

KEYNESIAN TEACHINGS: PAST AND PRESENT

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Abstract: *As markets are organized and influenced at present, the market estimation of the marginal efficiency of capital may suffer such enormously wide fluctuations that the offset cannot be sufficiently only by adjusting to the fluctuations of the interest rates. As long as injections of cash work by reducing interest rates, they cannot be taken as a reliable solution. According to Keynes, the duty of ordering the current volume of investment cannot safely be left in private hands. On the other hand, it does not imply that Keynes thought booms and slumps could be prevented merely by pulling fiscal and monetary policy levers.*

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In moments of economic sluggishness, politicians return to debates budgetary deficits values. The intellectual foundation of the fiscal stimulus was set up by John Maynard Keynes. Keynes's argument was that, when confronting with panic, investors and consumers become more reserved and reduce their expenditures. Under these circumstances, Keynes considered important the role of government to replace this demand on economy. At least temporary, the government could interfere by reducing fiscal policy or by increasing expenditures to maintain economy at a standstill till the appetite of consumption and investments reappear in the private field.

Keynes's solution has been used increasingly more, and made Richard Nixon to declare in 1971 amid a recession, that "We are all Keynesian, now". But, as seen in the ensuing period, the results of such policies have been catastrophic and the United States of America became acquainted with a period of stagflation: high inflation and low growth.

The skeptics have brought several arguments against this policy. First, because of the way in which economic data are presented, with the delay of several quarters, it is difficult to use fiscal policy to play fine-tuning role. The risk is that when fiscal loosening - lower taxes or higher spending - affect the economy, it might be too late. And as the money used to pay for this stimulus is borrowed, it will be returned by means of higher taxes, which, most of the times, makes the effect insignificant for the economy. Therefore, governments spend more than they should to sustain the weakening economies by inducing a money demand that only lead to inflation. Because central banks know this scenario, the more the budget deficit increases, the more the monetary policy begins to tighten.

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In an economy in recession, the combination of large deficits and loose monetary policy leads only to stagflation and a tightening of the monetary policy does only deepen the recession.

In this situation, there are some automatic stabilizers in the economy: unemployment and the exchange rate. If an economic recession takes place, unemployment increases, so does the exchange rate. Demand for imports decreases, but the volume of exports and investment in this area increases. The resources released from the import sector will migrate to exports and if the government took a cautious fiscal policy, then it can also afford to increase unemployment benefits without jeopardizing the long-term economic stability.

John Maynard Keynes's ideas on capitalism protection from capitalism itself appear to have increasing relevance. Keynes rejected Marxism, but we believe that the market economy can survive only if it wins the support of the public by improving living standards.

The role of economists, Keynes believed, was that of the patron of "the possibility of civilization" and no other economist had been more suitable for this role, but himself.

JM Keynes's conception in terms of economic activity and relationships between variables in the economy differ both from the classical school and the neoclassical thinking. JM Keynes is different from the classics as he denies the existence of natural laws that govern the modern economy and the idea of spontaneous market economy self balance.

Keynes's conception of the neoclassical approach is that it starts to explain the economic mechanism of the consumers and the psychological propensities of men. The general coordinator of the Keynesian doctrine applies to income and savings-investment variables.

People's marginal propensity to save is defined as the reverse of the fundamental psychological law, meaning that savings is cash, that portion of income that exceeds consumption. The second fundamental psychological law, concerning the impetuous investment, postulates that not all economies turn into investments. Investors' decisions to transform investments into economies are adopted in accordance with the criterion of maximizing profit, and especially considering the relationship between the marginal efficiency of capital and interest rate.

In accordance with Keynes's remarks people perceive *savings* as a surplus of income over the expenditures for consumption. The father of macroeconomics goes on explaining that any doubts on understanding savings must have its origins either in the definition *income*, or *consumption*[1]. Considering this approach, he believes that although the amount of savings is a result of the collective behavior of individual consumers and the investment volume, the result of collective behavior of individual entrepreneurs. These two quantities are needed because each of them is equal to income surplus for consumption.

Keynes accepts much of the classical theory, but he develops his own theory finding two major drawbacks: i)for him, economies must be equal to a given level of investment rate, the saving is influenced mainly by the dynamics of income

than the interest rate, ii) traditional thinking system and the employment rates are considered constant.

