

Critical evaluation of keynes economic theory

[Economics](#)



**ASSIGN
BUSTER**

Keynes economic theory was developed by a British Economist John Maynard Keynes, which explains the cause of less than full employment and role of government or activist Policies to stabilize the economy at equilibrium at or near full-employment with acceptable expected inflation.

After Keynes the fiscal policy objective was to manage aggregate demand and use the fiscal policy to redistribute income so that to have more consumption expenditure compared to the more unequal distribution of income in a market economy and use monetary policy to control inflation when the economy is closer to full-employment level. The effectiveness of any theory must be evaluated from the perspectives whether it has solved the economic problems it raises and whether it has the credible empirical evidence to support its stance.

As well whether it has given new insights in to the working of the economy and explains economic phenomenon better than previous theories and the existence of credible criticism of the theory and whether the theory has addressed these credible weaknesses identified by different economic schools of thought especially by classical and neoclassical economic schools of thought sufficiently and are they used to develop formulate economic policies based on the theory compared to competing theories or are they used in combination with other insights in contemporary market economic systems and their effectiveness in solving macroeconomic issues.

On the basis whether Keynes economic theories has solved the economic problem of unemployment with acceptable inflation and the economic evidence supports this is questionable. This is because in 1970's and 1980's all the major industrialized market economies of US, UK, Germany, France

<https://assignbuster.com/critical-evaluation-of-keynes-economic-theory/>

etc experienced high level of inflation and un acceptable level of unemployment even though they based their economic policies based on Keynesian economic policies of demand management and activist fiscal policy and deficit financing.

However before this period the Keynesian economic polices were successful in solving unemployment problems after the world war II period and the economy experienced high employment rates than ever before.

This shows the Keynesian Page: 2 economic polices are inflationary in nature at least in the perspectives of the neoclassical and classical school of economist. In the contemporary economic policymaking Economist mostly rely in controlling inflation as a macroeconomic objective than full-employment and insist on the labor market reform as a method to address unemployment

because they attribute unemployment because of inflexible labor market due to political influences and government involvement in the regulation and determination wages as well as trade union power and inflexibility in the labor market which causes unemployment rather than due to inadequate aggregate demand as well as a source of inflation. However in solving unemployment at least in short-term monetarist policies alone did not alleviate unemployment because of its negative impact on aggregate demand and effects on economic activity and investment levels at least in the short term.

In accordance with monetarist view involuntary unemployment cannot exist and if market forces are allowed to work they tend to gravitate towards near

full employment with little inflation or natural rate of unemployment. However the business cycles occur In all market economies and involuntary unemployment occurs at least in short term and and persistently and takes long periods to adjust to full-employment level without market intervention is a reality. Keynesian theory explains this more adequately than classical or neoclassical theories.

As well the post-Keynesian economists have addressed some weaknesses of the orthodox Keynesian theory and incorporated some ideas in there model particularly some classical and monetarist insights. In addition they have responded to the criticisms of monetarists and classical schools of economic thought to some extent. In addition all market economies use fiscal policy to different degrees as a macroeconomic policy instrument to achieve macroeconomic objectives in conjunction with classical and monetarist economic ideas to address the weaknesses of Keynesian economic theory particularly to solve chronic unemployment problems.

As well the role of government in economic intervention in market economies in different degrees is a norm than an exception in all developed market economies.

Page: 3 Based on the critical evaluation of Keynesian theory it is obvious it has some serious weaknesses in its theoretical basis. However it also has some strength compared to other economic thoughts like classical and neoclassical theory particularly explaining mass involuntary unemployment to solve to some extent the mass unemployment.

If Keynesian theory coupled with other insights is useful in formulating economic policies to achieve the macroeconomic objectives of full-employment, low inflation, external stability and economic growth even though they may have trade-offs between these objectives. b) Comparison of Classical and Keynesian Economic theories Classical economist theorist believes that if the free market is allowed to work with little or negligible government interventions then the market economy through its price mechanism in the goods, labor market and the monetary sector all can be at equilibrium at full employment.

Their theory is based on quantity theory of money and Says law. This means the money supply does not affect output and output do not affect money supply. That is other words the supply of money given the velocity of money is constant will only affect price level not output and the aggregate supply is vertical and the price mechanism will always make sure that the economy gravitates towards full-employment. As well they believes that production will create its own demand economy there fore will tend to be at equilibrium at full-employment in the long-term with little government intervention.

However after the great depression in 1930's and the inadequacy of the classical theory of theory not able to explain declining prices and mass unemployment with little government intervention at that time gave some economist to ask questions of the classical economic model how the economic system works. However Keynes believed the market would work better with government interventions and the market must be the major mechanism, which determines what to produce, how to produce when to

produce. Page: 4 As well he believed in the long term the market will tend to be at equilibrium at or near full employment.

But in the short-term the market can be at equilibrium less than full-employment primarily due to inadequate aggregate demand. That is in other words in Keynes economic theory they rejected the quantity theory of money and says law primarily because they believed the prices and wages are sticky and therefore not work in a downward direction and prevents the economy to move towards full-employment. In addition in Keynes theory the Investment is volatile and its level depends on future expectations of businesses to earn an income and uncertainty of future income

Read about Castro's economic policies

and therefore affects aggregate demand and therefore affects the output and employment less than full-employment because there is no mechanism to address this inadequacy of aggregate demand. Therefore government must intervene in the economy to boost economic activity through government spending or tax reduction to move the economy to full-employment and use monetary policy to control inflation by controlling money supply when the economy come closer to full-employment. In summary there is more

radical departure from the classical economic theory than similarities in Keynes economic theory. However Keynes believed in market economy as the classical economic theorist in market mechanism than in government planning and its involvement in making allocation of resources and production of goods and services like in command economies. However he

<https://assignbuster.com/critical-evaluation-of-keynes-economic-theory/>

emphasized the role government in demand management and the distribution of income as opposed to the classical economists. c) Evaluation of the contribution of Keynes General Theory to Economics

As explained above it is obvious that it has shed light on the working of the economy as a whole and the macroeconomic analysis as compared to the classical economist particularly explaining better than classical economist the greatdepressionand deflation at that time. In addition in contemporary times it is the main theoretical base for the fiscal policy of many industrialized countries even though they prefer the monetarists policy prescriptions to control inflation and give priority to inflation than

Page: 5 unemployment in the current economic thought of many economist and government economic policy framework. In addition it is the basis for post-Keynesians to refine the orthodox Keynesians and to incorporate other economic thought particularly of monetarist who are more classical than the Keynesians in their economic model. In addition it gave more economic insights to the causes of unemployment where the involuntary unemployment may be the cause of inadequate aggregate demand

and government can address this by discretionary fiscal policy with a combination of monetary policy as well as market reform and regulation of anti monopoly policies to increase competition in the market as well to reform the labor market processes and excessive union power in the labor market wage determination, which is the cause of unemployment according to classical economists and neoclassical economist. As well monetary policy is more effective in controlling inflation but not effective in solving

unemployment compared to fiscal policy due to time lag and its indirect impact on aggregate demand than fiscal policy.

As Keynesian general Economic Theory explains recessions and business cycle and has some insights how to resolve these macroeconomic issues and it has worked in some times in the past and still plays a part in economic analysis of the economy as a whole even though the neoclassical position is more wide spread in the contemporary economic thought it can be argued that Keynes General Economic theory has contributed to considerable extent to economics as it adds some further insights and knowledge how an economic system work in reality.