II. The Keynesian School – Episode III

Applications of theories in the goods markets

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Overview

The Legacies and Limits of the Keynesian School

Why is consumption so smooth?

Why is investment so volatile?

Where do we go from now?

References

The Legacies and Limits of the Keynesian School

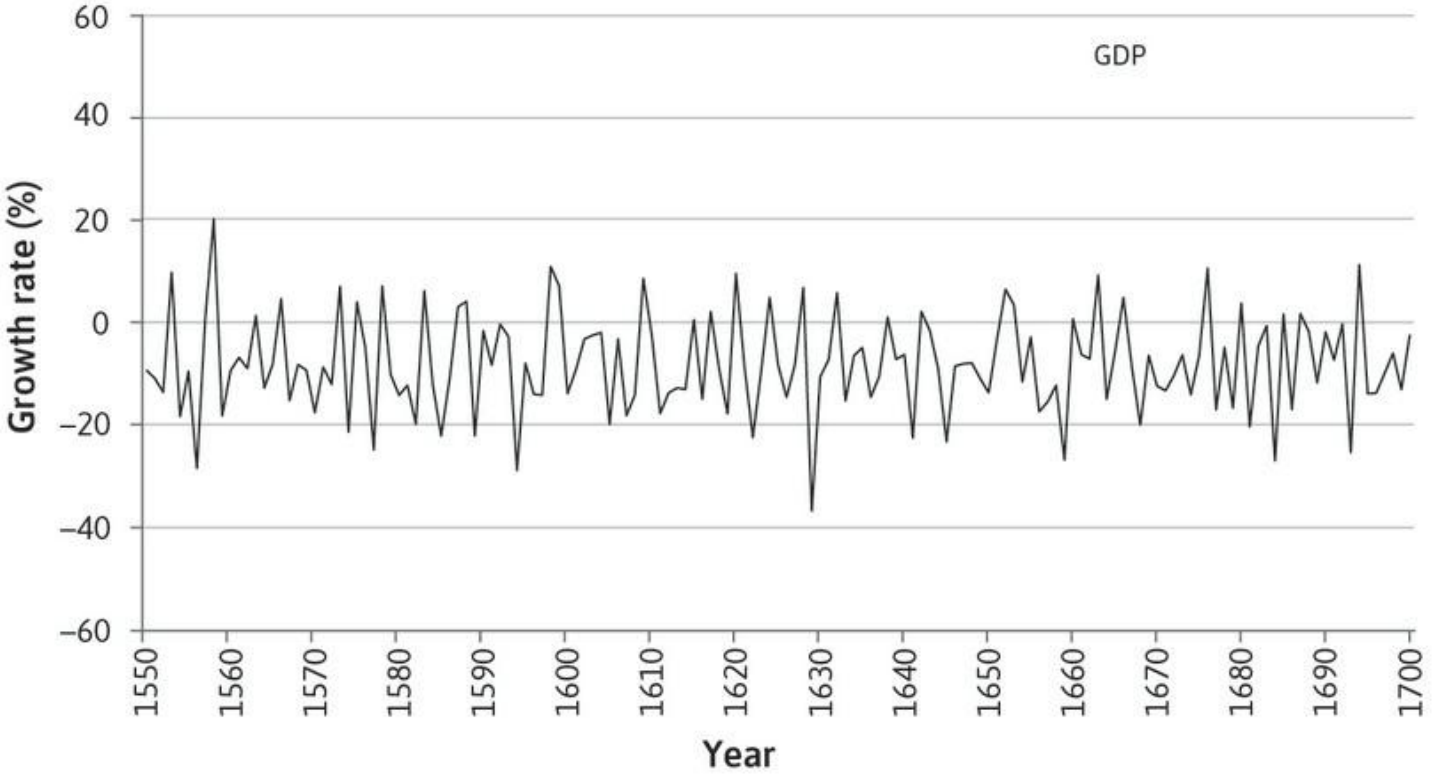
Back to the drawing board

There have been “improvements” since Keynesian Theory of Consumption. Again, with the help of data and computing power (2018 vs. 1932), our understanding has became more advanced.

Where are economic fluctuations from for the less industrialised?

History can tell us.

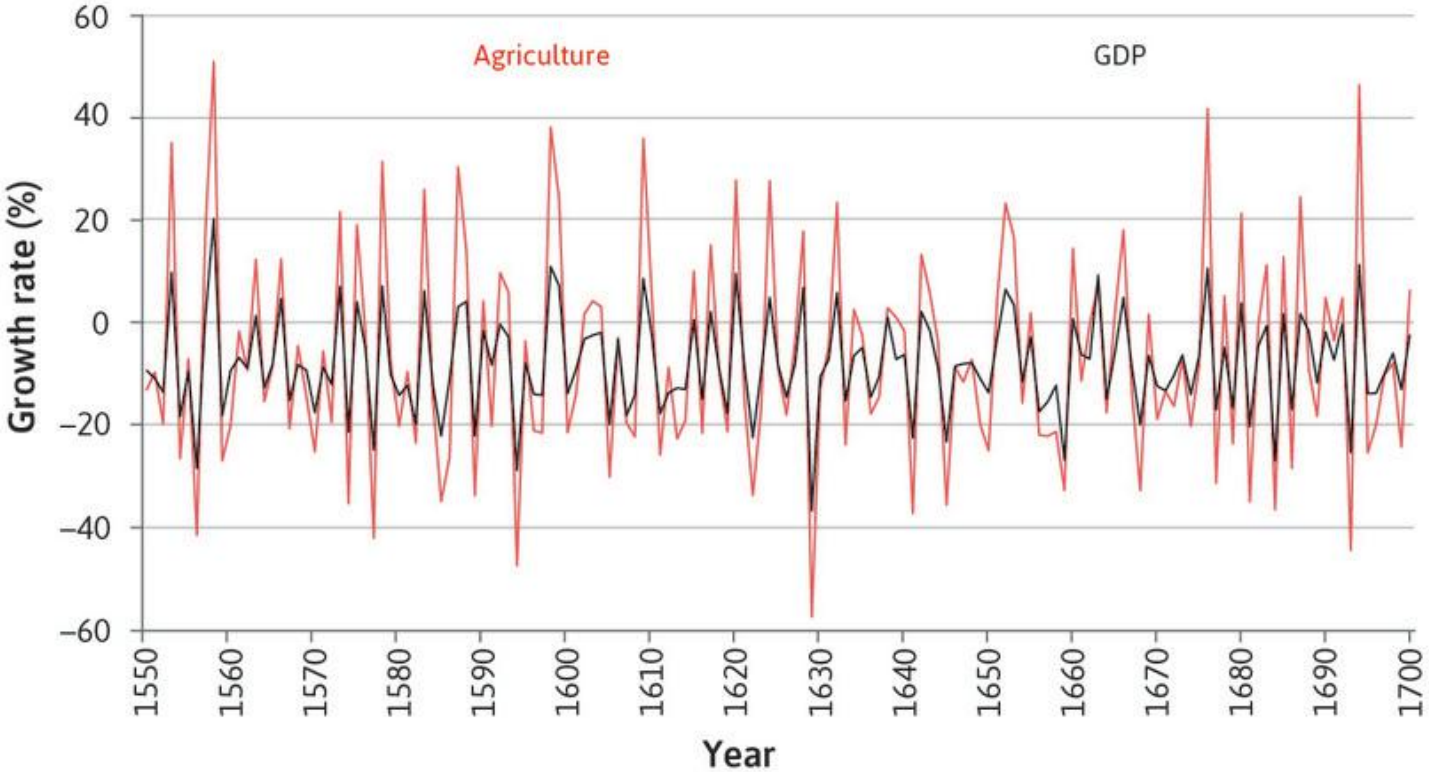
Figure: GDP growth between 1550 and 1700, Britain



Source: Reprinted from Unit 13 in The CORE Team, The Economy. Data based on Broadberry et al. (2012).

