

## Summary of Keynesian Economic Theory

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### Keynes' perspective on Great Depression

- ❑ Keynes disagreed on the self-adjusting classical economy theory that output and prices will return to a natural state of equilibrium. Keynesian perspective is emphasized on the need of using fiscal policy when the economy is facing recession. He said the government intervention should spend more and encourage people to spend more money in the overall economy.

### Possible solutions to Great Depression

- ❑ When the Great depression started, aggregate demand fell, wages fell then aggregate supply curve began shifting to the right. Then WWII occurred, the US government then used expansionary fiscal policy to boost consumer and government spendings then there's no recessionary gap and the economy recovered and this was the end of the Great Depression.

### Pros and cons of monetary policy

- ❑ Pros : Government intervention helps prevent unemployment, underemployment, and low economic demand. Slow change in prices can be beneficial in money supply and the Central Bank independently lowering interest rates encourages borrowing and lending. It boosts exports and also encourages investment.
- ❑ Cons : It required 'Active' intervention because wages and employment and short term demand are slower to respond to the market needs. Lowering the interest rate doesn't always result in excessive fluctuation and it will become less effective if it reaches 0%, liquidity trap, or some will face NIRP. It affects the entire economy, not the specific ones.

### Pros and cons of fiscal policy

- ❑ Pros : Spending boosts aggregate output and generates more income and stimulates specific economies. Also, more income means more investment then the resulting growth is in GDP. Spending more, MPC increases, this appeared to prevent the paradox of thrift. Also, a tool to reduce unemployment. There are also risks in government intervention such as corruption.
- ❑ Cons : According to Friedman and Rothbard, the Keynesian model misrepresented the relationship between saving, investment, and economic growth. The fiscal stimulus is less

effective than the original multiplier model. This also boosts more imports and creates a deficit budget.

### What is Keynesian economics?

- ❑ A demand-side theory that increases government spending and cuts taxes to stimulate demand and diminish recessionary gaps in the overall economy by the government intervention in the short run.

### Keynes' perspective on saving and economic growth

- ❑ Keynes said that excessive saving is dangerous for the economy except for education and retirement because it reduces Keynesian multipliers (Marginal Propensity to Consume) and money flow in the economy which has brought negative impacts on full employment and economic growth. Which can be seen more in Paradox of Thrift definition, people saving more money during recession essentially leads to the falls of demand and economic growth.

### Alternative theory on saving and economic growth

- ❑ Milton Friedman Model emphasizes the idea that marginal propensity to consume and savings decisions are more impacted by permanent income rather than current income. According to this, saving will lead to more investment and more spending in the economy.
- ❑ Ramsey--Cass--Koopmans Model is a neoclassical model of economic growth which differs from the Solow-Swan, it internally determines the saving rate in the market and saving rate may not be constant along the transition to the long run steady state. Some countries have high savings rates and it hinders economic growth because it cuts circular flow in the economy. Also, it has impacts on investment and capital utilisation.
- ❑ The Solow-Swan Model is a neoclassical model of economic growth which emphasized the exogenous impact of population, saving rate, technology, and employment on economic growth. Having the same saving rate and level of technology in poor countries will reach the same steady state growth rates in the long run. In the steady state, both  $k$  and  $y$  being constant, the growth rate is not affected by the saving rate. No new capital is being created means there is no economic growth. To increase consumption and economic growth, it can be increased by saving less.
- ❑ The Harrod-Domar model emphasized potential dysfunctional aspects of growth such as how growth increases as unemployment increases. Harrod-Domar focused on higher savings rate leads for more investment in physical capital and more economic growth.