

Keynesian Theory: Cognitive Dimensions in Political Economy



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Abstract:

During the Great Depression in the 1930s, the existing economic theory at the time could not explain the causes of the severe global economic collapse, nor could it provide an appropriate solution for public policies to stimulate production and employment.. In detail, we will try in this research paper to understand Keynes's social liberalism by analyzing his theoretical proposal; which relates to the concept of "big government" and expanding federal initiatives in economic activity on the one hand, and his interpretations regarding the concept of aggregate demand as the most important driving force in the economy on the other hand.

Key words: Keynesian theory; Keynesian political economy; Social liberalism; Post-Keynesian economics.

ملخص:

خلال فترة الكساد الأعظم في ثلاثينيات القرن العشرين، لم تتمكن النظرية الاقتصادية القائمة آنذاك من تفسير أسباب الانهيار الاقتصادي العالمي الشديد، كما لم تتمكن من تقديم حل مناسب للسياسات العامة لتحفيز الإنتاج والتشغيل. سنحاول عبر هذه الورقة البحثية فهم الليبرالية الاجتماعية عند كينز من خلال تحليل طرحه النظري؛ الذي يتعلق بمفهوم "الحكومة الكبيرة" وتوسيع المبادرات الفيدرالية في النشاط الاقتصادي من جهة، وتفسيراته فيما يتعلق بمفهوم الطلب الكلي باعتباره القوة الدافعة الأكثر أهمية في الاقتصاد من جهة أخرى.

الكلمات المفتاحية: النظرية الكينزية؛ الاقتصاد السياسي الكينزي؛ الليبرالية الاجتماعية؛ اقتصاد ما بعد

الكينزية

.Introduction:

Keynes had a clear vision of a successful society, which in his view was characterized by the combination of three goals: economic efficiency, social justice, and individual freedom. Keynes did not have a complete theory of the evolution of social justice; a position that did not invite long questions about the ultimate foundations of the concept. However, it must be acknowledged that Keynes had moral reasoning and that his recommendations for economic policy and the structural reforms he advocated were based on an explicit desire to achieve a more just society. This explains his decisive influence on the way governments responded to their roles in economic and social matters by maintaining full employment. It is worth noting that these recommendations are in keeping with the times of liberalism; and that the pursuit of full employment was not independent of his concept of justice, because he was thinking differently about the distant future.

Keynes's thinking was directly affected by the global depression in two ways. First, it shattered his faith in the power of monetary policy, a radical departure from his past. Despite the availability of cheap money after the devaluation of sterling in 1931, the recovery rate was very weak. Keynes concluded that "direct intervention by the state to promote and support new investment" might be "the only way to avoid a prolonged, and perhaps permanent, depression". Second, events in America prompted Keynes to think more broadly about the problem of rich economies. The generality of the depression worldwide ruled out solutions involving currency devaluation, protection, or other "external" elements.

These research conclusions confirm the important starting points that Keynes established to explain many economic problems, which is considered the main goal that the article seeks to achieve; by addressing the dimensions of Keynesian theory, especially with regard to applying the concept of social liberalism. Which makes us pose the following research question: **What are the theoretical starting points in Keynes's interpretation of the concept of social liberalism?**

Keynesian Theory: Ideas and Applications

1: Keynesian Approach: Key Meanings First Subtitle

Keynesianism is one of the most important macroeconomic theories. It refers to the doctrine developed by John Maynard Keynes, notably in the "General Theory of Employment, Interest and Money". Keynes defends the hypothesis that demand is the determining factor that explains the level of production and consequently employment. In this context, Keynes presented a set of key concepts to understand his argument. (la Toupie, 2006) They are: (la Toupie, 2006)

- the equilibrium of underemployment (unemployment) for a given level of

demand;

- the absence of adjustment by prices between job demands and offers, preventing the absorption of unemployment;
- a theory of money based on the preference for liquidity;
- the notion of marginal efficiency of capital as an explanation of investment, making investment the determining "cause" of savings;
- the psychological law according to which consumption increases less quickly than income.

