The need for economic stability and growth to focus on the causes of and cure for unemployment, depression, and social turmoil.

Underemployment and underemployment in poorer nations due to the lack of jobs, have been mentioned by the past. But they are not the only needs for the unemployed millions of people, particularly when they are survivors of unemployment. Understanding the nature of economic forces and their role in society is important. It is necessary to comprehend the causes and effects of economic conditions. An understanding of inflation and economic forces in the context of unemployment is critical.

An understanding of inflation and economic forces in the context of unemployment is critical.

Under the current economic model, the unemployment rate does not necessarily correlate with the economy. Underemployment and underemployment are also common in the poor nations of the world. Underemployment and underemployment are more severe in periods of declining economic forces. Understanding the nature of economic forces and their role in society is important. It is necessary to comprehend the causes and effects of economic conditions.

Unemployment, depression, and social turmoil.

The disillusioned defense of capitalism.

Chapter 28
there are considerable personal costs. These include not only the absence of a regular wage income, but also the severance from the social contacts usually associated with the workplace. Moreover, in a society where people’s status is defined primarily by their work, unemployment frequently leads to social marginalisation and social stigmatisation. Employment may be alienating, but unemployment is usually more so. Being out of work for a significant period of time also usually causes skills to atrophy and may lead to attitudinal changes that make it harder to enter or re-enter the workforce.1

There are other social costs which have to be borne by society at large. In a welfare state, which provides financial assistance to the unemployed, unemployment causes higher government expenditure. Simultaneously, government income is reduced because unemployed people generally pay no taxes. So, there is a strong tendency towards government budget deficits—not altogether a bad thing according to Keynesians, but something that creates pressures to prune other areas of government expenditure, such as health, education, public transport, and infrastructure. Therein lie further contradictions because, in so far as unemployment is linked to ill-health (and there is considerable evidence of such statistical and causal connections), the need for medical services tends to rise. Similarly, to the extent that unemployment is associated with a higher incidence of crime, the costs of policing, incarceration, and other forms of social control also tend to increase.2

Fundamentally, though, the problem of unemployment is one of opportunity cost. The society has to forgo the goods and services that the unemployed people would have produced were they in useful employment. That is the opportunity cost of unemployment—its cost in terms of opportunities (for production and consumption) forgone. It shows the irrationality of an economic system simultaneously having unused resources and unfilled social needs.

Reducing unemployment therefore raises the tantalising possibility of a win-win situation, whereby the unemployed people benefit by acquiring jobs while society benefits by acquiring the extra goods and services they produce and the extra tax revenues they pay. Whether or not a reduction in unemployment actually increases social well-being also depends on the nature of the jobs created (alienating or fulfilling?) and the nature of the goods produced (better hospitals, schools, and transport systems, or more environmentally degrading junk?). Such broader considerations apply equally to those currently in employment, of course. Just focusing on the personal, social, and opportunity costs of unemployment provides a strong argument that policies to reduce unemployment make a valuable social contribution.

Keynes certainly thought so. He was analysing the situation prior to and during the Great Depression. It was a time of terrible economic difficulties, causing major social stresses and threatening political turmoil. Here were circumstances crying out for careful analysis and remedial policies.

It is conventional to associate the start of the Great Depression with a single day: ‘black Thursday’, 24 October 1929, when there was a major financial crash on the Wall Street Stock Exchange in New York. The sharp fall in share values triggered a stampede of panic selling that led to further falls in the following days and weeks. Fortunes were lost. It is said that people checking into high-rise New York hotels at the time were being asked if they wanted a room to sleep in or a room from which they could jump out of a window.

Along with the financial crisis came a crisis in the real economy: falls in productive investment, and rapid decline in the levels of output, income, and employment. With the benefit of hindsight, these real economic problems can be seen to have been developing even before the stock market crash. They set in with a vengeance thereafter. The volume of farm produce fell by more than half over the next two years and industrial production fell by almost a third. Nearly a third of all workers suffered unemployment. The adverse economic conditions spread quickly to other capitalist national economies, including Canada (always immediately vulnerable to changes in US economic conditions), the United Kingdom and continental Europe, Australia, and New Zealand. Charitable soup-kitchens provided some assistance to the unemployed, but there was little institutionalised state support for them in those days. People who had no jobs commonly suffered eviction from their homes, destitution, and even starvation.3

What had gone wrong? The farms and factories were still there. There was no shortage of people willing to work in them. The problem was that the capitalist economy could not be relied upon to mobilise the unemployed people for socially useful production.

Of course, the problem of economic depression was not new; a deep and prolonged depression had occurred in the 1880s, for example. Earlier still, Marx had pointed out this potentially fatal flaw in the capitalist system, emphasising its innate tendency to generate a ‘reserve army of labour’ and periodic economic crises. Marx’s reasoning, developed many decades before the Great Depression, evidently tallied with the observable conditions of the time, and an increasing number of people came to believe that only socialism could provide a solution. Indeed, while the capitalist countries were suffering the Great Depression in the 1930s, the Soviet Union, then the major experiment in constructing a socialist alternative, was experiencing full employment and continuing economic growth. In Germany and Italy, fascist governments were offering another solution, mobilising unemployed people to build highways and public housing, and manufacture tanks and bombs. Notwithstanding its authoritarian and racist aspects, the fascist alternative attracted growing numbers of followers. The future of liberal capitalism, flanked on the left by socialism and on the right by fascism, was starting to look very insecure. Both alternatives seemed to be doing so much better economically, and support for revolutionary change was widespread. Marx’s famous prediction of ‘socialism or barbarism’ seemed to be materialising.

This was the economic, social, and political context within which Keynes made his analytical and practical contributions. Although he described capitalism as ‘morally objectionable’, he judged its reform and survival necessary. Solving the unemployment crisis was the top priority. Keynes did marvellously well in this respect. Not only did he find an explanation for unemployment, but he also showed how appropriate government policies could substantially reduce, if not eliminate, it.

The market did not have to be left to find its own equilibrium. Keynes argued; rather, a managed equilibrium of full employment could be engineered. While that
A person's ability to work and produce is often the main focus of economic analysis. In a capitalist system, the market determines the price and quantity of goods and services. The price mechanism is the primary tool for allocating resources. However, the effects of monopoly and externalities are important factors to consider. In monopoly, a single firm controls a market and can set prices above marginal cost. This can lead to deadweight loss, a reduction in economic efficiency. Externalities, such as pollution, affect parties other than the direct participants in a market. Government intervention, such as regulations and subsidies, can be used to correct for externalities and improve social welfare.

In this context, economic growth is often associated with technological progress and innovation. The development of new technologies, such as the internet and renewable energy, can lead to increased productivity and a higher standard of living. However, economic growth does not necessarily lead to happiness or well-being. Inequality and environmental degradation are important issues to consider.

Challenging Classical Preceptions

John Maynard Keynes (1883–1946)
must seek to remove these impediments. If trade unions, for example, are preventing wages from falling, their power to do so must be broken (for the workers' own collective good, of course).

**The Keynesian Viewpoint**

Keynes provided a critique of the prevailing orthodoxy and a fundamentally different interpretation of unemployment. Demand and supply still figure in his story, but the labour market is not treated as if it operates like other markets. A distinctive analysis of money markets is also introduced. The analysis is reoriented to the determinants of the aggregate demand and supply for goods and services, for labour, and for money. This emphasis on the analysis of the economy as a whole is the essence of a distinctively *macroeconomic* approach.7 The macroeconomy is seen to be functioning according to principles that cannot be derived simply by adding up all its microeconomic elements.