The role of agriculture in the fluctuations

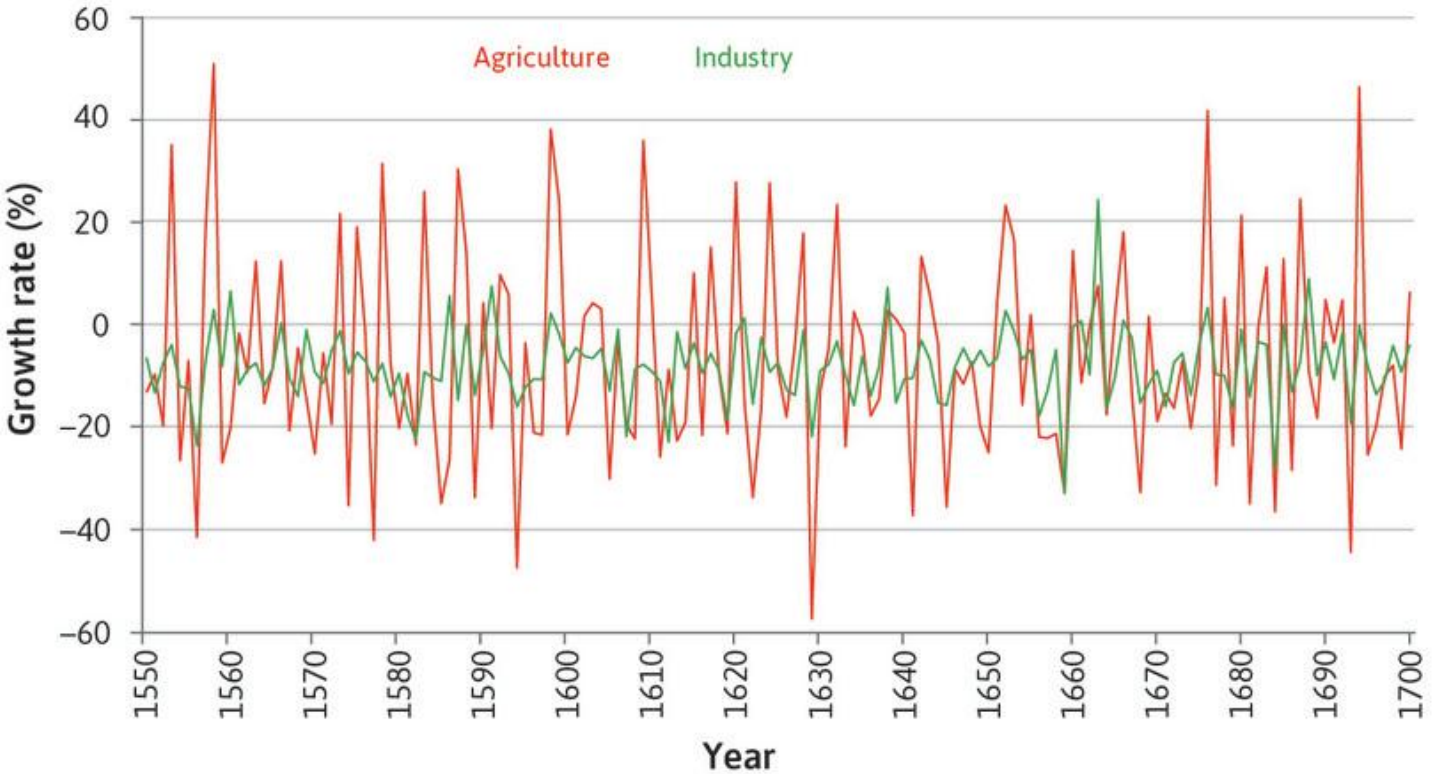
Figure: GDP growth between 1550 and 1700, Britain



Source: Reprinted from Unit 13 in The CORE Team, The Economy. Data based on Broadberry et al. (2012).

Fluctuations in agriculture is three times that of the industry

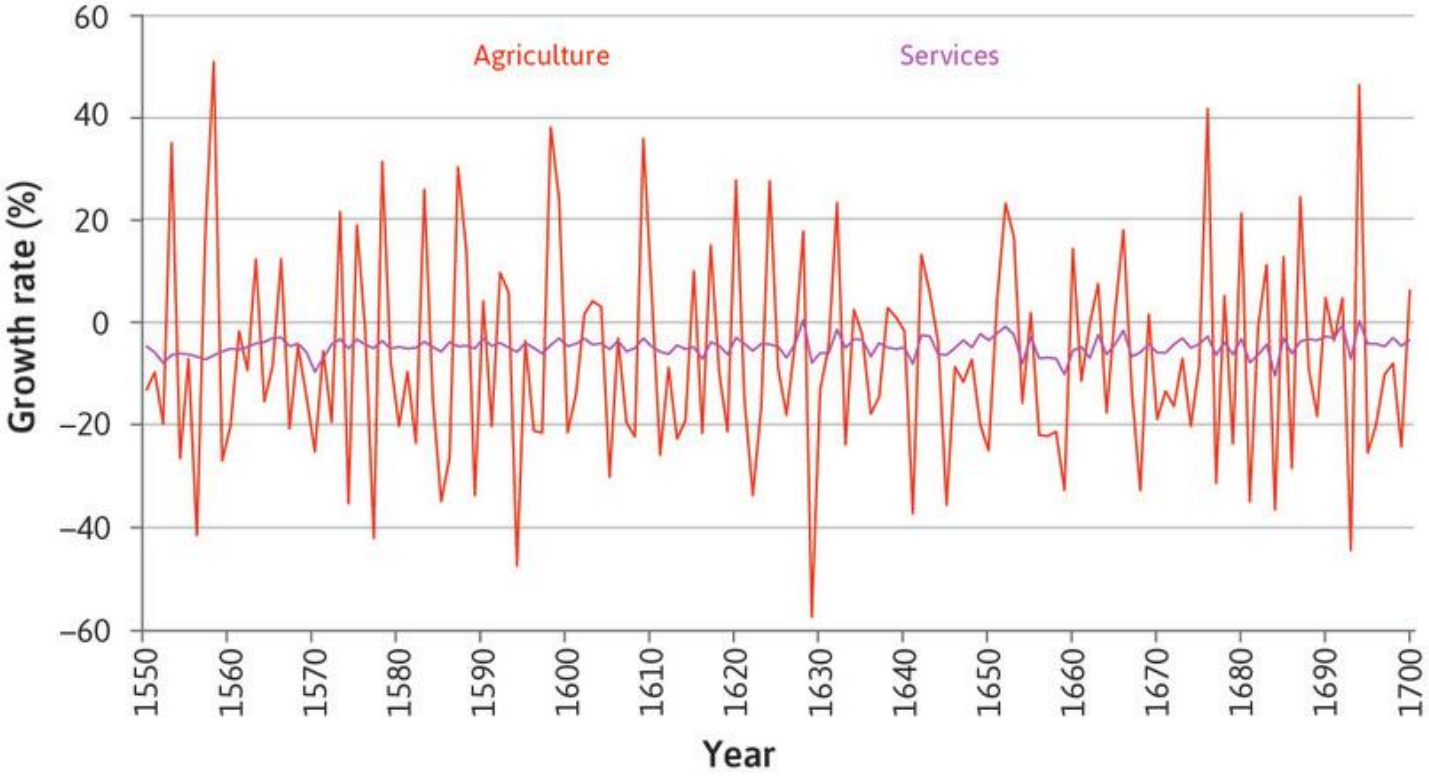
Figure: GDP growth between 1550 and 1700, Britain