From these concepts, which have given rise to macroeconomics, we can deduce the possibility of interventionist economic policies by the State in order to avoid recessions and to slow down the runaway economy. For Keynesians, there is a permanent trend towards underemployment and only state intervention can, in certain circumstances, combat unemployment. In this context, Opponents of Keynesianism maintain that there is no need to question the ability of markets to adjust supply to demand to explain unemployment and that it is public policies that subsidize, impose prices or set minimum wages that penalize hiring and prevent full employment. Post-Keynesians are less "interventionist" than the first generation of Keynesians. However, they are just as critical of the market's capacity for self-regulation. They base this on the observation of the regularity of market imbalances and financial crises, thus showing the inability of markets to manage uncertainty when they are poorly supervised. (la Toupie, 2006)

The equality between savings and investment finds its source in the definition of income. Keynes proposes his own definition which translates, at the global level, into the equality between income and the value of production. which is compatible to a creation of wealth by companies. It can be valued in different ways, but, in a market economy, it is prices that express the value that society recognizes in products. Production valued at market prices therefore represents the value that society recognizes in the wealth created. (Malherb)

The equality between national income and total added value is explained from two angles. The first: production represents the value of wealth created, intermediate consumption represents the value destroyed during the production process, their difference, that is, the added value, thus represents the value actually available for consumption and investment. In a certain way, this point of view corresponds to an analysis in physical terms", since, conceptually, intermediate production and consumption are obtained by valuing physical quantities using market prices. The second point of view is that of property rights. At the moment it appears, the wealth created necessarily becomes the property of an economic agent, it is then redistributed between the different economic agents in the form of wages, property income, taxes and other current transfers. Overall, the income corresponds to the market value of the new rights created during the year. This

approach represents the legal point of view.

In the same context; Keynes argued that insufficient aggregate demand could lead to prolonged periods of high unemployment. According to him, an economy's output of goods and services is the sum of four components: consumption, investment, government purchases, and net exports (the difference between what a country sells to foreign countries and what it buys from them). Any increase in demand must come from one of these four components. But during a recession, powerful forces often act to weaken demand as spending declines. This can be explained by the theory of uncertainty and the erosion of consumer confidence, a situation that leads to a reduction in spending. This decline in consumer spending can lead to a reduction in investment spending by businesses, as businesses respond to weak demand for their products. All of this, according to Keynes's view, leads to an increase in output at the expense of the government, which makes government intervention necessary to smooth out periods of boom and bust in economic activity, or what is known as the business cycle. (Sarwat Jahan, 2014, p. 53)

The Keynesian description of how the economy works is based on three main principles: (Sarwat Jahan, 2014, p. 54)

- Aggregate demand is affected by many economic decisions - public and private; where private sector decisions can sometimes lead to negative macroeconomic outcomes, such as: reducing consumer spending during a recession. This sometimes requires active policies by the government, by taking a fiscal stimulus package. Therefore, Keynesian economics supports the idea of a mixed economy directed primarily by the private sector, provided that it is partially operated by the government.

- That prices, especially wages, respond slowly to changes in supply and demand, leading to periodic shortages and surpluses, especially in labor;

- That changes in aggregate demand, whether expected or unexpected, prove their effects in the short run on real output and employment, not on prices.