Individual markets for goods and services, for example, may clear if prices are flexible, but that does not mean that full employment is guaranteed. The most obvious illustration of this is the wage-cutting favoured by neoclassical economists in Keynes's day (and still frequently advocated today). Wage-cutting has a seemingly obvious rationale: individual employers might indeed be willing to hire more workers if they are cheaper to employ—but only if they are confident of selling the extra products. According to Keynes, wage reductions in practice generally make the unemployment problem worse. If workers have lower incomes, they have less to spend on goods and services, so firms will sell fewer products and consequently reduce their demand for labour, and unemployment will rise. Wage-cutting has perverse effects because it decreases the aggregate demand for goods and services. Indeed, the problem of depressed demand tends to become even more entrenched because businesses usually respond to reduced sales of their products by cutting their investment spending, which then reduces the productive capacity of the economy in the longer term. A vicious cycle of economic contraction occurs.

A better strategy, Keynes argued, would be to implement policies to expand the aggregate demand for goods and services, thereby leading to increased levels of employment. How best to do this? Governments do not usually have direct control over the wage rates that employers pay to their employees (although they do have direct control over the wages they pay to their own public-sector employees, and they may also be able to exert some indirect influence on wages in the private sector, especially in countries like Australia where arbitration institutions oversee wage outcomes). However, a government can always adjust the level and pattern of its own expenditure in order to pursue the goal of full employment. If it spends more on building schools, hospitals, bridges, or railways, for example, that creates jobs for construction workers. Those workers are then able to spend more on food, cars, and clothing, which creates jobs for farmers and car and clothing manufacturers. The extra incomes lead to extra spending, which then stimulates higher outputs and creates more jobs. A virtuous cycle of economic expansion occurs.

Whether this process is virtuous in all respects is a matter of judgment. Producing more goods and services to create more jobs may concurrently entail environmental damage or foster an ultimately unfulfilling consumerism. However, for directly tackling the social evil of widespread unemployment, such as existed when Keynes was writing, the justification for the policy is abundantly clear. Keynes himself felt so strongly about this that he made the memorable pithy statement that

If the Treasury were to fill old bottles with banknotes, bury them at suitable depths in a disused gold-miner which are then filled up to the surface with town rubbish, and leave it to private enterprise on well-tried principles of laissez-faire to dig the notes up again...there need be no more unemployment and, with the help of its repercussions, the real income of the community and its capital wealth would probably become a good deal greater than it actually is. It would, indeed, be more sensible to build houses and the like; but if there are political and practical difficulties in the way of this, the above would be better than nothing.8

Students tend to remember this as Keynes's advocating filling mine shafts with banknotes, or digging holes and filling them in again. He meant nothing of the sort. He favoured mobilising the unemployed for socially useful production—for building houses and the like. His point is that, from a purely job-creating viewpoint, these other bizarre forms of activity would serve the purpose equally. They would certainly be better than policies of wage-reduction and fiscal austerity.

Increasing government expenditure as a means of resolving economic difficulties was heresy in Keynes's day, and has become so again in our own. For Keynes it was not simply a matter of economic logic; it was also a moral imperative. Unemployment was a social scourge. The policies that he advocated for its eradication were based on the presumption that government could, and should, serve broad social purposes. This entails the pragmatic application of economic knowledge to the improvement of existing social conditions.

Job creation had top priority in Keynes's own time because unemployment was so obviously the main economic problem requiring resolution. Some contend that this is still the case. However, Keynesian analysis is equally applicable to the analysis and control of inflation. Broadly speaking, the reverse policy measures apply. If inflation is the product of an excess of aggregate demand for goods and services, its reduction requires curtailment of that demand. The reduction of government spending is the most obvious prescription. These are circumstances in which Keynesians might well regard fiscal restraint as appropriate. Cuts in government spending may be supplemented by policies restricting the supply of money and/or raising the rate of interest, if there is a need to further discourage spending in the private sector. Such policies of macroeconomic 'fine-tuning' can steer the economy along the sensible path between unemployment on one side and inflation on the other.

Keynes's own analysis of the economy and economic policy was much more sophisticated than this summary implies. His best-known book, *The General Theory of Employment, Interest and Money*, is a particularly complex work, and most students prefer their Keynes in a more clearly organised and digestible form. Nevertheless, his *General Theory* (as it is almost universally abbreviated) can rightly be said to stand as one of the three key books in the development of economics... together with Adam Smith's *Wealth of Nations* and Marx's *Capital*.9 The parallels are significant. All three works can be criticised for their lack of organisational clarity and their
CHAPTER 29

The Circular Flow of Income

The economy is a system of interconnected parts, where the flow of goods and services is driven by the forces of supply and demand. The circular flow of income is the process by which goods and services are produced and exchanged, and the income generated from these transactions flows back to the people who produced the goods and services.

The circular flow of income can be illustrated using a model that includes the following components:

1. Households: Producers of labor and consumers of goods and services.
2. Firms: Producers of goods and services.
4. Foreign Entities: Suppliers of goods and services from outside the country.

The circular flow of income can be represented by the following equations:

- Consumption (C) = Income (Y) - Savings (S)
- Investment (I) = Business investment + Government investment
- Net Exports (X) = Exports (E) - Imports (M)

The aggregate demand is the sum of consumption, investment, government spending, and net exports.

In conclusion, understanding the circular flow of income is crucial for analyzing the economy and making informed economic decisions.
There is no reason why the three 'injections' should balance the three 'leakages'. This may not be obvious from the bottom diagram in Figure 29.1. It may seem that, if household savings are deposited in financial institutions, and firms borrow funds from those institutions to finance their investment, this pair of leakages and flows is likely to balance. It is not necessarily so. Savings and investment are undertaken by different people—by households and firms, respectively—and so it is quite possible for one to exceed the other. Similarly, there is no reason why the payments received for exports should balance the expenditure on imported goods. Indeed, international trade imbalances of that kind are common. Finally, there is no necessary equality between taxation and government expenditure, unless the government has a commitment to balanced budgets and is capable of actually realising that goal in practice. Keynes himself thought such a commitment unwise since budgetary deficits and surpluses could be used as policy instruments to adjust the level of economic activity.

An understanding of these various 'injections' and 'leakages' in the circular flow of income can help to explain the ups and downs of a national economy. If savings exceed investment, for example, national income tends to decline. At first sight, this seems strange. A high rate of household saving is generally thought to be desirable, surely? Indeed, it is usually good for individual households—thrift, if not inherently virtuous, is a means of personal insurance against future poverty. However, thrift can do more harm than good for the economy as a whole. When people save, they buy fewer goods and services, so the aggregate demand falls, causing the output of goods and services and the national income to decline. People's plans to save may not then be realised because, having reduced incomes, they cannot readily achieve their original savings intentions.

It is investment, not saving, that drives economic expansion. Saving is only economically beneficial, from a national economic viewpoint, if it is matched by investment. But businesses will only engage in investment spending when they anticipate a growing demand for their products. That, in turn, is likely to depend on whether national income is growing or contracting. Evidently, striking the 'right' balance between saving and investment is hazardous. Striking the 'right' balance between all the 'leakages' and 'injections' is yet more so.

The model of the circular flow of income is only a starting point for interpreting a complex set of behavioural relationships and economic interdependencies. It can be developed in various ways. Some economists at the London School of Economics and Political Science once built a hydraulic contraption made of pipes and valves, physically simulating the structure of an economy, seen from a Keynesian perspective. Extra water poured into the export revenue tube, for example, would flow through the apparatus, leading to higher levels of consumption and saving (depending on the relative diameters of those tubes) and higher levels of national income and tax revenues (depending on the amount of water diverted from the main flow into the government 'tank'). The consequences of a surge in exports could thereby be predicted. Similarly, one could monitor the 'flow-through' effects of injections of higher government expenditure or business investment, for example, on the overall level of incomes and expenditures. The
ACCECATE SUPPLY AND DEMAND

The supply and demand of goods and services in the economy is determined by the interaction of supply and demand. The supply of goods and services is determined by the producers, who are motivated by profit. The demand for goods and services is determined by consumers, who are motivated by their desire for goods and services.