Source: Reprinted from Unit 13 in The CORE Team, The Economy. Data based on Broadberry et al. (2012).

... and ten times that of the services sector

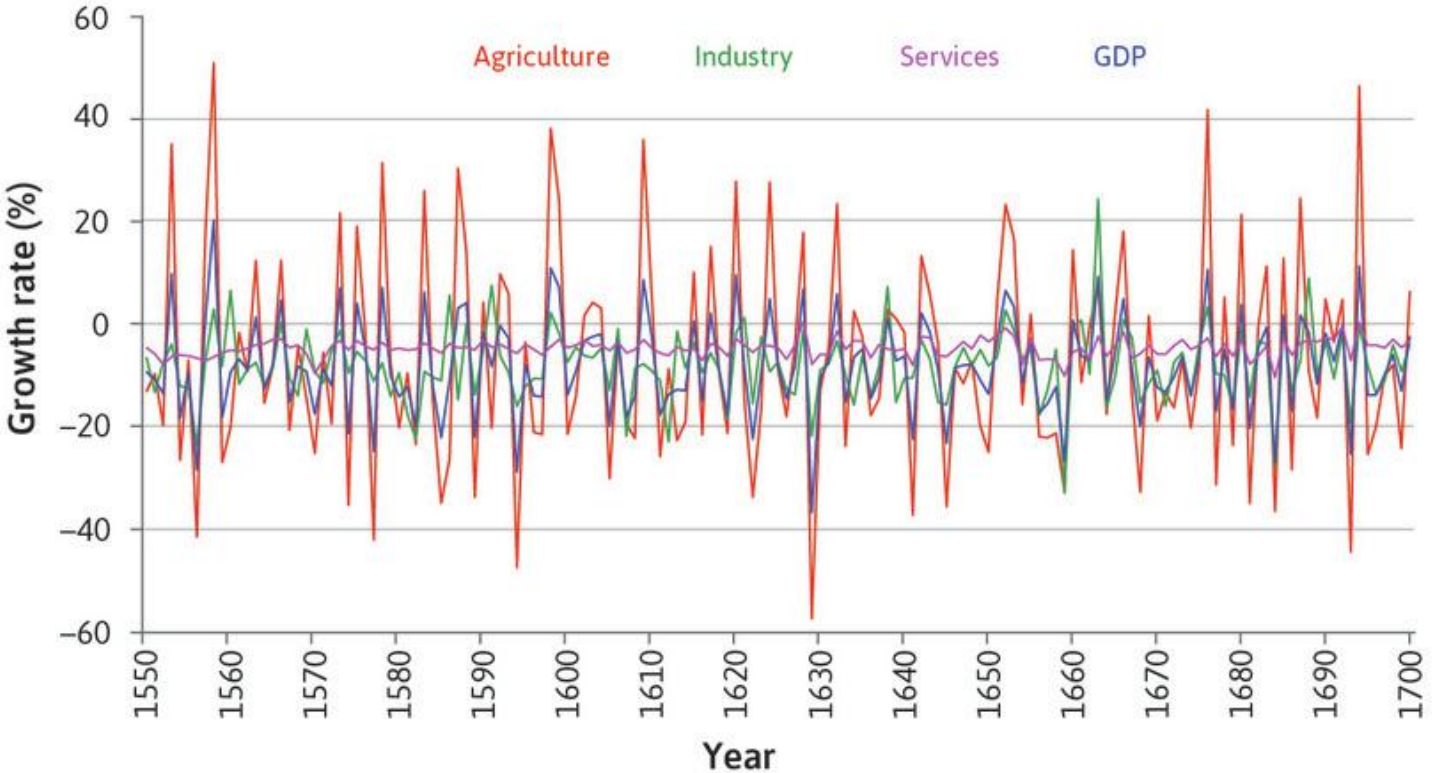
Figure: GDP growth between 1550 and 1700, Britain



Source: Reprinted from Unit 13 in The CORE Team, The Economy. Data based on Broadberry et al. (2012).