The basic principle of Keynesian economics is that if the level of investment exceeds the saving rate across a country or society, it will promote economic and commercial growth. Conversely, if the saving rate is higher than the investment rate, it will cause a slowdown and eventually recession. Keynes therefore emphasizes the idea that increased spending reduces unemployment and helps economic recovery. At the same time, Keynes believes that demand drives production, despite the opposite view at the time, which was that supply creates demand. (Ismail, p. 6)

2: Theoretical foundations of Keynesian economic thought

The most important components of the modern theory are summarized as follows:

- The lack of connection between savings plans and investment plans:-

The theory rejects Say's law by questioning the ability of the interest rate to achieve synchronization between the family sector's plans regarding savings and the business sector's plans regarding investment. While the classical believed that increasing savings would result in an increase in investments provided by businessmen, the modern theory says that more savings means less consumption and thus less demand for various goods and services provided. So how can we expect businessmen to expand their investments at a time when demand for products is shrinking? The modern theory also confirms this idea by stating that both saving and investment are done by two different teams and for different motives. The motives for saving (buying a commodity in the future, taking precautions for any emergency, ensuring the future of children, love of money, etc.) are completely different from the motives for investment (making a profit).

- Interest rate:-

Despite its impact on investors' decisions, the interest rate is not the only or most important factor. The decisive factor here is the profit rate expected by businessmen. In cases of recession and pessimism among businessmen about sales and profits, interest rates are low, but this decline does not encourage businessmen to increase their investments.

- Opposition to the idea of flexibility of wages and prices:-

The modern theory denies the existence of flexibility in prices and wages to the extent that it is possible to guarantee a return to full employment as a result of a decrease in total spending. The price system under the modern capitalist economic system is no longer a system of perfect competition, but rather a system distorted by the incompleteness of the market and restricted by practical and political obstacles that work to prevent the flexibility of prices and wages. There are producers who enjoy monopoly control over the markets of the most important goods and will not allow the prices of their products to decrease when demand decreases. In labor markets, we find strong labor unions opposing the trend towards reducing wages. Even if we assume that there is flexibility in wages and prices when total spending decreases, it is doubtful that this decrease will lead to a decrease in prices and wages as a result of a decrease in cash incomes.

By rejecting the classical employment theory, we acknowledge the lack of mechanism of the capitalist system in its ability to achieve full employment of resources, and that the level of employment, as seen by Keynesian theory, depends

directly on the level of total spending, which we will discuss and its components in subsequent lessons.

- ✓ How to combat involuntary unemployment?
- ✓ Economic policy according to Keynes: what are the objectives?

Broadening the functions of the State to achieve near full employment

Keynes wanted to broaden the functions of the State and create a decision-making centre in cyclical economic policy. The role of this decision-making centre was to "adjust the propensity to consume and the incentive to invest to each other" in order to achieve "near full employment", while avoiding situations of overheating. The aim was not to achieve full employment, but only to achieve an unemployment rate of around 5 to 6% of the working population. Keynes was sceptical about the realism of the objective proposed by W. Beveridge for the post-war period, in his report *Full Employment in a Free Society* (1944), namely an unemployment rate reduced to 3%. In reality, after 1945 in the United Kingdom, the rate fell below 3%! (Potier, 2024)

Supporting consumption or supporting investment? In theory, a stimulus policy can focus on either consumption or investment, or a combination of both. In the first case, it will take the form of an increase in monetary wages or a reduction in income tax. In the second case, it will take the form of a reduction in interest rates or an increase in public investment. In fact, Keynes expressed his skepticism about stimulus policies through wage increases. He had the opportunity to criticize "purchasing power policies", for example that introduced by Roosevelt in the United States as part of the New Deal, which discouraged investment. However, he was in favor of implementing a structural tax reform that would increase the community's propensity to consume (e.g., raising inheritance taxes). On the other hand, he was a strong advocate of policies to support private and public investment. (Potier, 2024)

3: The major role assigned to the State in Keynesian thought

The police state: "it is of the essence of state planning to do those things which ... lie outside the scope of the individual" (Chandavarkar, 1993, p. 126) Keynes defends the need for the State to intervene in the economy, not limiting it to a "police state". Classical and neoclassical economists defend a "police state" whose prerogatives are limited to guaranteeing the proper functioning of market rules and financing public infrastructures. (tanzi, 1997) Its prerogatives are confined within the narrow limits of a few sovereign functions as defined by Smith.