Market equilibrium occurs when the supply and demand for a good are equal. At this point, the market clears, and there is no shortage or surplus of the good.

To determine the equilibrium price and quantity, we can use the following equation:

\[ Q_d = Q_s \]

Where:
- \( Q_d \) represents the quantity demanded
- \( Q_s \) represents the quantity supplied

When the quantities demanded and supplied are equal, the market is in equilibrium.

When there is a shortage in the market (\( Q_s < Q_d \)), the price will rise to clear the market. Conversely, when there is a surplus (\( Q_s > Q_d \)), the price will fall to clear the market.

The price and quantity are determined by the interaction of supply and demand in the economy.
What determines the total volume of consumer expenditure on goods and services? It depends on income, obviously. This is true for individual consumers, and for the economy as a whole. Therein lies a significant analytical problem, though. In trying to explain the level of national income, consumption is identified as its largest component; but we then say that consumption spending depends on national income. It seems to be circular reasoning. The 'get-out' is that not all income is usually spent on consumption: some is saved. If we can explain what proportion is saved, a coherent theory of consumption is possible.

So, what determines the level of saving? As noted in box 29.1, numerous social and institutional factors can be expected to have a bearing on the nature of the relationship between income, consumption, and saving. According to Keynesian economics, the rate of interest is not particularly important in this respect. In this, Keynes differed significantly from pre-Keynesian economists, who thought that the level of savings would respond positively to a higher interest rate. The pre-Keynesian view stresses logical enough: higher interest rates would mean a higher financial reward for saving, so people would be inclined to save more, would they not? Indeed, people certainly might want to save more if the rate of interest were higher. However, because high interest rates deter investment, they also tend to reduce national income, which then reduces people's capacity to save. On the whole, therefore, Keynesians doubt the capacity of changes in interest rates to produce equilibrium between the levels of investment and savings in the economy. Keynesians typically take the view that interest rates shape how people save—whether they stuff their savings under the mattress, or put them in bank savings accounts or fixed term deposits, for example—rather than how much they save.

**Investment**

Investment (I) is the second component in aggregate demand. While not usually as large as consumption, it is usually more volatile. This is why it is so important as a determinant of the overall state of the economy in the short term. The volatility of investment can cause major fluctuations in the level of national income, output, and employment. It warrants careful analysis.

Investment is undertaken primarily by capitalist businesses. They invest in new plant, equipment, premises, and capital goods in general. Since the profit motive is the driving force (presumed to be axiomatic in a capitalist economy), investment will be undertaken when it is expected to be profitable. Thus, according to Keynesian economics, will be when the expected rate of return on investment exceeds the rate of interest on funds borrowed to undertake the investment. Box 29.2 explains the reasoning.

It does not matter in principle whether firms are borrowing money to undertake investment or financing it out of past profits. In the former case, the rate of interest is the *actual* cost of obtaining capital; in the latter, it is the *opportunity cost*, since it indicates the rate of return a firm could have earned by lending its money rather than using it for its own investment. (For simplicity here, we assume that borrowing and lending rates, if not identical, move in tandem.) Either way, the rate of interest is a negative influence on investment.

**Box 29.2**

What shapes business investment?

Investment is expenditure by firms on capital goods. Its aim is to expand firms' productive capacity. The overall amount of investment undertaken by firms depends on the relationship between the marginal efficiency of capital and the prevailing rate of interest, as shown in the following diagram:

![Diagram](image)

The marginal efficiency of capital indicates the expected rate of return on an additional unit of investment expenditure. Imagine a business person considering the various possible investments that could be made: he or she ranks them in order of expected rates of return, with the most profitable being undertaken first, the second most profitable being undertaken next, and so on. In other words, the marginal efficiency of capital declines as the amount of investment increases. Similar reasoning applies to the economy as a whole. Hence, the downward sloping m.e.c. schedule in the above diagram.

The rate of interest, on the other hand, must usually be taken by firms as given. It is the rate that banks or other financial institutions charge for money borrowed from them. A profit-seeking business person will normally weigh up that cost of borrowing against the income expected to be generated by using the borrowed funds for investment (that is, the marginal efficiency of capital). All projects where the expected rate of return is greater than the rate of interest are profitable to undertake; they would be given the go-ahead. Projects where the expected rate of return is less than the prevailing rate of interest would be unprofitable to undertake. Thus, investment ceases at the point where the marginal efficiency of capital equals the rate of interest (that is, at OA in the above diagram). The higher the rate of interest, the less the amount of investment undertaken.

The positive influence is the expected rate of return. 'Expected' is the key word here. Keynesians stress the importance of *business expectations* in determining the level of investment undertaken. The marginal efficiency of capital is the *anticipated* return on the last unit of investment spending undertaken. If business decision-makers are optimistic about the future, this marginal efficiency of capital will be high; if pessimistic, it will be low. The level of optimism is not simply a matter of whether they get out of bed in the morning feeling cheerful or not; it depends on their judgments.
A Diagnosological Adjustment Mechanism

The economy is complex, and the government plays a crucial role in maintaining economic stability. Various factors, such as changes in government policies, market conditions, and international trade, can affect the economy. A Diagnosological Adjustment Mechanism is a framework designed to identify and address economic imbalances.

1. **Government Policies**: The government can implement policies to adjust the economy. These policies can include changes in taxation, monetary policies, and fiscal policies. For example, increasing government spending can stimulate demand and help stabilize the economy during recessions.

2. **Market Conditions**: Market conditions, such as supply and demand, also play a significant role in the economy. Changes in market conditions can lead to economic imbalances, and the government may need to intervene to correct these imbalances.

3. **International Trade**: International trade is another critical factor in the economy. Changes in trade patterns, such as trade agreements and tariffs, can significantly affect the economy. The government may need to adjust policies to ensure that the economy remains balanced.

In summary, a Diagnosological Adjustment Mechanism is a comprehensive approach to identifying and addressing economic imbalances. By understanding the factors that affect the economy, the government can work to maintain stability and promote economic growth.
capacity, the previously underutilized resources will be put to productive use and unemployment can be expected to fall. On the other hand, if the economy is already operating at full capacity, the expansionary pressures are likely to cause the prices of goods and services to rise. Inflation is a probable outcome in the latter circumstances.

The reverse chain of reasoning applies to a reduction in aggregate demand. Inflationary pressures may be eased if the economy was previously operating at full capacity. Increased unemployment of resources (labour, capital, and land) is the more likely outcome, as capacity utilization falls. This is the recession scenario.

These considerations illustrate a Keynesian insight of great social significance: the mechanism that balances aggregate demand and supply is change in the levels of national income, output, and employment. This is usually a painful adjustment process. It entails major social damage when aggregate demand declines—people lose their jobs and face falling incomes. Equilibrium in the economy may be re-established, but it is not necessarily, indeed not typically, an equilibrium of full employment.

Pre-Keynesian economists had generally been more complacent. If, as they argued, the rate of interest serves as the adjustment mechanism between savings and investment, there need be no major volatility in the economic system. Equilibrium in the economy is continually restored without any major social costs (other than fluctuating incomes from interest payments for those with surplus funds to lend). Similarly, if exchange rate adjustments automatically restore balance between national exports and imports, then temporary trade imbalances need cause no concern. It is for these reasons that the pre-Keynesian view (which still has numerous adherents) produces a more laissez-faire inclination. It is this political complacency that Keynes and Keynesians have continually challenged.

The Keynesian view does not deny the existence of adjustment mechanisms. In that sense, Keynesian economics still has some of the features of an equilibrium theory. However, the Keynesian emphasis on changes in income, output, and employment as the principal adjustment mechanism leads to a quite distinctive interpretation of the problems of a capitalist economy. If the amount consumers plan to save exceeds the amount firms plan to invest, for example, the national income falls, and the consumers are not able in practice to save as much as they originally intended. A recession restores the equilibrium of savings and investment. Similarly, if imports exceed exports, there will be a downward pressure on the national income, tending to reduce people’s capacity to spend on imports, or on locally produced goods for that matter. Reduced material living standards occur. The adjustment mechanism in both cases is the overall level of economic activity.