Basic Concept (from investments), is that increased investment is based on increased production (extensive or intensive) activity (intensive side) and use of labor (broad side). In Keynes's conception is permitted a situation of imperfect balance, near the point where supply equals total demand $Y = S$.

Demand, is made up of goods consumption (so, C stands for consumption), and demand of goods consumption (so, I stands for investments),

$$S = C + I$$

We can rewrite the condition of equilibrium as follows:

$$Y = C + S \text{ \u0159i } S = C + I \Rightarrow C + S = C + I \Rightarrow S = I.$$

Here, it results the equality savings = investments from the classics' thinking - correspondent through equality between demand and global offer.

As Keynes's system recognizes that this is not possible for a short period of time, then, it results that no savings are equal to investment. When our economy is working well nearby equilibrium point (demand = supply), which means that we have a high profit rate. This stimulates the activity of reverse investment, when we have an economy in crisis; the rate of profit is declining, so we have a decrease in investment interest. This is where the state must intervene to regulate this phenomenon.

Governing the financial investment, this interest rate occurs after the application of capital, thus being influenced by the rate of return on the market. In view of such vision, offer meets the demand; it is conditional, not vice versa, as liberal. So, it is the profit that determines the level of consumption, so the investment level. To determine the proportions between them, the multiplier and the accelerator principles should be approached.

Multiplicator (k) measures how many times the investment yield (ΔI) is contained in the income yield (ΔY).

$$K = \Delta Y / \Delta I \text{ (a)}$$

For Keynes, this relation results in the following formula $K = 1 / 1 - c'$ (b)

c' - marginal inclination towards consumption.

From (a) and (b) $\Rightarrow \Delta Y / \Delta I = 1 / 1 - c' \Rightarrow \Delta Y = (1 / 1 - c') \Delta I \Rightarrow Y = (1 / 1 - c')$. So: $k = 1 / s'$ where multiplicator is equal inverse of the marginal propensity to save.

The Accelerator Principle (probably the most simple theory on investments) was introduced by *Thomas Nixon Carver* and *Albert Aftalion*. According to him, investments react to a modification of the general conditions of the aggregate demand. When it increases, companies have two choices of response: either raise prices or increase supply. According to Keynesian theory, companies will address the second option and thus, they will decide to make investments in order to increase production capacity. In other words, we can state that:

$$I = \Delta K = \alpha \cdot \Delta Ca$$

I- investments

ΔK - capital modification

ΔCa - modification of the aggregate demand

α - coefficient of accelerator, $0 < \alpha < 1$, due to the fact that companies do not adjust immediately the level of production capacities, but, gradually: $\alpha = K / Ca$

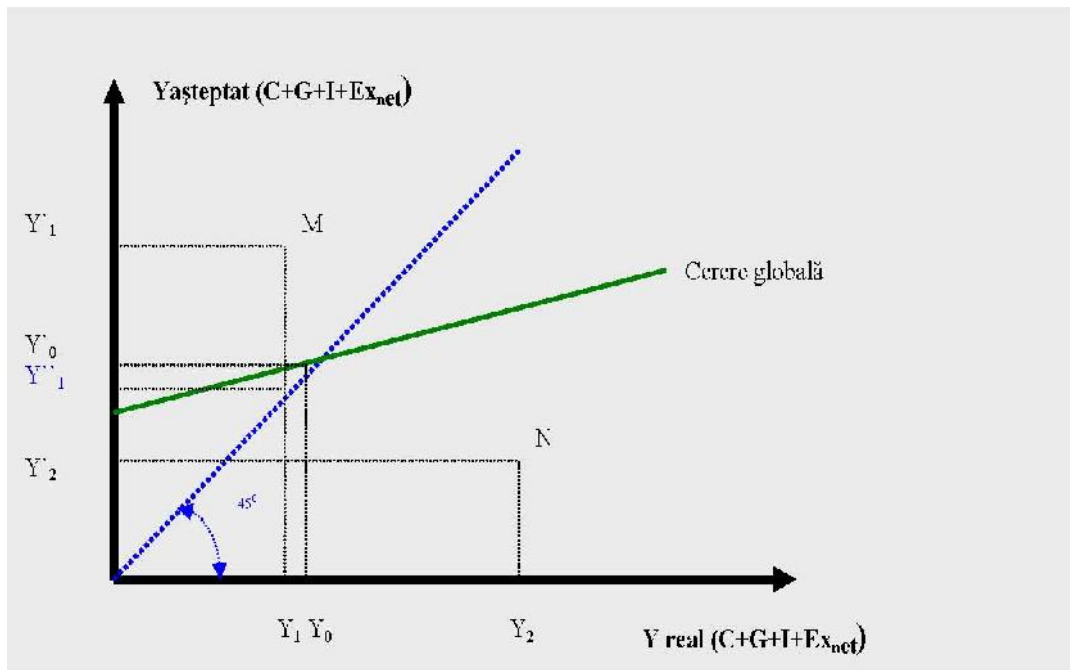
So, investments achieved in short run (I) stand for a part of the investments expected by companies (I*):

