and Patinkin [11; pp. 37, 45]. First, only profit inflation has the power to stimulate output and growth.

"It is the teaching of this treatise," he said, "that the wealth of nations is <https://assignbuster.com/john-maynard-keynes-circular-flow-money-modern-macroeconomics-economics-essay/>

enriched, not during income inflations, but during profit inflations . . . at times, that is to say, when prices are running away from costs" [9; p. 137].

More precisely, profit inflation stimulates both current and long-term real output. It stimulates current output by raising prices relative to wages thus lowering real wages and increasing employment. And it stimulates long-term real output by shifting income from wages to profit thereby permitting faster capital accumulation and a higher rate of economic growth.

In short, the effects of profit inflation include " the spirit of buoyancy and enterprise and the good employment which are engendered; but mainly the rapid growth of capital wealth and the benefits obtained from this in succeeding years" [9; p. 144]. These benefits, however, are possible only when prices are outrunning costs, leaving a substantial margin of profit to finance investment and growth.

They cannot occur in income inflations where wages rise as fast as prices and thus annihilate the very profits. that constitute both the means and the inducement to economic growth. It follows that income inflation, unlike profit inflation, is incapable of enhancing growth. Second, what matters for investment and growth is how long it takes for profit inflation to give way to income inflation, and this depends on the speed of adjustment of wages to prices.

If the interval is short and wages adjust rapidly to prices, then inflation will have little or no impact on capital formation and growth. But if the interval is long and wages adjust slowly to prices, then the stimulus may be

considerable and profit inflation, in Keynes' own words, becomes " a most potent instrument for the increase of accumulated wealth" [8; p. 267].

Regarding the interval, Keynes apparently felt that it had indeed been long in particular historical episodes-" quite long enough," he said, " to include (and, perhaps to contrive) the rise . . . of the greatness of a nation" [9; p. 141]. In this connection he advanced the hypothesis that the early industrialization of England and France had been powered by profit inflation.

" It is unthinkable," he declared, " that the difference between the amount of wealth in France and England in 1700 and the amount in 1500 could ever have been built up by thrift alone. The intervening profit inflation which created the modern world was surely worth while if we take the long view" [9; p. 145]. Lest one wrongly conclude from the foregoing that Keynes of the Treatise was an out-and-out inflationist, three cautionary observations should be made.

First, he was referring to gently rising prices and not to the rapid double-digit inflation that is unfortunately so common today. More precisely, he was referring to slow creeping secular inflation of no more than 1 to 2 percent per year. Today such mild inflation would be viewed as constituting virtual price stability.

Second, his analysis of beneficial inflation refers chiefly to capital-poor preindustrial societies and not to wealthy modern capitalist economies. 11 Most of his historical examples are taken from the pre-capitalist or early-capitalist era when western Europe was " very poor in accumulated wealth"

and “ greatly in need of a rapid accumulation of capital” [9; p. 145 and 8; p. 268].

Under these conditions it is conceivable that slowly-creeping profit inflation might indeed have spurred industrialization not only by diverting resources from consumption to capital formation, but also by breaking feudal bonds, stimulating enterprise, encouraging market-oriented activity, and widening the scope of the market. These latter benefits, however, are no longer available to wealthy, market-oriented modern capitalist economies that are more likely to find secular inflation a curse rather than a blessing.

For this reason Keynes refrained from recommending even slightly inflationary policies for modern economies. Finally, it should be remembered that Keynes was referring to profit inflation characterized by prices persistently rising faster than wages and not to modern inflations in which wages sometimes rise ahead of prices or at least follow them without delay thereby wiping out the profits generated by the price increases. ¹² As previously mentioned, Keynes held that inflation stimulates growth only if wages lag substantially behind prices leaving a large and persistent margin of profit to finance capital formation.

This wage lag, however, is hardly characteristic of modern inflations in which wages rise swiftly not only to restore real earnings eroded by past inflation but also to protect real earnings from expected future inflation. The clear implication is that Keynes would have opposed these modern inflations, which according to his analysis are income rather than profit inflations.

Accordingly, it is not surprising that Keynes, at the end of a long passage extolling the historical accomplishments of profit inflation, nevertheless declared, “ I am not yet converted, taking everything into ac-11 On this point see Haberler [2; pp. 98-100]. 12 See Haberler [2; p. 99]. count, from a preference for a policy today which, whilst avoiding deflation at all costs, aims at the stability of purchasing power as its ideal objective” [9; p. 145].

There is no reason to believe that he ever changed that position. On the contrary,. there is strong evidence that he remained a determined foe of inflation and an adamant proponent of price stability even to the extent of warning of the potential danger of inflation in 1937 when the unemployment rate was in excess of 10 percent of the labor force.

Articles in The Times (1937)

The most convincing evidence of his continuing strong opposition to inflation in the 1930s even after the publication of his celebrated General Theory, appears in four articles he wrote for The Times in early 1937. 13 There, in discussing policies for dealing with unemployment at the business cycle peak of 1937, he made it abundantly clear that his primary concern was preventing inflation.

In particular, he argued that the 1937 unemployment rate, although very high (“ indeed, as high as 12½ percent”), was nevertheless at its minimum noninflationary level at which demand pressure must be curtailed to prevent inflation. Accordingly, he recommended a sharp cutback in government expenditure on the grounds that the economy was rapidly approaching the point where further increases in aggregate demand would be purely
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inflationary. "I believe," he said, "that we are approaching, or have reached, the point where there is not much advantage in applying a further general stimulus at the centre" [4; pp. 11, 44, 65].

In so stating, he identified the noninflationary full employment rate of unemployment (NIFERU) below which industrial bottlenecks frustrate the intended output and employment effects of aggregate demand expansion policy so that mainly prices rise. 14 Beyond that point, he said, noninflationary reductions in joblessness could only be achieved by specific structural policies designed to lower the full employment rate of unemployment itself. As for the existing high level of that unemployment rate, he attributed it to structural rigidities in the 1.

These articles are reprinted and discussed in Hutchison [4]. Unless otherwise noted, all references in this section are to Hutchison. 14 The NIFERU concept also appears in the General Theory where Keynes asserts that! beyond a certain point, structural impediments ("a series of bottle-necks") would prevent the noninflationary expansion of output and employment long before full capacity is reached.

At the bottleneck point any further increase in aggregate demand would, in his words, largely "spend itself in raising prices, as distinct from employment" [10; pp. 300-1]. British economy, in particular to a substantial mismatch between the location and skill mix of the labor force and the location and composition of demand. As he put it, "the economic structure is unfortunately rigid" and this rigidity prevented output and employment from

responding to increases in aggregate demand so that only prices rise [4; pp. 11, 65-6].

It follows, he said, that to achieve noninflationary reductions in unemployment “ we are more in need today of a rightly distributed demand than of a greater aggregate demand” [4 ; pp. 11, 66]. In other words, noninflationary reductions in unemployment cannot be obtained by expansionary aggregate demand-management policies but rather “ require a different technique” [4; pp. 11, 14, 44, 66].

To this end he advocated specific structural policies to reduce unemployment on the grounds that noninflationary reductions in unemployment could only be achieved via measures that eradicate structural rigidities and lower the equilibrium unemployment rate itself. In so arguing, he foreshadowed by 30 years the modern monetarist concept of the natural rate of unemployment.

He also refuted the popular contention that he was an inflationist who advocated full employment at any cost. That is, his 1937 articles amply demonstrate that, far from being an inflationist, his main consideration was preventing inflation-even at a time when the u