Therein lies the source of systemic instability, the cause of alternating booms and slumps. Therein lies the Keynesian rationale for significant government intervention in order to stabilise an otherwise unstable capitalist economic system.

CONCLUSION

The Keynesian analysis, focusing on the factors affecting the aggregate demand and supply for goods and services, provides a coherent explanation for some of the recurrent problems of capitalism. The explanation of the problems of unemployment and inflation is particularly powerful. The confidence in the capacity of economic policy to correct these flaws is an equally distinctive feature of Keynesian reasoning, contrasting with both Marxian and neoclassical perspectives. In this last respect, Keynesian economics has more in common with some of the more politically optimistic currents within institutional economics. However, the story becomes rather more complicated when the role of money in the economy is considered. Therein lie further sources of economic instability, but also further opportunities for management of the economy as a whole.
In the real world, economic theories and models often rely on the concept of exchange. When goods and services are exchanged, the price of goods and services is determined by the forces of supply and demand. In a market economy, the price of goods and services is determined by the interaction of buyers and sellers. The price of goods and services is then used to allocate resources in the economy. The economic system is designed to allocate resources efficiently, but the process of exchange is not always perfect. There are times when the price of goods and services does not reflect the true value of goods and services. In such cases, economic theories and models are used to predict the outcomes of exchange and to suggest ways to improve the economic system.
THE DEMAND AND SUPPLY OF MONEY

Why hold money? At first sight, doing so seems illogical. Holding substantial amounts of cash, for example, incurs an obvious opportunity cost—the income foregone by not putting that cash into some interest-earning form. If, in the event of holding cash, you put your money into an interest-earning deposit account at a bank, you would be making your money work for you. As George Argyros puts it: "Surely a rational person would either consume their income, and thereby gain immediate satisfaction, or else lend their income to a capitalist and thereby receive an interest payment which will increase their ability to consume in the future. Why give up present gratification for no reward when a reward is available? Money is barren—only a miser can get satisfaction from the holding of cash as such." Keynes identified three reasons why rational people—not just misers—might instead want to hold their income in a liquid form, as cash. These constitute the three types of demand for money:

- **Transactions demand:** We usually need to keep some cash handy for our normal day-to-day shopping and other expenditures. If workers are paid weekly, for example, they need this "pocketful" of money to see them through to the next pay day. Less frequent, say monthly, payments could be expected to result in higher average amounts of money being held.

- **Precautionary demand:** Some additional money may be kept handy as a safeguard against unforeseeable personal problems, such as ill-health or personal accidents, or to take advantage of unforeseen opportunities.

- **Speculative demand:** Financial speculators may choose to hold money rather than interest-bearing assets so that they can buy financial assets at a later date when the prospect of making capital gains is greater.

The first two sources of demand can be expected to be pretty stable and predictable, rising and falling broadly in proportion to national income. The third is potentially much more volatile. Keynes, a successful financial speculator himself, thought that the speculative demand of money was particularly significant in determining how the economy functions—for better or worse.

Consider, for example, a speculator choosing between holding two types of asset: cash and government securities. These securities, sometimes called bonds, command a fixed rate of interest. If the current interest rate is 5 per cent, a bond costing $100 will yield a guaranteed $5 annual income to its holder. That sounds more attractive than simply holding cash, does it not? There is no risk associated with government bonds, unlike shares in corporations and other financial assets whose market prices are volatile. But, what if the rate of interest applying to bonds were to rise to 8 per cent in the next year? The holder of this year's bond, earning only $5 per annum, would want out. The holder would want to sell the old bond in order to buy a new one that would give a higher yield. However, no one would buy that old bond at its face value of $100 because a new bond yielding 8 per cent interest would be a better deal. The old bond will sell in the market for only $100 x 5/8. So, selling it would entail a substantial capital loss. With the benefit of hindsight, it was a mistake to buy the bond in the first place. The speculator would have done better to hold cash and wait for the interest rate to rise before buying a bond. Of course, the problem is that one can never know for sure how interest rates will move in the future. So, whether speculators hold cash or interest-bearing assets depends crucially on their expectations about interest rate changes.

Why does any of this matter? If speculation were simply part of an economic 'shocker' in which people gambled against future price movements, sometimes making capital gains and sometimes making losses, it would be of no great significance (other than the diversion of human energies into what is essentially a zero-sum game of no public benefit). Keynes recognised that it is more than this. The activities of the speculators have real economic impacts, affecting society as a whole. This is partly because their speculative activities tend to have self-fulfilling effects.

Consider, for example, a situation where speculators en masse are anticipating a rise in interest rates. A surge in inflation or the trade deficit often leads the financial media pundits to make such a prediction. Speculators will then want to hold cash rather than interest-bearing assets. They exhibit what Keynes called a strong liquidity preference. However, if the supply of money is fixed, the speculators can only hold more cash if ordinary household savers hold less cash. That means a higher market rate of interest is necessary in order to induce household savers to put the cash that they would have otherwise held into buying interest-bearing financial assets. The effect of the speculators' actions has been to push the interest rate up. Their expectations have become self-fulfilling.

It sounds like a complicated process, producing a strange outcome. The role of the rate of interest is at the heart of the matter. Herein is a striking contrast between the neoclassical and Keynesian views about how the economy works. The neoclassical expect interest rate changes to continually restore a balance between savings and investment, the market interest rate rising when investment exceeds savings (thus discouraging investment and encouraging saving) and falling when savings exceed investment (thus discouraging saving and encouraging investment). By contrast, Keynesians emphasise that market interest rates do not depend on the overall level of savings, but on whether people want to hold their savings as cash or as interest-bearing assets. But their liquidity preference itself depends on the prevailing rate of interest and predictions about its likely future movements. The overall effect is a tendency to economic instability, accentuated by self-fulfilling expectations.

Whether the monetary authorities can, or should, do anything to stabilise this otherwise unstable economy is an interesting question. The analysis so far has assumed that the supply of money is fixed. However, the supply of money in practice is variable. The key question is who or what determines it? The standard Keynesian view is that it is a policy variable (similar, in this respect, to government expenditure, as analysed in the preceding chapter). The supply of money may be varied by the central monetary authority (for example the Reserve Bank), usually working in tandem with government for social goals, such as full employment and/or the elimination of inflation. So, if speculative activities are causing interest rates to rise, and thereby threatening to cause a recession, it is possible for the monetary authority to intervene in order to offset that tendency. It can, for instance, increase the money supply, which will normally cause interest rates to fall and thus encourage investment and economic growth. From a Keynesian perspective, control of the money supply is, in principle at least, integral to stabilising an economy otherwise affected
In the economy, the quantity of goods and services are in equilibrium when the quantity supplied (S) is equal to the quantity demanded (D). This is depicted by the point where the supply and demand curves intersect, known as the equilibrium point. If the economy is not in equilibrium, there will be a price adjustment until the equilibrium is reached. A mechanism for this adjustment is the price mechanism, where the price adjusts to bring supply and demand into balance.

In a monetary economy, the price mechanism is further influenced by the money supply and monetary policies. Changes in the money supply can shift the supply and demand curves, affecting the equilibrium price and quantity. For example, an increase in the money supply can shift the demand curve rightward, leading to a higher equilibrium price and quantity.

A mechanismistic interpretation of Keynesian Economics

In the short run, the economy may not be in equilibrium as the price mechanism takes time to adjust. In such cases, policymakers may intervene to stimulate the economy. One approach is to increase the money supply, shifting the demand curve rightward and raising the equilibrium price and quantity.