The State and Economic Imbalances He claimed that the state's economic

policies are capable of stimulating economic activity, stressing that the rate of capital growth in the transportation system, public utilities and housing in any country depends to a large extent on the policy of the treasury and the current government. According to him, economic imbalances can arise within the economy itself, especially in the wrong expectations of economic actors. (Fábio Henrique Bittes Terra, 2022)

The instrument of fiscal policy (lumni, 2024): Fiscal policy consists of using variations in the state's budget balance to achieve certain objectives. It is the preferred instrument of Keynesians. Fiscal policy meets 3 objectives:

- the stabilization of activity (smoothing of cycles);
- the redistribution of income in order to support consumption;
- the promotion of an optimal growth path based on the accumulation of capital (capital must be invested and not saved)

Regarding the most important mathematical calculations of the equations proposed by John Maynard Keynes, he gave a set of mathematical models, which are as follows:

4: Keynesian Theory: Mathematical and Complex Extensions

4.1. Aggregate Demand (AD) Equation (Mankiw, pp. 241-260)

Keynesian aggregate demand is the sum of consumption, investment, government spending, and net exports:

$$AD = C + I + G + (X - M)$$

Where:

- C = Consumption.
- I = Investment.
- G = Government spending.
- X = Exports.
- M = Imports.

4.2. Consumption Function. (Mankiw)

The consumption function expresses consumption as a function of disposable income.

(Y_d):

$$C = C_0 + MPC \times Y_d$$

Where:

- C₀ = Autonomous consumption.
- MPC = Marginal propensity to consume.
- Y_d = Disposable income.

4.3. Investment Function. (Mankiw)

Investment can be modeled as a function of interest rates:

$$I = I_0 - b \cdot r$$

Where:

- I_0 = Autonomous investment.
- b = Sensitivity of investment to interest rates.
- r = Interest rate.

✓ Equilibrium Output

Equilibrium output is determined when aggregate demand equals total output (Y):

$$Y = C + I + G$$

Substituting the consumption function:

$$Y = C_0 + MPC \times Y_d + I + G$$

4.4. The Multiplier Effect. (Blanchard, 2017, pp. 109-125)

The Keynesian multiplier shows how an increase in spending leads to a larger increase in total output:

$$k = 1 / (1 - MPC)$$

For government spending (G):

$$\Delta Y = k \times \Delta G$$

➤ Complex Keynesian Extensions.

4.5. The IS-LM Model. (Blanchard, 2017, pp. 109-125)

✓ IS Curve: Equilibrium in the Goods Market.

$$Y = C(Y - T) + I(r) + G$$

➤ LM Curve: Equilibrium in the Money Market.

The LM curve represents equilibrium in the money market. It is derived from the money demand and supply equation:

$$M/P = L(Y, r)$$

Where:

- M/P = Real money supply.
- $L(Y, r)$ = Money demand, depending on income (Y) and interest rates (r).

➤ IS-LM Equilibrium.

The equilibrium in both markets occurs where the IS and LM curves intersect, determining output and interest rates.

4.6. The Phillips Curve. (Blanchard, 2017, pp. 189-206)

✓ Short-Run Phillips Curve.

The Phillips Curve shows the relationship between inflation (π) and unemployment (u):

$$\pi = \pi_e - \alpha (u - u^n)$$

Where:

- π = Inflation rate.
- π_e = Expected inflation rate.
- u = Unemployment rate.
- u^n = Natural rate of unemployment.

✓ Long-Run Phillips Curve (NAIRU)

In the long run, the Phillips Curve is vertical at the natural rate of unemployment (NAIRU), suggesting no trade-off between inflation and unemployment.

4.7. Extensions with Fiscal and Monetary Policy.

✓ Fiscal Policy. (Samuelson, 2010, p. 442)

Fiscal policy shifts the IS curve. Expansionary fiscal policy (higher government spending or lower taxes) shifts the IS curve to the right.