Agriculture drove fluctuations in the GDP in 16th-18th century Britain

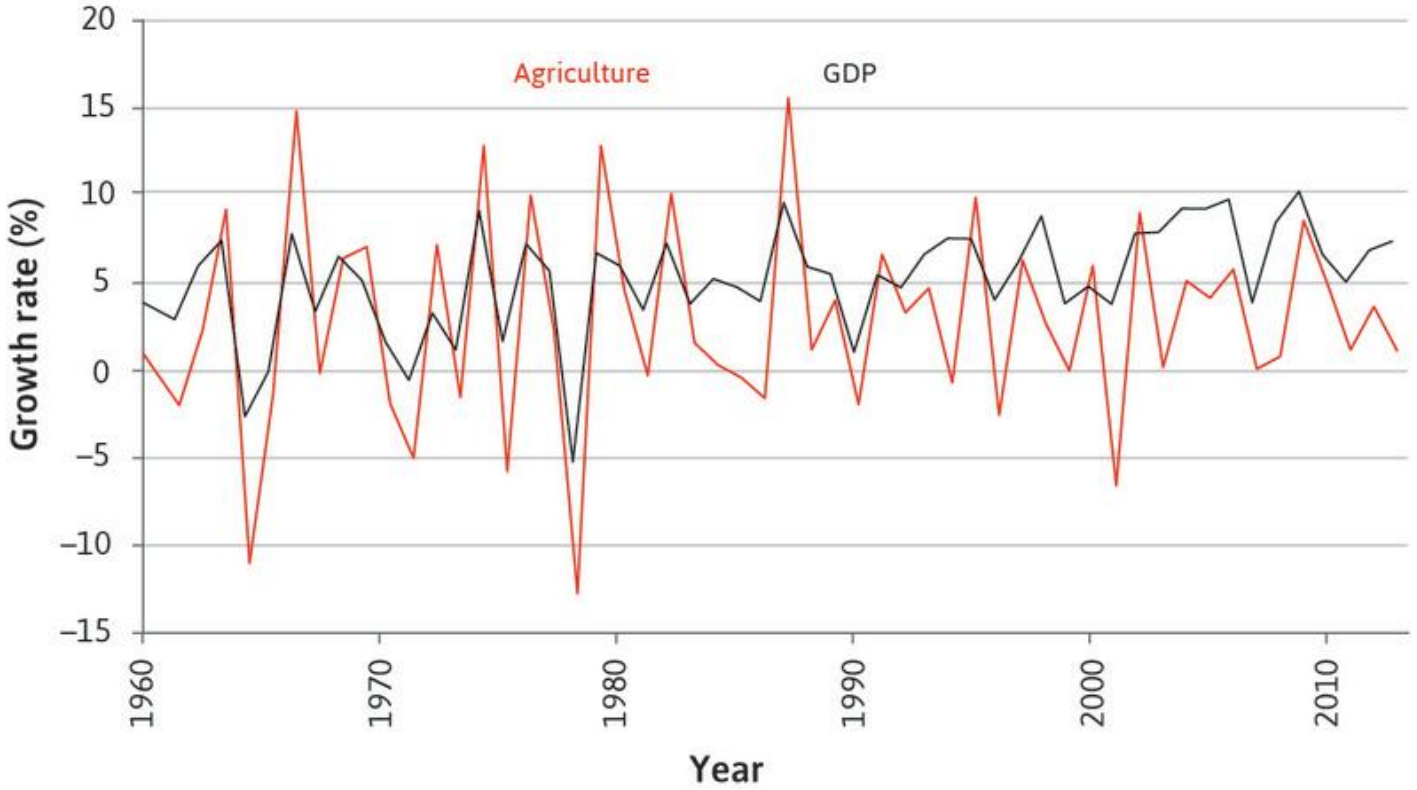
Figure: GDP growth between 1550 and 1700, Britain



Source: Reprinted from Unit 13 in The CORE Team, The Economy. Data based on Broadberry et al. (2012).

A more recent history – India

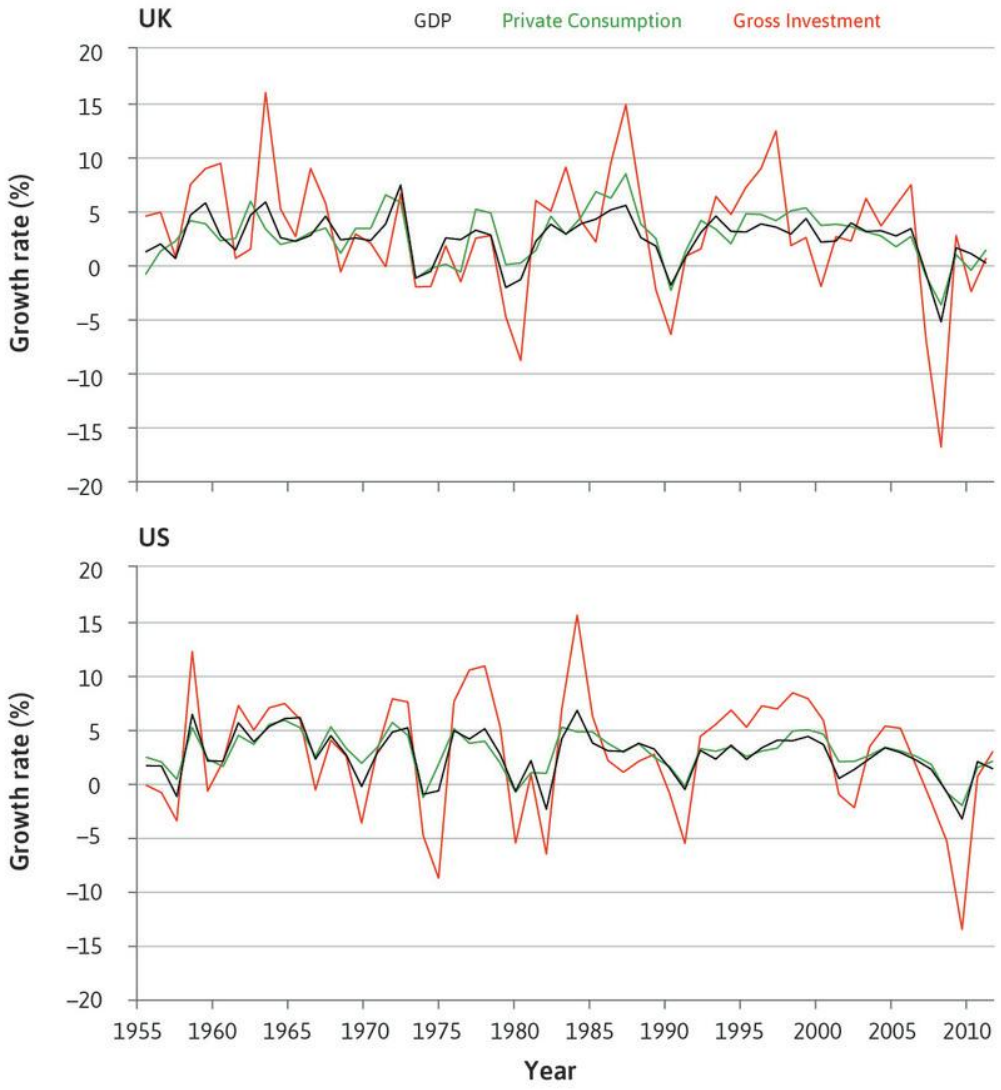
Figure: The role of agriculture in the fluctuations of the aggregate economy in India (1961-2014).



Source: Reprinted from Unit 13 in The CORE Team, The Economy. Data based on The World Bank. 2015. World Development Indicators.