"An Integrated Keynesian Model"
The IS/LM analysis is also limited in that it does not—indeed cannot in this two-dimensional diagrammatic form—show how these variables are linked to labour-market conditions. All one can say is that there is no necessary convergence between the equilibrium level of national income and the level that would be necessary to establish full employment. It would be quite accidental if the equilibrium level were also the full employment level. Further consideration of the labour market, including analysis of how technological change may affect the ratio of output to employment, is needed in order to assess the prospects for full employment in practice.

THE LABOUR MARKET

Do income, output, and employment move together? So far, this has been assumed. When the output of goods and services is rising, more incomes are generated, and more employees will presumably be hired to produce the growing volume of products. Conversely, if output is shrinking, total income falls and unemployment can be expected to rise. It seems a reasonable assumption to make about the behaviour of the economy in the short term, when its productive capacity is relatively fixed. It is integral to the Keynesian reasoning as it explains changes in the number of people employed by reference to changes in the level of output and national income.

What view about the labour market is implied? Keynesians do not regard it as a market in which changes in wage rates ensure equilibrium. In this respect, Keynesian economics differs both in analytical construction and political implications from neoclassical economics. Neoclassical economists tend to advocate wage reductions to deal with unemployment, since they see it as resulting from the excess supply of labour relative to the demand for labour. Where supply exceeds demand, the price (in this case, the wage rate) should fall. Any ‘market imperfections’ that impede that outcome should be removed. Keynesians, on the other hand, usually point out that wages are generally not flexible downwards. Of course, wage cuts for particular groups of workers may, and do, occur; but workers, certainly those who are organised in trade unions, can be expected to use their collective organisational strength to resist such cuts. What does often happen, though, is that the real value of wages is eroded by inflation. That is one reason why trade unions advocate wage rises to protect the real purchasing power of their members. However, the apparent gains from a rising money wage may be eroded by further rises in the price of goods and services, so that there is no increase in the real wage (the quantity of goods and services that can be purchased with the wage).

In any case, from a Keynesian perspective, a general policy of wage reduction is not a sensible economic strategy for dealing with unemployment because of its negative effects on the demand for goods and services and, therefore, on the demand for labour. Keynesians, while not necessarily supportive of working class interests per se, at least recognise the importance of wages as a source of aggregate demand. They emphasise the positive role of wage incomes in the realisation of surplus value (to use the Marxist terminology), rather than the negative role (from a capitalist viewpoint) of wage costs in the production of surplus value.

Over a longer period of time, another type of threat to full employment has to be considered. When the nature of technology is variable, labour displacement may occur, even though output is increasing. Most goods and services can be produced in various ways, and the type of technology a business chooses to use can be expected to be influenced by the prevailing level of wages relative to the cost of capital goods. So, if wage rates are rising relative to the cost of capital goods, labour displacement is likely. Generally, the effect of technological change is to open up possibilities for increasingly sophisticated methods of production, including automation. Under these circumstances, the conventional Keynesian assumption that income, output, and employment move together is less reasonable.

In the extreme case, increases in output may occur without any corresponding increases in employment. This is the controversial phenomenon of ‘jobless growth’.

In Keynes’s time it could safely be ignored: the immediate task was to get the masses of unemployed people back to work by creating conditions conducive to economic expansion. Nowadays, it seems that policies concerned with the redistribution of work—its more equitable sharing throughout the society—are of comparable importance in resolving the persistence of the unemployment problem. This is not to minimise the enduring value of the Keynesian perspective, only to emphasise the need to subject its underlying assumptions to critical scrutiny in contemporary conditions.

CONCLUSION

The analysis of capitalism as a monetary economy is a distinctive feature of Keynesian economics. ‘Money’, according to the old adage, ‘makes the world go round’. Keynes showed that it also makes it go up and down. Monetary factors, especially those associated with speculation, impart additional sources of instability to the economy. Where speculators have a high liquidity preference, for example, the savings that would otherwise be available for productive investment, may be diverted instead into speculative activities. Upward pressure is exerted on the market rate of interest, with potentially damaging consequences for investment, employment stability, and economic growth.

Keynes said that ‘if the capital requirements of the economy are determined as a side-effect of a casino then the job is likely to be ill-done’.

He also expressed a broader concern about the adverse economic consequences of the persistence of the ’rentier’ class—those who derive incomes and from the ownership of assets without contributing directly to productive activity. Keynes welcomed the prospect of the ’euthanasia of the rentier’.

In this respect, the Keynesian view is akin to Veblen’s, at least in distinguishing between the contribution of those who use capital productively and those who pursue more ‘predatory’ purposes. It contrasts with the Marxist view about the need to challenge the dominance of the capitalist class as a whole. What all these viewpoints—deriving from Marx, Veblen, and Keynes—have in common is the recognition of systemic structural flaws in the capitalist system. Politically, what distinguishes the Keynesian view is its emphasis on the role that governments can play in readdressing these adverse aspects of the capitalist economy by seeking goals such as full employment without inflation.
POLICY INSTRUMENTS

In addition to economic instruments, monetary and fiscal policy have a strategic role in the implementation of the economic policy objectives of the government. Monetary policy is conducted by the central bank, which controls the money supply and interest rates. Fiscal policy is conducted by the government, which influences the deficit or surplus of the budget and public investment. The government may use fiscal policy tools such as changes in government spending, taxation, and debt management.

THE INFORMATION BASE

Economic data is collected and analyzed by government agencies and international organizations such as the World Bank and the International Monetary Fund. The data includes information on economic growth, inflation, employment, and wages. This data is used to assess the effectiveness of economic policies and to inform future policy decisions.

THE ECONOMIC POLICY IMPERATIVE

The economic policy imperative is to achieve economic stability, promote growth, and ensure social welfare. This involves managing the trade-off between inflation and unemployment, and ensuring that the economy is not overly dependent on any one sector. The government may use fiscal and monetary policy tools to achieve these objectives.
for short-term macroeconomic stabilization and grander measures to steer economic growth and development in the longer term. These may be seen as the two faces of Keynesian economic policy, reflecting liberal and radical interpretations of the contribution by Keynes. Fiscal and monetary policies are the basic stock-in-trade of the liberal interpretation, while the more radical view also embraces policies to shape the distribution of incomes, and the patterns of investment, industry development, and trade. Each of these forms of policy requires careful consideration of their potential and their pitfalls.

**Fiscal policy**

Fiscal policy is the most direct means of managing the overall level of income, output, and employment in a national economy. It entails adjustments to government expenditure and taxation. Of course, governments usually do not implement massive stockpiling of their spending and income anyway, and vary expenditure patterns and tax rates to accord with their political priorities. From a liberal Keynesian perspective, the key issue is the overall fiscal stance—whether expansionary or contractionary. The standard prescription is for a budgetary deficit (an excess of expenditure over taxation) to deal with recession and unemployment, and for a budgetary surplus (an excess of taxation over expenditure) to deal with excess demand and inflation.

This emphasis on judgments about deficits and surpluses stands in striking contrast to the pre-Keynesian view (revived in recent years as a new orthodoxy) that governments should seek a balanced budget. A balanced budget—no spending more than you earn—sounds like a prudent basis for household management, but, as Keynes emphasised, it is usually not good macroeconomics. Keynes thought that, over the whole of an economic cycle, perhaps spanning a decade or more, it would be sensible to roughly balance expenditures and taxation levels; but that, in any one year, it would be better to use fiscal policy in a counter-cyclical manner.

Deficits and surpluses tend to happen anyway, as the economy moves between periods of recession and growth. During a recession, social security expenditures rise because there are more claimants for unemployment benefits, for example. Meanwhile, tax revenues tend to fall because average incomes are lower. Both income taxes and consumption taxes generate less revenue in those circumstances. So, a natural tendency towards budgetary deficit exists during a recession. This is good, Keynesians argue, because that injection of government expenditure into the circular flow of income helps to raise the overall level of economic activity and bring the recession to an end. The reverse reasoning applies in a boom: government social security expenditures tend to fall and tax revenues tend to rise, causing a budget surplus that dampens the rate of economic growth, and reduces potential inflationary pressures.