✓ Monetary Policy. (Mukher, 2024)

Monetary policy shifts the LM curve. Expansionary monetary policy (increased money supply) shifts the LM curve to the right, lowering interest rates.

Keynesian Theory: Criticism and Future

1: Criticism of Keynesian Theory in Political Economy

When reading Keynesian theory and the subsequent critical literature on the set of economic rules that emerged from it, some of the criticisms can be linked to the methodological aspect adopted by Keynes. In contrast to the approach of contemporary economists, Keynes's work contains few models or mathematical formulas. Moreover, he tended to make assumptions and predict results that were not supported by any evidence from the real world. In fact, Keynes's recommendations in political economy were very theoretical.

In the same vein, a more fundamental criticism concerns the concept of “big government” and the expansion of federal initiatives in economic activity advocated by Keynes. Opponents claim that federal spending discourages private investment. Those of the Austrian School of Economics and the Chicago School of Economics believe that recessions and booms are part of the natural order of business cycles and that direct government intervention only exacerbates the recovery. (Ismail, p. 6)

Keynes has also been criticized for his central idea that “you can spend your way out of a recession.” Many economists believe that continued government spending and debt accumulation ultimately lead to inflation, rising prices that reduce the value of money and wages—which can be disastrous if not accompanied by substantial economic growth. Monetarists also argue that Keynesian economics goes too far in advocating government influence in the economy, while socialist and communist economists argue that it does not go too far. They firmly believe that central authority should not only influence businesses and the means of production, but should actually control and own them. (Ismail, p. 6)

2: An End to the Keynesian Era?

This question, which constitutes an important title in the study entitled: "John Maynard Keynes and the Modern Revolution in Political Economy", By researcher James Piereson, where he addressed the issue of the future of Keynesian thought in political economy.

The most important ideas in this topic are as follows: (Piereson, 2012, pp. 271- 273)

- “An economy with a dense network of narrowly self-interested organizations will be vulnerable during periods of deflation or contraction to depression or stagflation,” Olson wrote. An unexpected deflation will expose incomes and prices that exceed the market in the “fixed-price sector,” forcing the sector to shift toward a “flexible-price” sector where incomes, wages, and prices are determined by market competition. This increases chances of state intervention to pump money and return to the “fixed price sector.”
- Keynes argued that the capitalist system evolves in stages through the development of new forms of organization through innovation. However, there is no general agreement that the Keynesian Age represents a final stage in the development of capitalism. There is a possibility: the United States, and the advanced economies in general, are still in the early stages of a turmoil that will test the Keynesian system to its limits.
- There are persistent attempts to preserve the relevance of Keynesianism; this is embodied in the ideas put forward by post-Keynesians on issues of income distribution, inflation and recession. This is the sense in which Milton Friedman declared that “We are all Keynesians now... We all use the Keynesian language and apparatus,” although he also added the incorrect observation that “none of us any longer accepts the initial Keynesian conclusions” (Ahiakpor, 2004, p. 26)

- Howard Minsky defended the "financial instability hypothesis" as a "version of Keynesian theory" in response to neoclassical Keynesianism. This argument is often associated with post-Keynesian theory. (Ahiakpor, 2004, p. 26)

Conclusion:

This research paper shows us the great efforts made by Keynes; which are reflected in his theoretical and applied attempts to solve economic problems. Accordingly; and after relying on various specialized literature in Keynesian theory, it can be said that the Keynesian model is still valid in various economies across the world. The main idea related to the role of the state according to the Keynesian perspective has proven its great importance, especially with the major repercussions of the Covid pandemic on the world's economies. Finally, theoretically, Keynesian ideas must be recognized as ideas that are still embodied - if not in the process of being embodied - and that hybridizing capitalism with transactions with a social dimension (state intervention) is a policy that has its benefits in the field of political economy for developing countries. His mathematical calculations are also applicable in the process of searching for the empirical results of the various aforementioned economic problems.

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