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Homework 8

1. What is Keynesian Economics?

Keynesian economics was developed by the by British economist John Maynard Keynes during the 1930s to response to the Great Depression because of highly critical of classical economic argument. This theory is using active government policy to manage aggregate demand in order to address or prevent economic recessions.

2. Why Classical Theory Failed During Great Depression?

According to the Classical Theory, when aggregate demand goes down, it leads to in decrease in production and jobs and the price and wages would be decline. Then, a lower inflation and wages would make investor to invest and employ more people and that restoring the economic growth. But the Great Depression proved that people will be starved and died before economic return to equilibrium without government subsidy.

3. What is Keynesian Economics Focus On?

So, the Keynesian economics will be more focus on spending, output and inflation. Also, it is focus on changes in the economy over the short run which using government policy to manage aggregate demand to prevent economic recessions instead of self-adjust of output and prices to the state of equilibrium like neo-classical theory.

4. What is Keynes's perspective During Great Depression?

Keynes found that output and prices did not return to the equilibrium during great depression. He argued that when economic is in downturns, the fear that endangers among businesses and investors will tend to become self-fulfilling and leads to a sustained period of depressed economic activity and unemployment. So, he rejected this theory.

5. Possible Solution to Great Depression

Keynes advocated that the government should undertake deficit spending to make up for the decline in investment to boost consumer spending to stabilize aggregate demand during the recession period. He explained more that British government cut welfare spending and raised taxed to balance national books, but it does not encourage people to spend more, but it will unable to lead the economic to recover. So, this support that government should spend more money which would increase consumer demand in the economy and the economy would be recover and reduction in unemployment.

6. Keynesian Economics and Fiscal Policy

Pros – Because of the multiplier effect, which is spending of one consumer becomes income for a business that then spends more and more, an injection of government spending will lead to added business activity and even more spending. It will boost the aggregate output and generates more income. Also, when worker happy to spend more of their extra income, it will lead to growth in the GDP and could be even greater than initial stimulus amount.

Cons – Other economist argued that the Keynesian model misrepresented the relationship between saving, investment and economic growth.

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7. **Keynesian Economics and Monetary Policy**

Pros – As Keynesian theorist argue that economic do not stabilize themselves very quickly and require government intervention to boosts short-term demand in the economy. Also, prices do not react quickly so, to make it possible is to use money supply (monetary policy) as a tool and change interest rates to encourage borrowing and lending. When borrowing is encouraged, businesses often increase their spending, and this will stimulate the economy. Therefore, lowering the interest rates is one-way to increase the demand and reinvigorate the economic system, restore employment and demand for services. Without this intervention, they believe that cycle will be disrupt and market growth becomes unstable.

Cons – Therefore, lowering the interest rate does not always improve the economic. When Keynes focus on lower interest rate, he tries to avoid interest rate to approach zero unless the monetary policy will become less effective because it reduces the incentive to invest rather than simply hold money in cash and this called liquidity trap.

8. **Other Strategies to Boost Economics**

Because of the fails in monetary policy, Keynesian economist argue that other strategies must be use. Other interventionist policies are including direct control of the labor supply, changing tax rates to increase or decrease the money supply of goods and services until employment and demand are restored.

9. **Keynesians' perspective on saving and economic growth**

Because of the multiplier is directly related to the marginal propensity to consume which is spending from one consumer becomes income for another and the cycle continues. So, Keynes believe individuals should save less and spend more, raising their marginal propensity to consume to effect full employment and economic growth. Keynes also criticized the idea of excessive saving that it is dangerous for the economy to have more money sitting stagnant because it will have less money in the economic cycle.

10. **Alternative Theory on Saving and Economic Growth**

A major impacting economic growth in a society is the level of saving. Classical economists believed that if saving go up, investment increases because the interest rate and economic growth follows. As I do a research, there are a lot of literature review about saving and economic growth.

Tinaromm (2005) – Private saving has both direct and indirect effects on economic growth. In his view, the direct effect of saving is through private investment. He also showed that economic growth has a positive effect on the private saving rate.

Hemmi et al. (2007) – He said that there is a one-way causal relationship from saving to economic growth.

Masih and Peters (2010) – Concluded that savings have positive effect on economic growth.

Singh (2010) – He said that there is a two-way relationship between saving and economic growth. His result also showed that an increase in. saving and capital accumulation will lead to higher income and economic growth.