$$I = \mu I^*, \text{ where } 0 < \mu < 1$$

$$I = K^* - K_0, \text{ } K^*, \text{ fixed assets that are expected.}$$

Keynesian Cross Diagram (45-degree line diagram). In his work, "The General Theory of Employment, Interest and Money" (published in 1936), income V is equal to: $V = C + G + I + Ex_{net}$

If for C, G and Ex net, one can perceive the necessary signs for investments - consumers, government and foreign investors who decide when to buy - their costs display an interesting structure. Sometimes, business people cannot manage to sell as expected and so, they cannot get the right funds for the planned investments. It might also happen to spend on unexpected investments. Both planned and unplanned increases are considered investments. But, the unplanned increases firstly include undesirable stocks due to some sales figures situated under estimation:



Real income is measured on the abscissa $C + G + I + Ex_{net}$ and expected income is measured on the ordinate $C + G + I + Ex_{net}$ where I' is the investment firms would like to make. For point M located above the first leap, the expected investments are higher than the real ones since the corresponding income is higher than income Y_1 . $Y'1 = Y_1$ real. The difference between Y_0 and Y_1 is higher than the actual difference between the revenues recorded Y_1 and Y_0 , as this is reflected in the difference between the volumes of investment activity. A recording of a lower income is reflected primarily on the volume of investment. In

this context, a policy of income rise is necessary. For N point situated below the first bisecting line, the registered investments are greater than forecast increases. This fact however is not due to real investment activities but also to an increase in inventories. If in the first case, lower revenues were due to overproduction, this income is lower (see $Y_2 < Y_1 = Y_2$) due to a "sub-sale". If in the first case, real income records on real income axis (Ox), as for N point revenues are recorded when getting expected investments, which would mean that, we are witnessing the realization of a planned growth. Things are not so because of unplanned stock growth means unforeseen additional costs, which undermine the level of investment. If the first case requires an expansion of manufacturing activity, in the second, a restriction should be needed. In both cases it is necessary to enhance productive activity. We appreciate that for point M, global demand was above expectations and for point N, it was overestimated.

Equality between planned growth (or planned demand) and recorded growth (or effective growth) is recorded in the intersection point where demand line crosses the first bisecting line- the point of coordinates (Y_0, Y'_0) .

Critics of Keynesian theory. "Pertinence or non-pertinence of analyses and recommendations made by J.M. Keynes are submitted to triple assessments that are found in economic literature under the form of three questions: Is Keynes deceived? Is Keynes criticized? Is Keynes out of date?"

Armen Alchian challenges us when approaching Keynesian theory. He starts from the idea that firms do not maximize consciously the profit, always, they can expect to "survive" on the market; however competitive price mechanism manifested in the long term will decide who is worthy to stay on the market and who isn't. [2] Starting from this he develops the following critique of Keynes's theory: Function investments according to the formula $I = I_0 + I(d')$ implies a memorial to a common denominator of the various forms of investment, thus, achieving those goals that exceed the expectations of the marginal income rate.

The first theory comes from the imprecision of defining marginal revenue at the firm level, causing it to Keynes identified as "marginal efficiency of capital" We define the marginal efficiency of capital as being equal to the discounted sum of a series of annual payments made by the capital goods during their operation is equal to demand price (price-cost supply of replacement-replacement cost)) in the same school of thought, Abba Lerner later reworded marginal revenue at the firm level as "marginal efficiency of investment"[3].