There is a strong case for supplementing these automatic stabilizers with discretionary fiscal policy to smooth out the ups and downs in the level of economic activity even more. On this reasoning, governments should run even larger deficits in times of recession in order to "kick start" economic recovery, either by cutting tax rates or increasing expenditures. That is the best time to spend on infrastructure construction projects that will create jobs. In boom times, on the other hand, bigger surpluses can be engineered by increasing tax rates or cutting back on government spending.

There are significant pitfalls in the application of these discretionary fiscal policies. The timing has to be good, otherwise there is the danger that the policies may accentuate rather than dampen the amplitude of the economic cycle. The effect of fluctuations in government expenditure on investment expenditure in the private sector also needs to be considered. How changes in a government's fiscal stance impact on volatile business expectations will have a major bearing on the macroeconomic outcomes. The distributional consequences of changing patterns of taxes and expenditures also warrants further attention—there are always winners and losers in such policy changes. And, as a matter of political expediency, the relationship between the economic cycle and the political electoral cycle can be expected to have an influence on a government's fiscal policy stance. Increasing spending before elections in order to woo voters and increasing taxes after being elected may be effective, albeit cynical, politics. However, it makes no positive contribution to, and may significantly undermine, macroeconomic stability.

These features notwithstanding, discretionary fiscal policy has the obvious appeal of providing a direct means of levelling out the ups and downs to which the capitalist economy is otherwise prone. It simultaneously extends political decision-making over the allocation of economic resources in order to achieve broader social goals.

**Monetary policy**

Governments may also influence the general state of the economy through their influence over the supply of money and the cost of borrowing it. The instruments of monetary policy can be used either as supplements or as alternatives to fiscal policy for the purposes of demand management in a counter-cyclical economic strategy. Few would claim that monetary policy can contribute, like fiscal policy, to broader social goals in the long term, but it can have a significant effect on economic conditions in the short term.

The relevant policy instruments, in principle, are clear. Governments directly control the issue of notes and coins; they may indirectly influence the extent to which banks and other financial institutions extend credit facilities; and they may determine the general direction of change in interest rates. Through these measures they can influence the levels of consumption and investment in the private sector of the economy and thereby seek to steer the economy towards a more stable growth path consistent with full employment without inflation.

In practice, things are much more complicated. Indeed, developments since Keynes's time bear heavily on how monetary policy can actually be applied. First, governments often do not have the policy instruments directly at their disposal. Monetary policy is commonly in the hands of central banks that have a considerable degree of independence from governments. The extent of such independence in policy varies: the German Bundesbank has had more than the Bank of England, and the Reserve Bank of New Zealand has more than the Reserve Bank of Australia, for example. The goals that the central banks should pursue (whether full employment or the control of inflation, for example) are also matters of intense political controversy in many countries. The dominant tendency seems to be towards the central banks being given more independence and asserting the control
of income from capital to labour would increase the total level of consumption, fuelling aggregate demand and thus, ironically, adding to the income stream of capitalists, too, in the longer term. Capitalists, acting individually, would never seek to initiate such redistributions, although they would ultimately benefit from the resulting boost to the level of economic activity. Incomes policy becomes a role for government because, while it improves conditions in the economy as a whole, none of the other players has the collective capacity to implement it.

Of course, all government economic activity has distributional consequences. In practice, the issue is only whether incomes policy should be implicit and passive, or explicit and purposeful. If the latter, then it can be linked more directly to goals, such as the pursuit of a more equitable society. Keynes himself thought that a less unequal distribution would be both economically and socially desirable. In his own words: 'I believe that there is social and psychological justification for significant inequalities of income and wealth, but not for such large disparities as exist today...' Much lower taxes will serve the purpose equally well, as soon as the players are accustomed to them.7

Incomes policies in practice do not necessarily produce egalitarian outcomes. The Labour government in the United Kingdom in the 1970s, for example, adopted a 'social contract' with the trade union movement that emphasized control over wage increases to combat inflationary pressures, but the absence of any corresponding regulation of the incomes of capital led to the policy becoming widely regarded as a 'social con-trick'. The Labor government in Australia between 1983 and 1996 also used an incomes policy, rather more successfully, as part of its Accord with the trade union movement; but it also eventually suffered loss of support because, among other things, the wage restraint was unmatched by any control over the sources and disposition of non-wage incomes.8

Investment and industry policy

From a Keynesian perspective, the level of expenditure on investment in the economy is crucial for two reasons. In the short run, it boosts the level of effective demand, raising incomes, output, and employment. In the long run, it adds to productive capacity. Because it impacts on both aggregate demand and aggregate supply, it is a key determinant of economic prosperity. Yet, as previously noted, when left purely in private hands, investment tends to be volatile, fluctuating according to changes in the 'animal spirits' of business people. Is there a role for government here, too, in the regulation, stabilisation, or direct control of investment expenditures?

Keynes used the memorably enigmatic phrase 'a somewhat comprehensive socialisation of investment' to indicate what he thought might be needed. To quote him in full:

It seems unlikely that the influence of banking policy on the rate of interest will be sufficient by itself to determine an optimum rate of investment. I conceive therefore that a somewhat comprehensive socialisation of investment will prove to be the only means of securing an approximation to full employment, though this need not exclude all manner of compromises and of devices by which public authority will cooperate with private initiative.9

Not surprisingly, debate continues about what is implied by such an open-ended policy prescription. Possibilities include joint ventures between government and private-sector enterprises, and interventionist industry policies designed to create the conditions for more stable and/or buoyant patterns of private-sector investment. Although Keynes did not personally favour the extension of government ownership of key industry sectors ('nationalisation'), a similar logic applies. Because investment is so important to the state of the economy, it cannot sensibly be left to business people alone.

One particularly interesting possibility arises from the expansion of superannuation schemes in recent years. The workers' savings in those superannuation funds could be systematically channeled into investment projects of national economic benefit. This would build a direct bridge between savings and investment. The savings in the superannuation funds—pension funds—as they are sometimes called—are normally invested in shares, government bonds, real estate, and other financial assets in order to maximize private rates of return. Capitalist investment criteria currently prevail. If, instead, the process were coordinated through a national investment fund, the savings could be channeled into the development of particular industries that the government wishes to promote—technologically advanced sectors requiring substantial research and development expenditures, for example, or industries conducive to more ecologically sustainable development. 'Picking winners' this is sometimes called, especially by critics who are worried by the possibility of government picking losers. Some nations, such as Sweden, have used national investment schemes as instruments for successful industry development.10 Some level of public-sector investment is integral to the financing of infrastructure and public goods, anyway—a fact acknowledged as necessary by economists across the political spectrum ever since Adam Smith. The issue in practice is deciding on the most appropriate public-private balance and how best to achieve it. These are political economic decisions per excellence.

The international context

The assumption of a national economy, and of the possibility of managing it systematically, pervades most discussion of Keynesian economics. However, policies that treat the national economy as if it were a closed economy are always going to be of limited effectiveness. This was so in Keynes's time; it is even more so in the current age of globalisation. The most modest response to the challenge involves using policy instruments that impinge on the relationship between the national economy and the rest of the world—exchange rate policy, and tariff policies, for example. The more ambitious response is to seek to influence the broader international economic conditions themselves—through international agreements on trade, debt, and taxation, for example.

It is axiomatic that a nation's 'external sector' has a significant bearing on its overall level of income, output, and employment. The standard Keynesian macroeconomic analysis shows that a trade deficit (M > X) will have a depressing effect, unless offset by a government budgetary deficit (and the latter may not be a sustainable option if the trade deficit persists across all stages of the economic cycle).
CONCLUSION

The proposed approach can contribute to a better understanding of the economy's performance, complementing existing macroeconomic indicators. By focusing on household consumption and labor market indicators, it offers a more comprehensive view of economic activity. The findings suggest that consumer spending plays a crucial role in driving economic growth, while labor market conditions are key determinants of household well-being. Moreover, the approach highlights the importance of considering local labor market dynamics, which can vary significantly across regions. The use of advanced analytical techniques, such as machine learning algorithms, enables more accurate predictions and insights into future economic trends. Overall, this study underscores the need for continued research and policy development to better understand and support the economy's dynamics.
CHAPTER 32

The Keynesian Legacy

Revolution, counter-revolution, renaissance?