Stylised fact: investment is more volatile than consumption

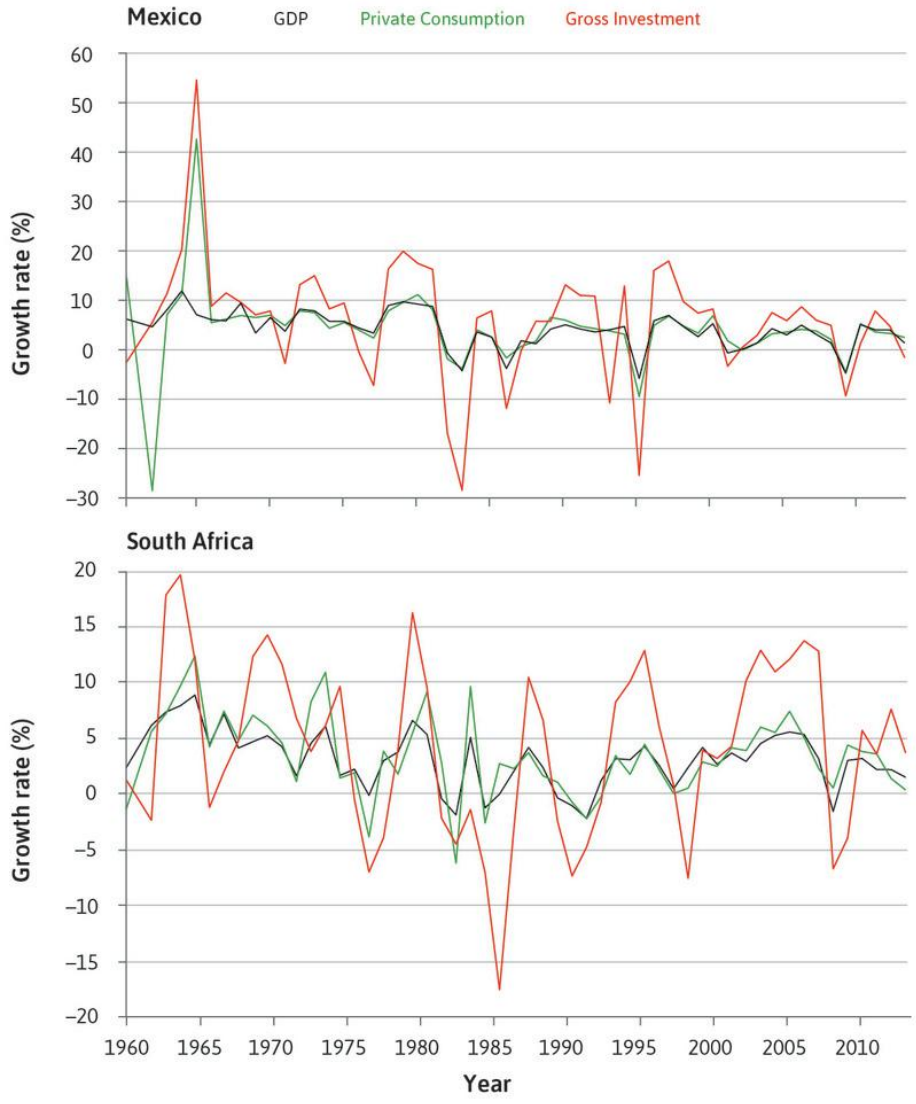
Figure: Growth rates of consumption, investment, and GDP in the UK and US, per cent per annum (1956-2012).



Source: Reprinted from Unit 13 in The CORE Team, The Economy. Data based on Federal Reserve Bank of St. Louis. 2015. FRED.

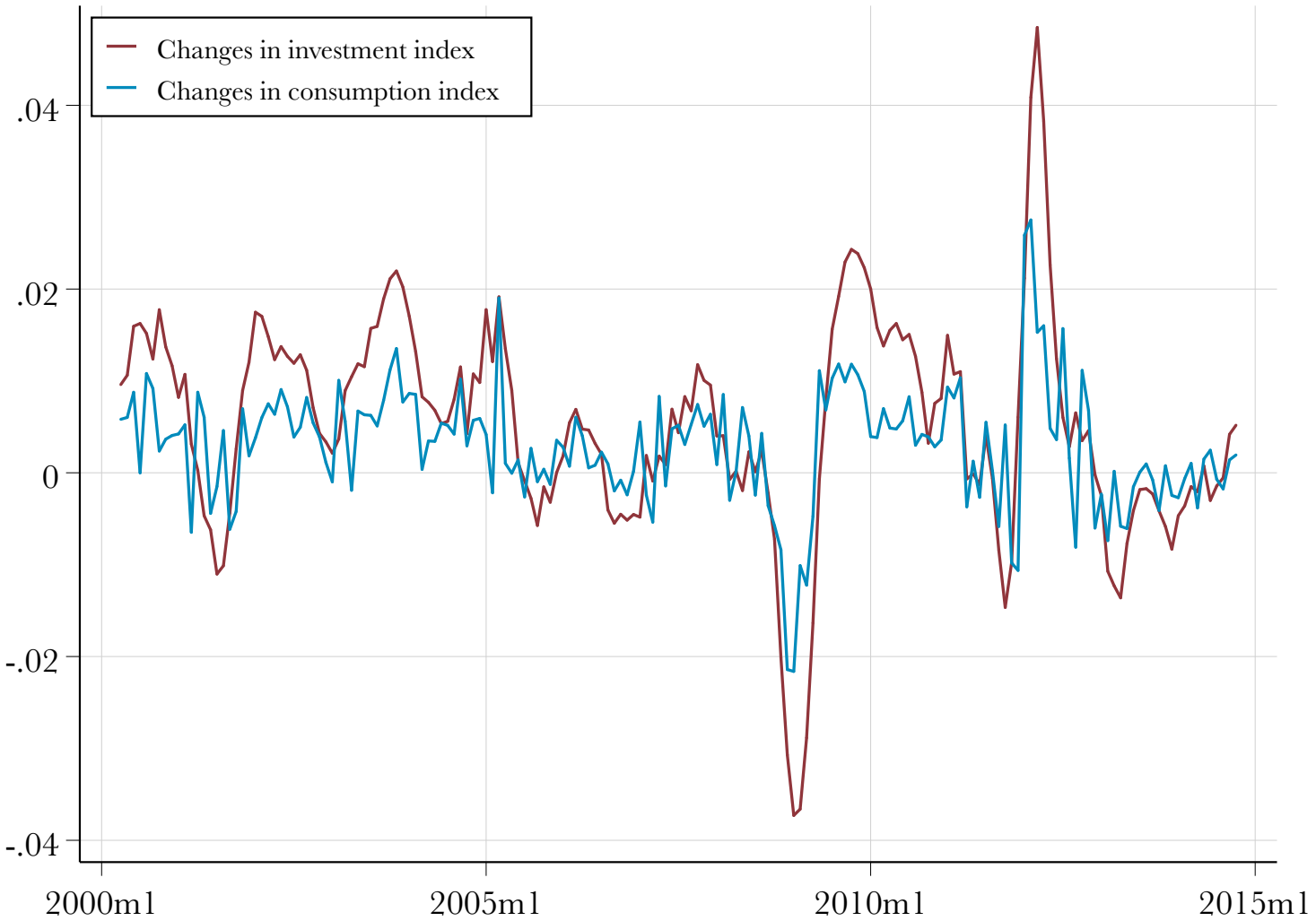
Stylised fact: investment is more volatile than consumption

Figure: Growth rates of consumption, investment, and GDP in Mexico and South Africa (1961-2012).



Source: Reprinted from Unit 13 in The CORE Team, The Economy. Data based on Federal Reserve Bank of St. Louis. 2015. FRED.