If the rates of rebound in investments are $v_1; v_2; \dots; v_n$ then the value of investments is: $\sum v_n / (1+d)^n$, where d' stand for interest rate.

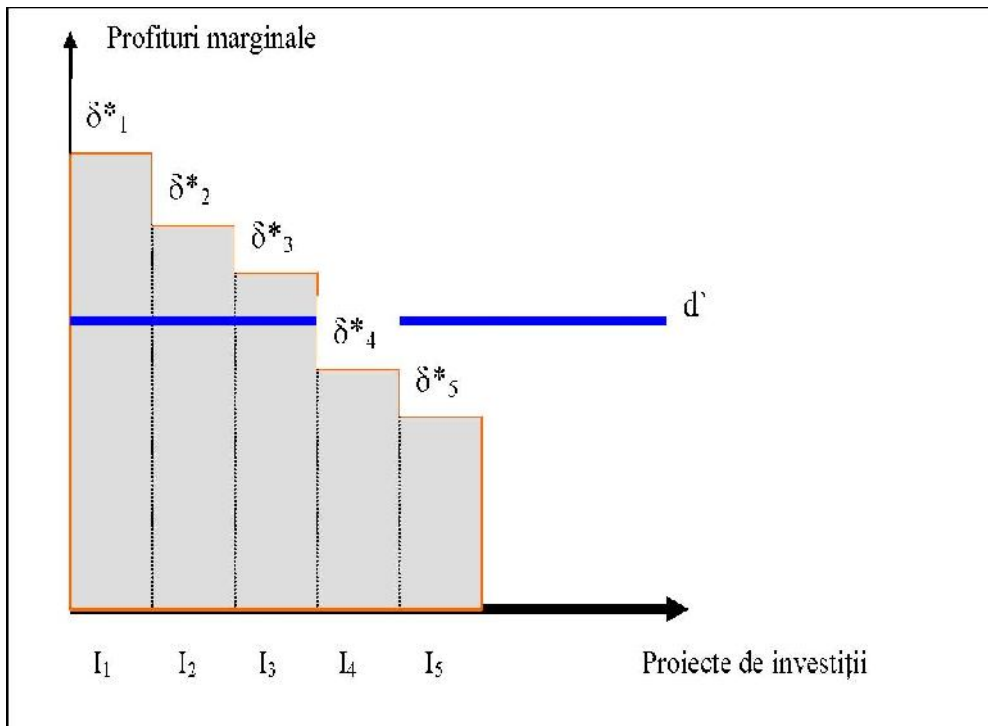
The entrepreneurial costs of investment - C- are got (by Keynes) through the discounting rates of rebound with the value " δ^* " which stands for the marginal profit of investment ("internal rate of return"), thus: $\sum v_n / (1 + \delta^*)^n$.

So an investment project is achieved if $\delta^* > d'$, otherwise it is abandoned or reconsidered.

Achieving a particular investment stock in the national economy thus depends on the interest rate.

The figure above shows five investment projects I1-5 that have marginal profits differentiated $\delta^* 1-5$. The stock of investment in the national economy is

formed by the $I_1 + I_2 + I_3$, these investment projects are those that will be implemented because if $I_4, 5; \delta^* 4.5 < d'$.



Any new value of the interest rate changes the situation involving the effectiveness of each investment project. Significant increase of the interest rate may cause any of I_{1-3} to generate losses; also a decrease in interest rates may capitalize I_4 or even I_5 .

Thus, the return on investment becomes a problem external to companies; it mainly depends on the interest rate that is not a variable managed by companies, the risk of bankruptcy is uncontrollable and entrepreneurial competence is heavily restricted. Another criticism of Keynes's theory is if the interest rate is no longer considered a single value of the market with zero impact on the functioning of domestic production processes in companies. Therefore, a company will consider the interest she receives from negotiating with a bank for a loan application.

Establishing the exact level of interest rates charged under a credit agreement is fluctuating from one situation of market and companies to another. It depends on a number of unexpected factors (described in detail in economic theory when discussing the model of Cournot or Nash equilibrium) which makes a level considered as reference interest rate vary for different companies, for the same company or different situations. We thus conclude that the profitability threshold and (CTM or CVM = P and the average profit) of a firm may change without the firm's internal performance (the CTM's) or market conditions (price level for your company) to change, what is wrong. Moreover,

according to the Keynesian theory, the evolution of the investment processes is linked to the multiplier.