Was there a 'Keynesian revolution'? Why did Keynesian policy prescriptions fall from favour? What does post-Keynesian offer? Are Keynesian ideas still relevant?

In the long run we are all dead' is the one quotation from Keynes that students invariably get right (while usually missing his point). 'Yes, but not all at once,' added Joan Robinson later. A focus on short-run economic problems and their immediate resolution is necessary, socially and politically, but it is not enough. Dealing with widespread unemployment was the obvious short-run priority in Keynes's time, although that problem has in recent decades re-established itself as a seemingly long-run, if not permanent, feature of modern capitalist economies. Keynes was also concerned, generally, with the conditions conducive to economic and social progress. Joan Robinson's quip is a reminder that society, as an ongoing entity, has to be equally concerned with those long-term goals.

How have Keynes's ideas fared in this longer-term context? We conclude our consideration of Keynesian economics by looking at its influence and the subsequent backlash against it. How could it have once commanded widespread respect but become vulnerable to the resurgence of pre-Keynesian views? Whither Keynesianism now?

FOUNDATIONS FOR A PARTIAL REVOLUTION

Keynes expected his General Theory to 'largely revolutionise ... the way the world thinks about economic problems'. Indeed, his ideas had a dramatic impact on economic analysis and policy between the 1930s, when his General Theory was published, and the 1970s, when his ideas fell foul of the monetarist economists. They constituted the basis for a new orthodoxy in economics for approximately three decades. The initial resistance was strong, both among academic economists and among business people and politicians uncomfortable with the 'interventionist' approach to the management of capitalism that his ideas implied. The force of actual political economic circumstances proved stronger. The termination of the Great Depression by the onset of World War II was the most obvious factor. Economic conditions had been improving slowly during the middle to late 1930s, but sharply deteriorated again in 1937–38. The war restored full employment to the capitalist nations. War preparations had already reduced unemployment in Nazi Germany, prompting Galbraith's subsequent ironical remark that Adolf Hitler was 'the true protagonist of the Keynesian ideas'. Keynes would not have approved, of course, favouring employment for socially useful, peacetime production. However, in purely macroeconomic terms, the effect was similar. Many people who might otherwise have been unemployed in countries that were enlisted in the armed forces; others were employed in industries producing munitions, uniforms, and so on. In nations partly cut off from international trade by naval blockades, more land was brought under cultivation to feed the citizenry. The whole process—the 'war effort'—was coordinated by the respective national governments.

The war itself inflicted widespread economic devastation on the countries at the centre of the action. Both in the victorious and defeated nations, the bombing had destroyed houses, factories, bridges, roads, railways, power stations and electricity supply systems. After the war, this infrastructure had to be rebuilt. Even in nations geographically distant from the principal theatres of war (such as Australia and 'mainland' United States), a major backlog in the building of houses and social infrastructure had developed because resources had been diverted to the war effort. There was much work to be done when the war ended. That ensured the continuation of full employment, although the transition from military to peacetime production was not always smooth.

Politically, too, this economic reconstruction and expansion was imperative. People make enormous personal sacrifices during times of war, foregoing much of the consumption they normally enjoy. Their homes may be bombed, and sometimes family members killed or maimed. Such sacrifices need to be justified as the price to be paid in the struggle for a better society, or at least compensated by a significant social dividend. After World War II, it was inconceivable that the people who had made such sacrifices would tolerate a return to the conditions of the Great Depression. A more prosperous and secure society had to be engineered in the victorious nations. Having won the war, it was now necessary to 'win the peace'.

Meanwhile, the countries that lost the war would have to be reconstructed under international supervision—a process dominated in practice by the United States. The short-sightedness of impoverishing the defeated nations through punitive war reparations had been realised in the years following the end of World War I. Keynes had warned in the late 1930s about the likely adverse consequences of pursuing that strategy and, in practice, the rise of fascism had proved his point. For all the capitalist nations, victors and vanquished alike, policies to promote economic prosperity were the priority after World War II.

These political economic conditions were fertile ground for the acceptance and implementation of Keynesian economics. Governments in the major capitalist nations committed themselves to the pursuit of full employment as the primary economic objective. The British government, for example, formally committed itself to full employment in 1945, and the Australian government issued a White Paper on full employment in the same year. In the United States, the Employment Act of 1946 proclaimed 'the continuing policy and responsibility of the Federal government to use all practical means ... to promote maximum employment, production and purchasing power'.
The extension of the secondti-fi-sion premium view is the explanation that the action of the Federal Reserve has moved up to 100% at the end of November. 11916. It explains that the Federal Reserve has moved up to 100% at the end of November. 11916.

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The expansion of the secondti-fi-sion premium view is the explanation that the action of the Federal Reserve has moved up to 100% at the end of November. 11916. It explains that the Federal Reserve has moved up to 100% at the end of November. 11916.
According to Friedman, economic policy should simply ensure the steady expansion of the money supply at a rate matching the long-term growth of economic output. This is the essence of the monetarist position that was embraced—but not consistently implemented—by right-wing politicians in the 1970s and 1980s. 

MONETARISM AND THE ‘NEW CLASSICAL’ REVIVAL

Monetarism has its roots in pre-Keynesian economics, specifically in the quantity theory of money. This is most simply expressed as the ‘equation of exchange’:

\[ MV = PQ \]

In this formulation, \( M \) is the money supply; \( V \) is the velocity of circulation (the rate at which money moves around the economy); \( P \) is the general price level for goods and services (a measure of inflation); and \( Q \) is the output of goods and services produced in the economy. This equation of exchange is written as an identity (1) because its proponents say it is true by definition; thus, for any given level of output \( Q \), changes in the money supply \( M \) and the price level \( P \) will always move together, assuming the velocity of circulation \( V \) is fixed. In other words, the effect of increases in the money supply, over and above increases in the volume of goods and services produced, is always to raise the general price level. Expansionary monetary policy causes inflation. So, too, will expansionary fiscal policy, if budgetary deficits are financed by money supply increases.

According to monetarists, inflation is a scourge: it erodes the value of savings, creates greater economic uncertainty among consumers and investors, and becomes self-perpetuating because it comes to be ‘built into’ consumers’ and investors’ expectations and the behaviour resulting from those expectations. However, since its cause is clear—excessive growth in the money supply—it is remedy is equally obvious. Governments must restrict their policies to the management of a slower and steadier expansion in the supply of money that is just sufficient to match the growth in the output of goods and services.

Monetarists acknowledge some safety valves. If workers are willing to work harder at the current wage rate, for example, total output can be raised and the inflationary pressures thereby alleviated. Alternatively, inflationary pressures are reduced if households are willing to save more of their income at the current rate of interest; the problem of ‘too much money chasing too few goods’ then becomes less severe. In both cases, sacrifices must be made—harder work and deferred gratification from consumption. Austerity or ‘belt-tightening’, targeted particularly at the working class and those benefiting from an expansion of state support, is the implied antidote to the forces that otherwise fuel inflation. As former Australian prime minister Malcolm Fraser (himself only a half-hearted convert to monetarism) said at the time when monetarism was coming into vogue, ‘Life isn’t meant to be easy’. It certainly is not easy when monetarists are in charge.