A more recent history – Thailand



Source: Lecturer's calculation based on the Bank of Thailand's data.

Why is consumption so smooth?

Why is consumption so smooth?

The model we have discussed so far is overly simplistic. Households – you, I, us – are much more complexed than that. Households faces two types of shocks:

1. Good or bad fortunes strike the household;
2. Good or bad fortunes strike the economy as a whole.

Mitigating household shocks

Two main ways that household can try to deal with shocks on the household's income:

1. Self-insurance
2. Co-insurance

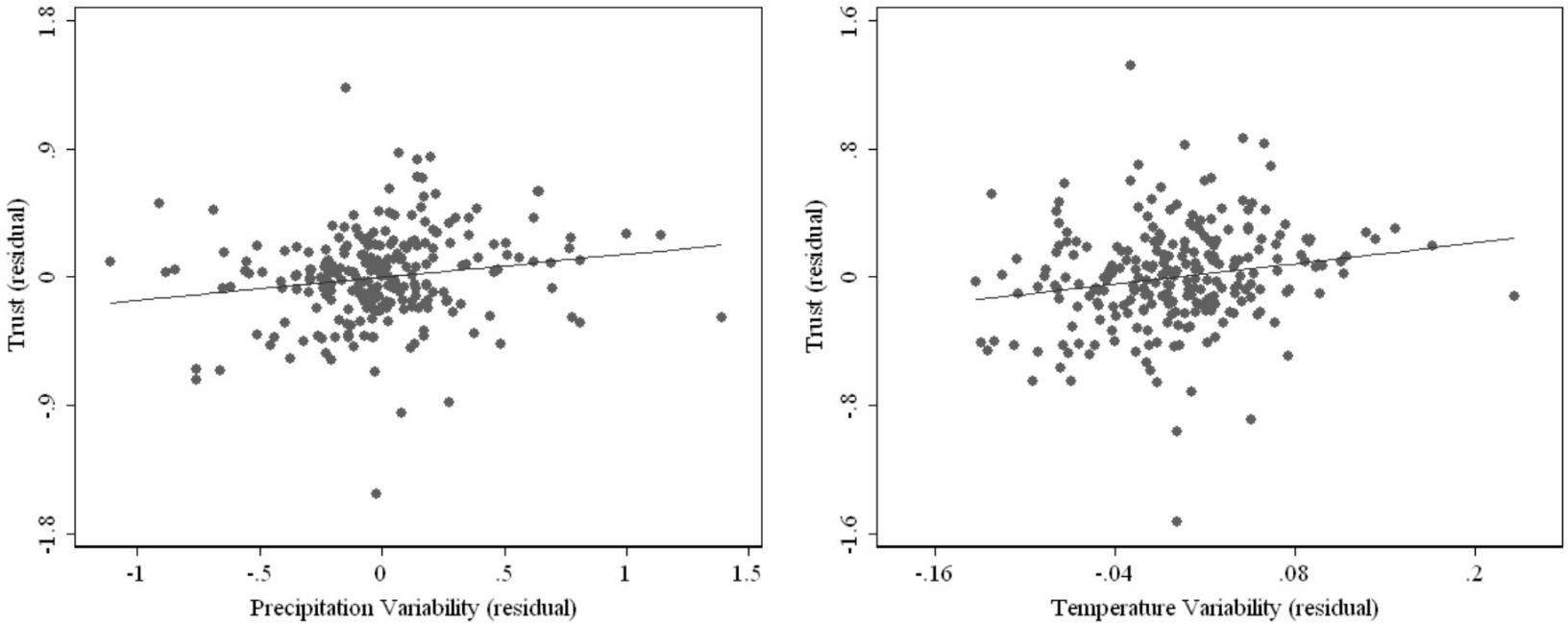
As such, households (i) like it smooth; (ii) are not that selfish actually. The second point is especially clear for economy-wide shocks.

Evidence: people in the regions with high year-to-year variability in rainfall and temperature during the past 500 years

- Display high levels of trust;
- have more modern day co-insurance institutions (Durante, 2010).

500 years of fluctuations and social trusts

Figure: Climate variability and trust, OLS residuals from country FE and regional controls.



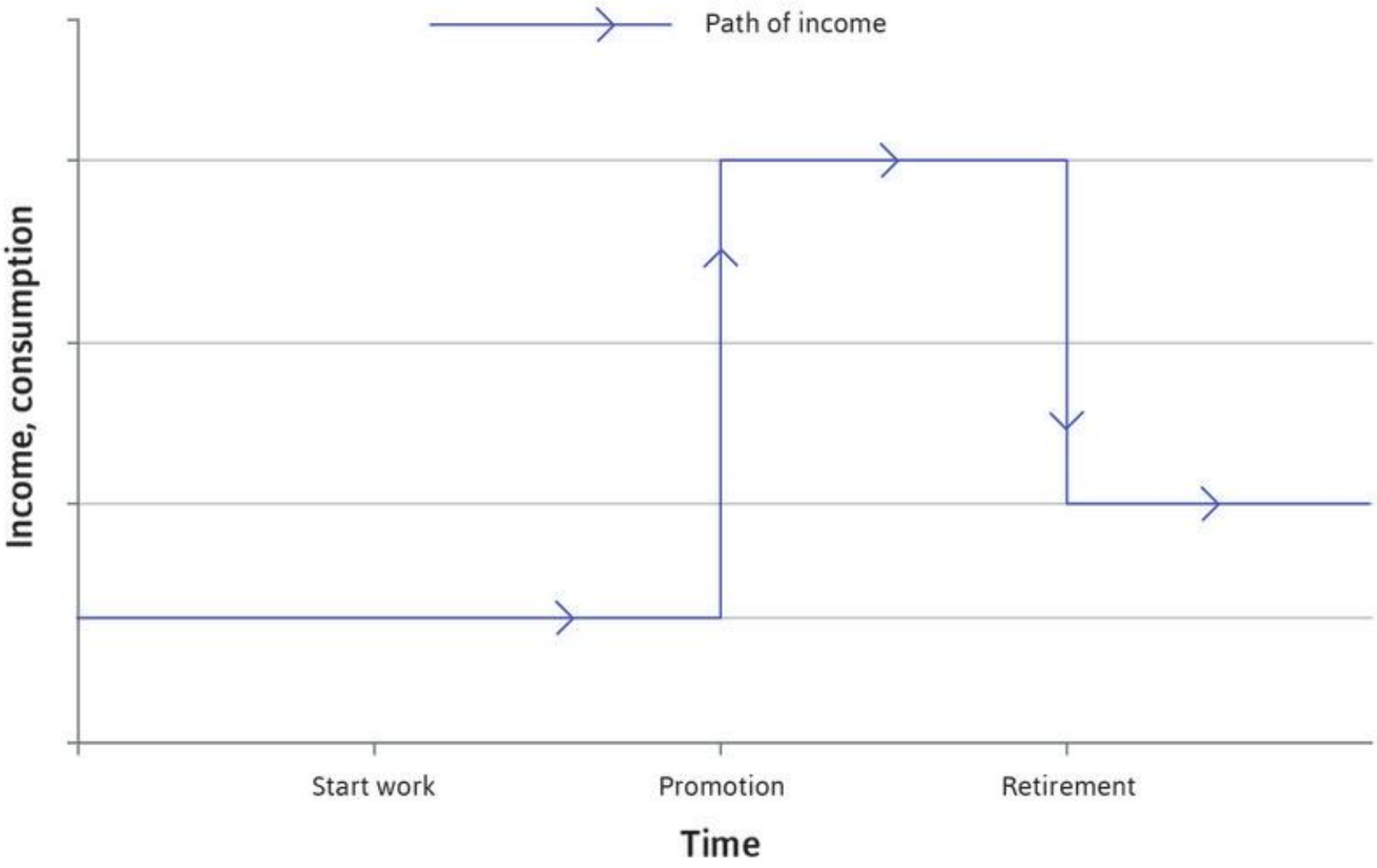
Source: Reprinted from Durante (2010).