Any new investment achieved by an economic operator will determine the salary increase for all employees engaged in business activities (the wage is tied to the marginal cost of labor of the last worker employed). This should result in an increase in annuity rates of return due to increase of aggregate demand. This phenomenon may represent in a particular case a Keynesian condition for achieving investment if it is based on credit because rising demand for loans (at the macro level) or indebtedness (of an economic agent) will strengthen interest rate level [4] So while the marginal profit of each plant decreases (by market share increasingly lower production level of the individual) investment position remains firm at a constant slope.

The explanation for this phenomenon can be found in Irving Fisher's theory of "Nature of Capital and Income" (1906), "Rate of Interest" (1907) and especially in the important work of his "Theory of Interest" (1930) which show that the investment function is especially a problem of inter-temporal decision.

According to his opinion, investment function is as follows:

$V_2 = f(L, I_1)$ where:

V_2 representing the investment incomes

L labour force is a constant

I_1 achieved investment

As an investment generates money after having been fully achieved, we must take into account two successive periods t_1 , the establishing term of investment and t_2 the period of establishing investments. How labor costs is a constant, it means that incomes depend on the costs of the investment, so the function becomes: $V_2 = f(I_1)$.

If interest rate is d we can say that it will influence the investment function at the level $(1+d)I_1$, which possibly implies the amount of interests paid by the company when achieving investments by credits. Investment profit is represented by:

$\pi = f(I_1) - (1+d)I_1$

Its maximization is reached when:

$f' = (1+d)$

What for Fisher " $f' - 1$ " represents the marginal profit that exceeds the cost ("marginal rate of return over cost") in the Keynesian theory, the name of the marginal investment is marginal efficiency of investment. It is obvious (as in the Keynesian theory) the existence of a negative relationship between interest rate and the volume of investment. This theory generates many problems mainly because it does not address situations in which the contractor does not depend on loans to finance investment or the company is to maximize short term profit, lacking a strategic vision. According to Fisher, the capital is intended for all production processes, there is no capital stock or withdrawal under form of profit distribution to shareholders.

This issue was under discussion by Friedrich August von Hayek in his "Pure Theory of Capital" (1941). For him, the capital involved in investment processes is

determined as difference between the existing capital stock at the beginning of the reporting period and the one prevailing at the end of it.

Hayek sees a difference between the investment theory and the theory of capital stock, it is not necessarily a fixed capital stock and a flow of investment to match the value in a period of time. A consistent difference across the Keynesian theory appears, the decision to invest is linked to a desire to hold a stock of capital in a certain period of time, thus involving decisions on the amount of inputs allocated, moments of achieving investments etc. Hayek's vision of such a link feasibility processes more than the existing capital stock, implies taking into account more restrictions than the rate decision based on the marginal profit on investment.

An important improvement is brought on the Keynesian theory which implies that the phenomenon of economic growth is simple and clear: population consumes and saves, and entrepreneurs invest. At this point, the idea of time restriction is necessary to record an economic surge in accordance with the decision of investment. A capital increase from K_0 to K_1 may be achieved through investment programmes I_{1-3} which through its decision and design determinations may determine the same boost of real capital, but on different periods.

The floating (Tourgot 1766) capital has been important an important concept since early times. The decisions regarding the optimum of the capital stock and its achievement have been relatively recently introduced by neo and post Keynesian scholars.

The return to the Keynesian economic theory is not any longer possible due to some different conditions of the market. It can be easily achieved with efficient public expenditures, namely aggregate demand compounded with restrictive currency measures in order to reduce the inflationist pressure, as well as with fiscal measures meant to encourage the business environment such as fiscal stimuli and not necessarily reduced taxation. These fiscal stimuli help production grow creating the premises of income and investments acceleration.

The simplest way to understand Keynes is to identify the differences between the classical and neoclassical economists regarding the self adjusting process or, on contrary, the need of adjustment. Keynes shows that the economic equilibrium is given by both employment rate which balance demand and offer. Keynes's conclusion results both in mood and emotion: Keynes realized that decision making process is not a simple rational mathematical calculation; it is an impulsive, uncertain and incontinent process influenced by various events.

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