On closer examination, the monetarist interpretation of the ‘equation of exchange’ can be seen to rest on dubious assumptions. The economy is taken to be operating at full capacity, for example. If it were not, it is possible that an increase in the money supply could flow through into increased output. The monetarist

### Box 32.2

**A trade-off between unemployment and inflation?**

The Phillips curve is a popular means of interpreting the relationship between unemployment and inflation. It takes its name from a diagram constructed by A.W. Phillips, a New Zealand economist working in London during the 1950s (also the inventor of the hydraulic model mentioned in chapter 29). He plotted the levels of unemployment and inflation in the British economy over a number of years and found a generally inverse relationship. The years when unemployment was high generally had low inflation, whereas years when unemployment was low typically featured a higher rate of inflation.


What had gone wrong? An empirical description cannot indicate the causal factors underlying this change in the patterns of unemployment and inflation. Posited explanations were plentiful at the time; some blamed trade unions (for seeking wage increases in excess of labour productivity growth). Others blamed governments (for the failures of macroeconomic ‘fine-tuning’). Reviewing the current state of opinion, one orthodox economist concludes that the ‘inflation–unemployment trade-off has a secure place in economics . . .[but] the bad news is that the dynamic relationship between inflation and unemployment remains a mystery’.

\[ \text{Unemployment} \]

\[ \text{Inflation} \]
stabilisers (described in chapter 31) continue to cause budgets to move into deficit during recessions and into surplus during booms, whatever the declared intention of the government. Meanwhile, discretionary monetary policy seems to have become re-established as the principal policy tool to control the economic cycle. This is ironic in that the pervasive problems associated with monetary policy (also described in chapter 31) featured prominently among the reasons put forward by monetarists for the adoption of a simpler, long-term monetary rule. It is doubly ironic that, in the meantime, financial deregulation has effectively left pressure on interest rates as the only available policy instrument—and that is usually in the hands of appointed central bankers than elected governments.

Perhaps the most extreme variation on this theme of anti-Keynesian economics comes in the form of the 'policy ineffectiveness proposition'. Here is the claim that, because people have rational expectations about the future, economic policy is generally important. People anticipate the consequences of any change in policy and, by modifying their behaviour appropriately, negate its effects. According to this reasoning, as people come to know more about the economy and anticipate government policy changes, the policies become ineffective. If people know that economic policies are ineffective, the policies in practice work only if people make systematic errors. This sort of reasoning is typical of what has come to be known as 'new classical economics'. Its emphasis on individual choice and general equilibrium outcomes means it has more in common with analytical and political, with neoclassical economics than with classical political economy. Like the postulated natural rate of unemployment, the effect of the 'policy ineffectiveness proposition' is to buttress free-market ideology. Notwithstanding some analytical novelty, the practical upshot looks more like a revival of an old-time religion.

**POST-KEYNESIAN ECONOMICS**

Where does all this leave Keynesian economics today? Rather schematically, two types of Keynesian economics can be identified. One is what has earlier been called the mechanistic interpretation of Keynes, illustrated by the analysis summarised in box 30.1. Analytically, it stresses the equilibrium tendencies in the macroeconomic system—albeit not guaranteeing full employment. Politically, it accepts the case for a limited set of discretionary fiscal and monetary policies to 'fine-tune' the economy, reconciling equilibrium with full employment, but otherwise leaving the economy to function largely according to the principles of private enterprise. In the economics textbooks, this is the interpretation of Keynes that Paul Samuelson proudly proclaimed as the 'neoclassical synthesis', combining neoclassical microeconomics with a mechanistic interpretation of Keynesian macroeconomics. It is what Joan Robinson later called, rather less flattering, 'bastard Keynesianism'—the illegitimate product of marrying Keynes to neoclassical theory. 'Neo-Keynesianism' is a less pejorative term. Its practical influence shaped government policies. However, it was always incoherent, politically if not analytically, because it spliced together microeconomics emphasising the general desirability of free markets and a macroeconomics stressing the need for recurrent government 'intervention'.

This mainstream interpretation of Keynesian economics was the obvious casualty of the stagflation era and the monetarist assault. Many of the orthodox economics textbooks have since been purged of their residual Keynesianism, a process that their authors may have sometimes sought to justify by claiming the need for better developed 'micro foundations of macroeconomics'.17 Such a quest for greater analytical coherence is commendably reasonable. The problem is that coherence is re-established on the neoclassical terrain. In effect, it constitutes a return to pre-Keynesian economic theory, but under the name of 'new classical' economics. Concurrently, in the policy arena, the primary emphasis of government policies has switched from macroeconomic management to 'microeconomic reform'.18 This is no coincidence. This policy push, which focuses on labour-market deregulation, privatisation, and trade liberalisation, is based on the reassertion of free-market economics. It constitutes a return to pre-Keynesian economics in the realm of public policy.

A second, quite different, interpretation of Keynes is possible, providing the basis for post-Keynesian economics. It places more emphasis on Keynes's view of the economy as an inherently unstable system—indeed, one might argue, not really a 'system' at all. The crucial, but volatile, character of investment—responding to the 'animal spirits' of business people and needing 'somewhat comprehensive socialisation' is a focal point. So, too, is income distribution, since it has a major influence on the size of the multiplier and the determination of the overall state of the economy, as well as being a crucial social concern in its own right. These original concerns of Keynes were marginalised, if not lost altogether, in the dominant neo-Keynesianism. From a policy perspective, they are incompatible with a laissez-faire stance, perhaps even a 'liberal-interventionist' stance. Their re-emphasis by post-Keynesians puts more extensive policy reforms on the agenda. Incomes policies and industry policies are particular focal points. There has also recently been a strong advocacy of policies to combat unemployment, by extending the role of the government as 'employer of the last resort'.19

Post-Keynesian economic theory, drawing on more radical interpretation of Keynes, has been influenced by the work of Keynes's colleague at Cambridge, Piero Sraffa. Sraffa's contribution is based primarily on a mathematical model of the production of commodities by means of commodities that shows the structure of the economy as a whole can be analysed without recourse to the market theories of the neoclassical school.20 The technical interdependences of the different sectors of the economy are the key. In this respect, the theory parallels the empirically based input-output analysis pioneered by Wassily Leontief and used as a tool for economic planning under both capitalism and socialism. The impersonal economic forces determine the conditions for efficient production, leaving questions of income distribution to other processes of a social and political character. Echoes of both David Ricardo and John Stuart Mill can be heard in the (implicit) politics of this analysis. On a more technical level, Sraffa's work enables post-Keynesian economists to match the orthodox economists' 'equation for equation'—should they be so inclined.21

The contribution of Michal Kalecki (1899–1970) to post-Keynesian economics is of more direct political significance. Kalecki was a Polish economist working within the Marxist tradition who developed a penetrating analysis of capitalism at about the same time as Keynes was working on his General Theory. Like Keynes, Kalecki
CONCLUSION

The economic and political dynamics that shape the futures of countries are increasingly intertwined. This interconnection is particularly evident in the context of globalization, where economic policies and international agreements are shaping the development of countries and regions. The economic policies of a country not only influence its own development but also have implications for other countries. The current global economic landscape, characterized by financial crises, economic growth, and political instability, highlights the need for a more nuanced understanding of the factors that drive economic growth and stability. The importance of sustainable development and the role of international cooperation in addressing global challenges cannot be overstated. In light of these considerations, it is crucial to explore the interplay between economic policies, political stability, and social indicators in shaping economic outcomes. This requires a comprehensive approach that integrates economic theory with empirical analysis and considers the diverse perspectives of stakeholders.

The development of the economy is a multifaceted process that involves a range of factors, including policies, investments, and international interactions. The economy is not a static entity but rather a dynamic system that responds to changes in the political, social, and technological environments. Understanding these dynamics is essential for policymakers and economists alike. As we look towards the future, it is clear that the challenges of the present will continue to shape the economic landscape. Therefore, it is imperative to foster an environment that encourages innovation, promotes inclusivity, and addresses the needs of all stakeholders. By doing so, we can work towards a more prosperous and equitable future for all.