Therefore, there exists other theories of consumption

We have covered what is called the absolute income hypothesis – real consumption depends directly on real income. Since smooth consumption is preferred, what other theories attempt to explain this?

- Relative income hypothesis (Duesenberry et al., 1949)
- Permanent income hypothesis (Friedman, 1957)
- Life-cycle hypothesis (Ando & Modigliani, 1963)

Household intertemporal decisions



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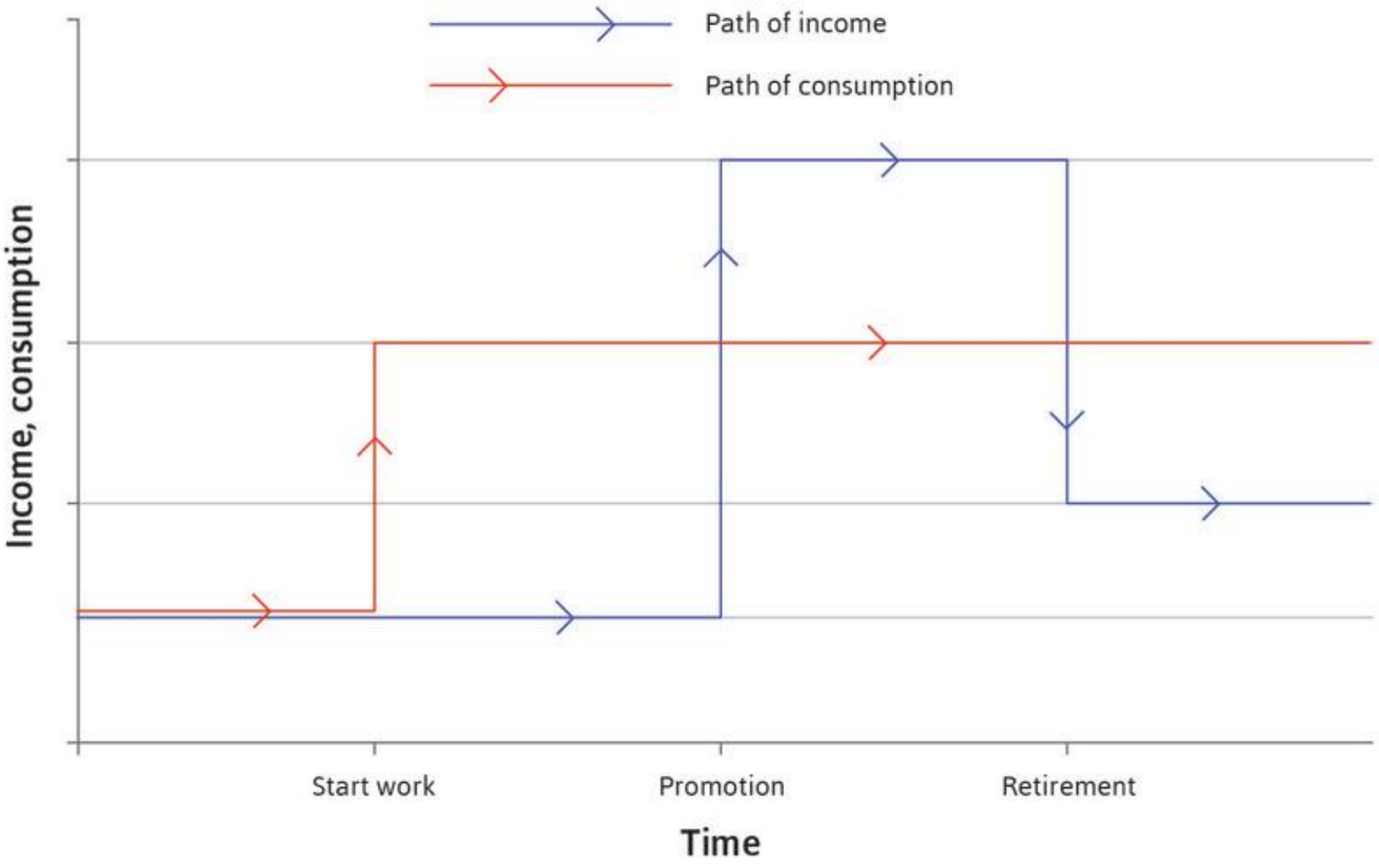
Household intertemporal decisions



