The Keynesian Attack and Solution

It is 1936 and the West has experienced 7 years of absurdly, inexplicably high unemployment. GDP keeps falling, as do prices and wages. Keynes believes the Classical Theory offers a model of the economy that does not apply to the prevailing environment and, therefore, yields incorrect policy prescriptions. Keynes has decided that it can't be "self-correcting" because it hasn't "self-corrected"!!!

THE CLASSICAL MODEL:

$D_L = VMP_L = f(w, P, MP_L)$

$S_L = MdisutilyL = f(w, P, Tastes)$ where "tastes"=the worker's disutility from labor

The intersection of D_L and S_L determines w_e and L_e — the amount of labor employed in the economy. If there are NO impediments to the market process, there will be NO UNEMPLOYMENT (see Figure 1).

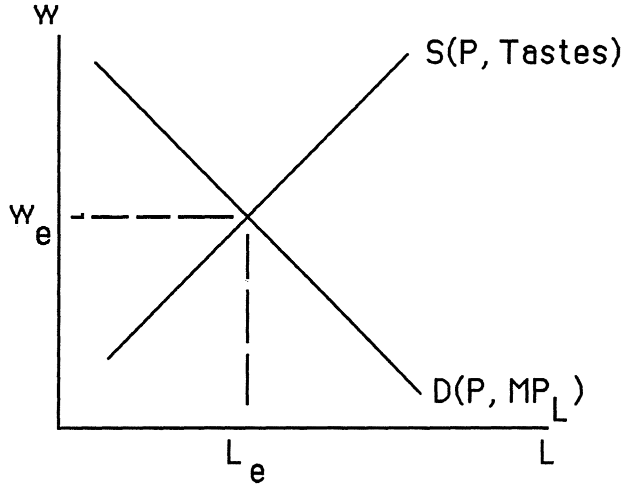

Figure 1: Classical No Voluntary Unemployment

The Classical View of Unemployment:

Unemployment will occur if and only if $w > w_e$ because that's the only time $Q^s_L > Q^d_L$.

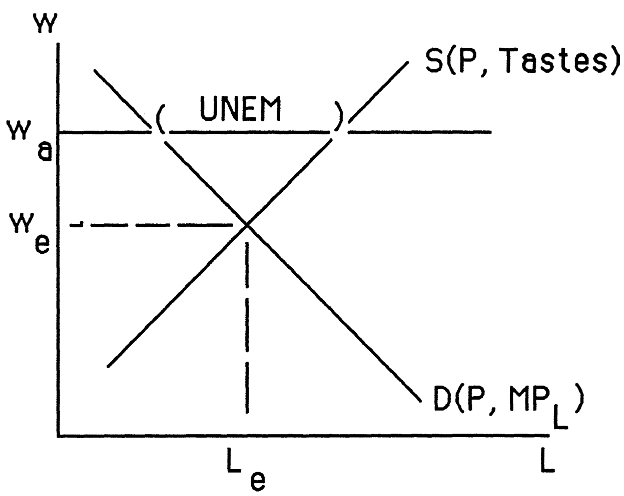

Figure 2: Classical Voluntary Unemployment

The higher than equilibrium wage can only be maintained if there are impediments to the market process — these include: legislation, social practices, unions, or mere human obstinacy.

Classical economists would argue that high unemployment and falling GDP can only be caused by obstacles to the free market.

Classical Solutions to Unemployment:

Urge workers to take cuts in wages and repeal all government legislation that affects the labor market (including minimum wage and social insurance programs).
The state could also call for more innovation or impovements in the quality of labor to increase the "marginal physical productivity of labor". This would increase the D_L and increase employment.

But the classical "bottom line" is really: DO NOTHING. There are self-regulating mechanisms that will drive the system back to full-employment. Furthermore, there is a feeling that it is the workers' fault because a fall in wages would ensure an increase in employment.

THE KEYNESIAN ATTACK ON THE CLASSICAL MODEL:

Keynes mocks these "solutions" as useless and far off the mark. The classical model does not apply to the present problem and, thus, the policy prescriptions cannot possibly be effective.

The Inapplicability of the Classical Model:

Labor resists decreases in money wage, but not increases in the general price level. The classical model does not contain (and cannot explain) this type of behavior.

Labor bargains only over the money wage, not the real wage. Since Labor can't affect P, it can't possibly determine the real wage. To chastise Labor for being unwilling to accept lower real wages is ridiculous because that variable is outside their control.

THE KEYNESIAN EXPLANATION OF UNEMPLOYMENT:

The fact that unemployment and decreasing GDP have continued for such a long time provides evidence that the classical model does not apply. The specific place where reality diverges from classical theory is in the second postulate (which derives the supply of labor).

S_L is not a function of w, P and Tastes; it is instead a function of money wage and tastes:

S_L = f(w, Tastes).

This conforms with the fact that Labor refuses to accept decreases in w, while it acquieses to increases in P.

Changes in P leave the supply of labor unchanged.

This "money illusion" is not illogical or based entirely on stupidity

Given this new S_L, we can show involuntary unemployment graphically as:

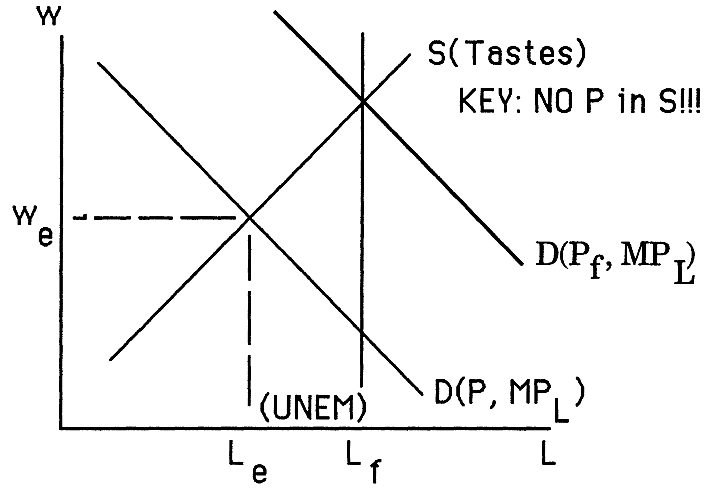

Figure 3: Keynesian Involuntary Unemployment

The system, since it is in equilibrium, has no tendency to change. This is why we have had unemployment for so long. It is involuntary unemployment because there is **nothing** that Labor can do to increase employment.

WHY IT'S CALLED "THE GENERAL THEORY":

Notice the General Theory: the price level can be completely ignored by labor OR completely, rationally incorporated by labor OR labor can fractionally (anywhere from 0 to 100%) take prices of goods and services into account.

The Classical Theory is a special case of the more General Theory because it picks out one of these possibilities and makes it the only case under consideration. It picks out the 100% position as the always prevailing position.

Actually, most of the time, that's OK. Unfortunately, we can get into other environments and when we do, the Classical, special case will NOT apply. The West in the 1930s did not contain the characteristics of the special case.

Keynes believed that labor would not respond to increase in prices by reducing the supply of labor. That was the key to fixing the problem of unemployment.

THE KEYNESIAN SOLUTION TO UNEMPLOYMENT:

No amount of chastising and cajoling designed to generate lower money wages is going to increase employment. Increasing productivity and/or decreasing the marginal disutility of labor would work, but these solutions are vague and take time. The State cannot easily manipulate these variables.

The proper solution is to have the government stimulate aggregate demand, which will increase the price level, which will increase D_L (yet leave S_L unchanged), which will increase employment!

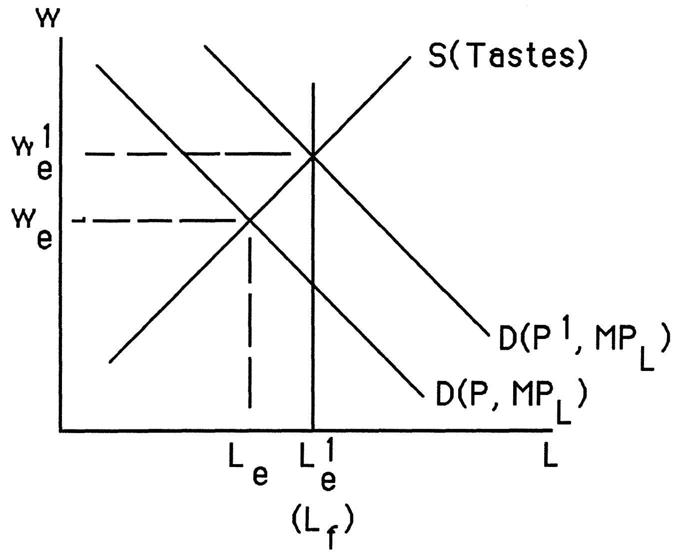

Figure 4: Keynesian Solution to Involuntary Unemployment

Keynes on Economic Growth in a Market Economy:

The market system usually works great. However, every once in a while, it gets stuck. It spins out of control and can't right itself. The proper role of government is to *selectively intervene* at these times in order to prevent a prolonged unemployment. (Such a crisis may precipitate a revolution such as the one envisioned by that unprincipled degenerate, Marx!). We want to maintain the present system—it has enabled me to be the Great Man I am today. I am the Savior of Capitalism. I am the most amazing, awesome man I have ever met. Thank you very much. Feel very free to clap, cheer, or kiss my feet!!!!