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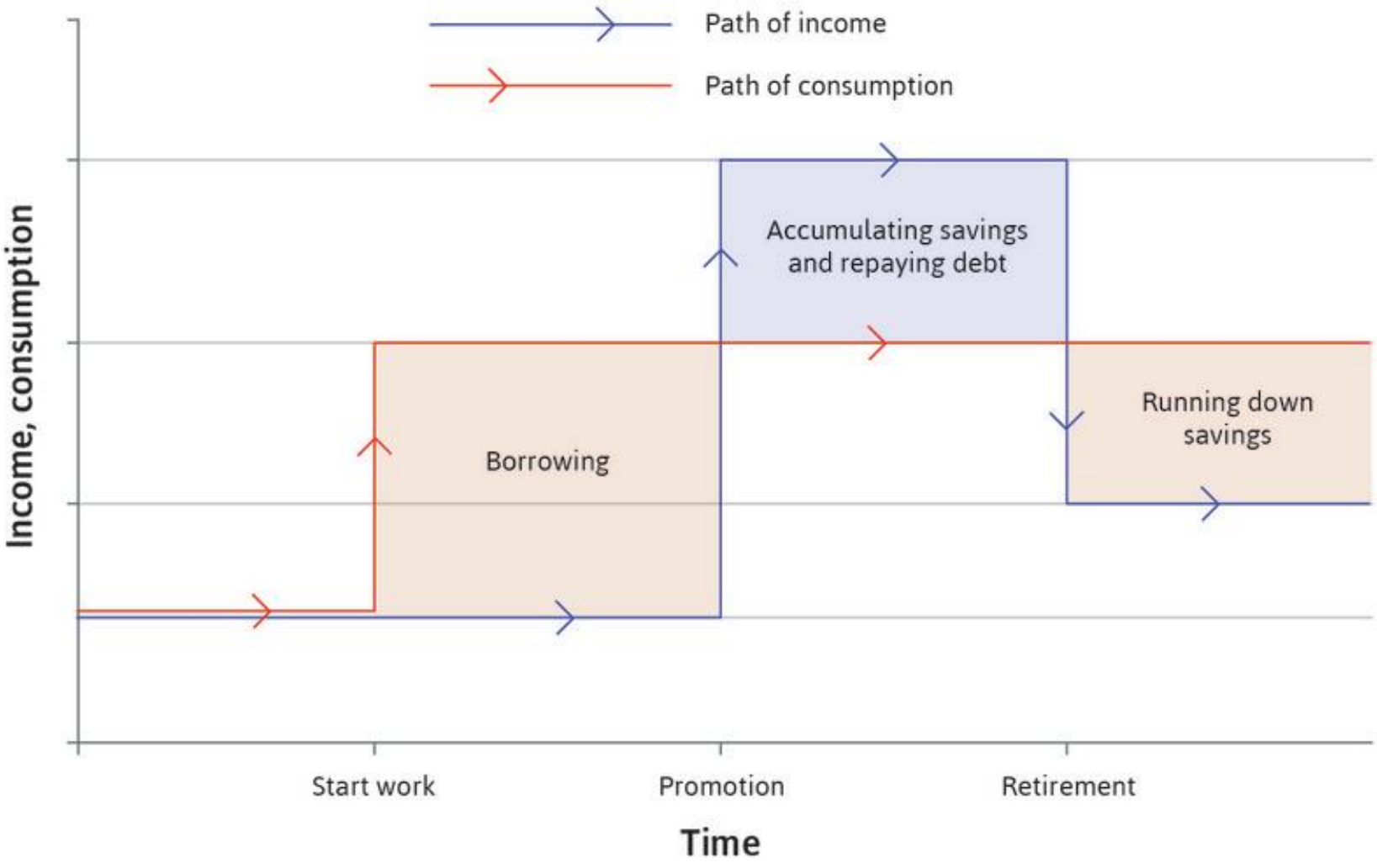
Household intertemporal decisions – why consumption is smooth



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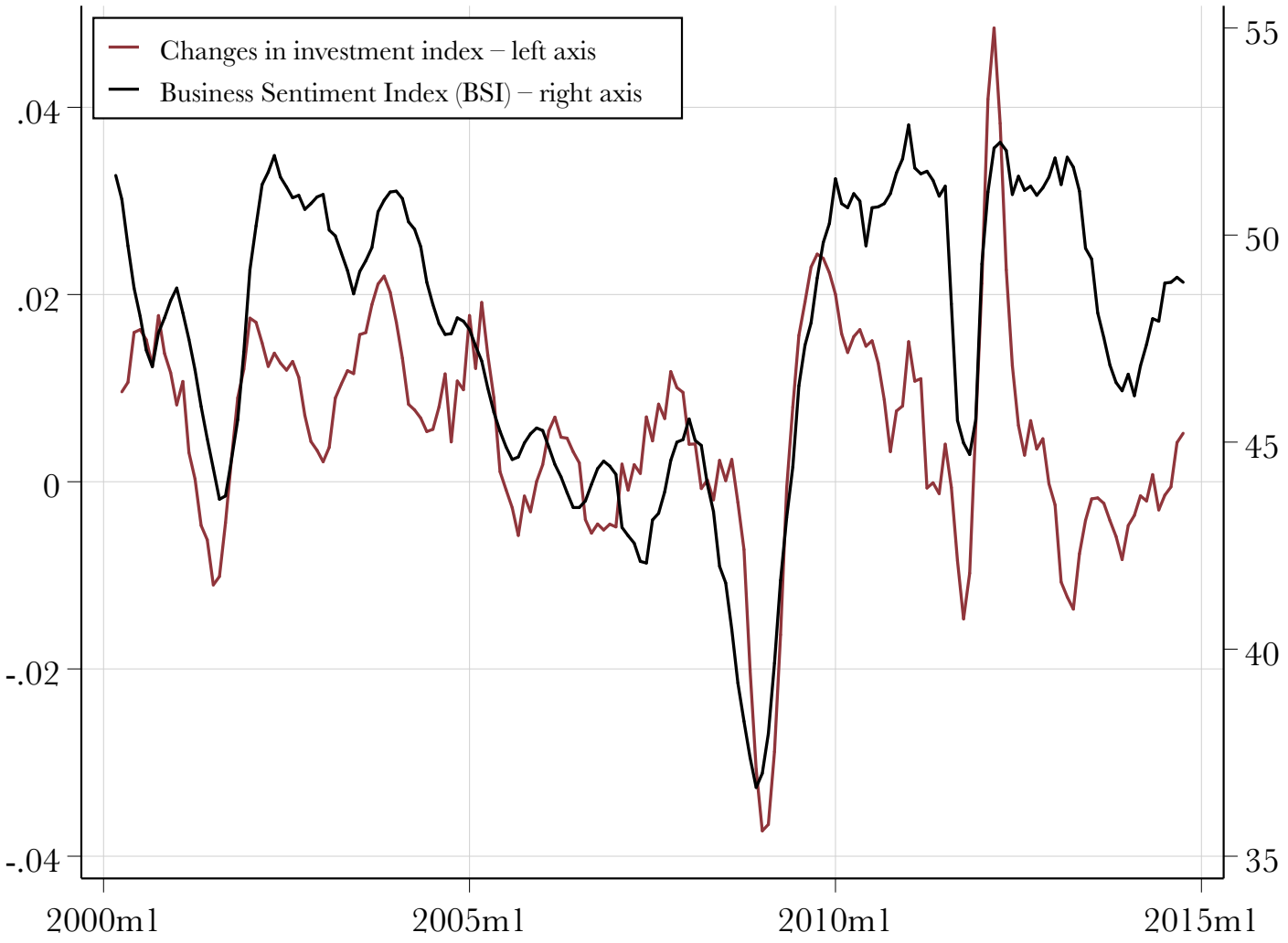
Why is investment so volatile?

Investment has a vastly different problem



Source: Lecturer's calculation based on the Bank of Thailand's data.

Why is investment so volatile?

- Firms will invest when they think there is an opportunity for making profits.
- Firms do not know what will happen in the future as well. **Expectations** play a big role.
- Investment, unlike consumption, can be postponed.
- Most importantly, investments are likely to happen in waves – coordination issues.

Where do we go from now?

Keynes worked... until the oil shocks

Keynes predicted that inflation is driven by demand – but then the oil price shocks happen. We had cost-pushed inflation in our midst.

However, Keynesian contributions with regards to the money market and what the central bank should do will be discussed *after the midterms.* We shall hold off the discussion about the limits of Keynesian school of thought until then.

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