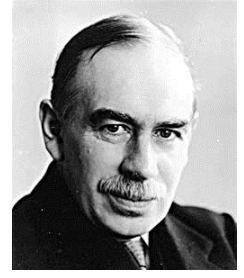


JOHN MAYNARD KEYNES

(5 June 1883 – 21 April 1946)



John Maynard Keynes was a British economist whose ideas have fundamentally affected the theory and practice of modern macroeconomics, and informed the economic policies of governments. He is widely considered to be one of the founders of modern macroeconomics and the most influential economist of the 20th century. His ideas are the basis for the school of thought known as Keynesian economics.

His major work, *The General Theory of Employment, Interest and Money*, included the determination of National Income and Employment.

Output is determined by demand for goods and services

Keynes took the view that the size of national income depended on expenditure (i.e) consumer spending, investing, government investments, exports less imports. Unemployment was caused by people not spending enough money. He was not in favour of wage cuts as he felt it had a harmful effect on consumption (spending), income and total demand. He thought wage cuts increased unemployment rather than reducing it as the more people that were unemployed, the less consumption.

The Multiplier

In recessions, the aggregate demand falls as people and businesses spend less. Lower spending causes a fall in demand and further falls in spending. Keynes thought that Governments should borrow money and redistribute it into the economy. Once the economy recovered and was expanding again, governments should pay back the loans. This is known as the Keynesian multiplier. One person's spending becomes another person's income. The initial increase in spending can cause further rounds of spending. Therefore, the final increase in National Income is greater than the initial spending (or injection of Money) e.g if Government increase spending on the wages of nurses by £2billion. That means National Income increases by £2billion. However, if nurses spend part of their extra wages, additional output and incomes will be generated. The final increase in National Income may be £3 billion. Therefore, there is a multiplier effect of $3/2 = 1.5$

Government Intervention

Keynes took the view that governments should intervene in the economy by means of fiscal policy (government policies on income and expenditure). He wrote that governments should borrow and engage in budget deficits to stimulate economic activity in recessionary times. This was in complete contrast to views expressed before this.

Liquidity Preference Theory

Previous economists thought that people saved money when offered a high rate of interest as money was seen as a form of exchange. Keynes adopted a new approach by studying the holding rather than the spending. He saw three motives that the public had for holding money: transactionary, precautionary and speculative motives.

National Income could be at equilibrium below full employment

Keynes thought that national income could reach equilibrium (demand = supply) without reaching full employment and thus suggested government intervention to help create jobs.

Investment decisions by entrepreneurs

The classical school of thought was that the rate of interest ensured all savings were invested. Keynes did not agree. He stated that investment by entrepreneurs was more dependent on business people's expectations rather than the rate of interest. Hence, investment could be less than savings, resulting in a leakage from the circular flow of income and leading to a fall in demand and more unemployment.

PAST EXAM QUESTIONS ON KEYNES

2013 Question 3 (C)

(i) Using the Keynesian multiplier process outline how a fiscal stimulus (i.e. a government injection) would affect an economy's Aggregate Demand.

The initial increase in government expenditure will have a greater final increase in aggregate demand. **(4 marks)**

Increase in aggregate demand = initial increase in government expenditure x by the multiplier. **(9 marks)**

or

Example

Government injects €10m. Multiplier is 2. So increase in Aggregate Demand = €10m x 2 = €20m.

(ii) Explain why the Irish government might find it difficult to implement such a Keynesian stimulus plan at the current time.

1. Ireland is in a bailout programme / Current Budget Deficit currently

The Irish Government is relying on funding from the IMF/EU/ECB to run the country. Even if a fiscal stimulus was appropriate, the Irish Government would have to seek permission (and money) to do it.

2. Ireland is an open economy

The value of the multiplier falls when imports are taken into account. This is because imports are a leakage from the circular flow of income. If the Irish Government increased spending some of that spending would leak out of the Irish economy due to the purchase of imports.

3. Ireland needs a global recovery

Ireland cannot recover on its own. It needs a global economic recovery. Growth in our national income depends on both a strong domestic and a strong international economy.

4. Reaction of the public

If the public don't believe that the fiscal plan is credible then it has a much less likely chance of working. If the Government did try to expand the economy they would need to convince Irish people that the plan would work and that the Government would be able to pay back the debt incurred by the increased spending.

5. Current economic climate / expectations of citizens

Citizens are fearful of the future. If the government injected money into the economy citizens may save more rather than spend. So the MPS may rise while the MPC may fall.

12 marks. 2 points

First point 8 marks (4+4)

Second point 4 marks (2+2)

2012 Question 8 (C)

*The economist John Maynard Keynes, author of **The General Theory of Employment, Interest and Money (1936)**, supported the use of fiscal policy by Government to create full employment.*

(i) Explain the above statement.

He suggested government cut direct taxation to boost income, therefore boosting expenditure to help create jobs.

The government could increase its expenditure, thereby increasing demand (through direct public works) so as to help create jobs.

13 (9+4) marks.

(ii) Discuss two other key concepts which Keynes contributed to economic thought.

1. Equilibrium National Income.

National income could reach equilibrium without reaching full employment.

2. Output is demand determined.

The size of national income depends on expenditure i.e. $Y = C + I + G + X - M$

3. Investment decisions by entrepreneurs.

He stated that investment by entrepreneurs depended more on businessmen's expectations than on the rate of interest.

4. Investment could be less than savings.

This could result in a leakage in spending which decreases national income and employment.

5. New Economic Concepts – The Multiplier

He developed new tools to explain his theories including the multiplier: Any initial increase in spending will cause a much greater increase in GNP due to the fact that one person's expenditure is another person's income. He developed concepts such as: MPC, MPM, etc.

6. Liquidity Preference Theory:

People may prefer to hold their wealth in money form for three reasons: transactionary; precautionary and speculative reasons.

7. Managed system of exchange rates:

He favoured a system of foreign exchange rates which could be 'managed' by the state rather than the gold standard.

2 at 6 marks each.

2009 Question 4 (B)

Keynes' concept of 'Liquidity Preference' is based on three reasons why people desire to hold wealth in money form.

(i) State and explain each of these reasons

Transactionary motive	Precautionary motive	Speculative motive
People desire to hold money for day-to-day expenses e.g. buying goods & services	People desire to hold money for emergencies/rainy day e.g. illness, house repairs.	People desire to hold money for any possible profitable future investment opportunities.

3 reasons (stated and explained) @ 6 marks each graded

2007 Question 4 (C)

In the case of any TWO of the following economists, outline TWO contributions which each one has made to the development of economic ideas: Adam Smith, Alfred Marshall, Keynes, Milton Friedman (20 marks)

John Maynard Keynes

(a) National Income at less than full employment:

Keynes observed that national income could reach equilibrium without reaching full employment and hence he suggested government intervention to help create jobs when required.

(b) Output is demand determined.

The size of national income depends on expenditure i.e. $C = I + G + X - M$

(c) Favoured government intervention in the economy.

The job of the government is to manage the economy. The government can use fiscal policy to create full employment.

(d) Investment decisions by entrepreneurs.

He stated that investment by entrepreneurs depended more on businessmen's expectations than on the rate of interest.

(e) Investment could be less than savings.

This could result in a leakage in spending which decreases national income and employment.

(f) New Economic Concepts – The Multiplier

He developed new tools to explain his theories including the multiplier: Any initial increase in spending will cause a greater much greater increase in GNP due to the fact that one person's expenditure is another person's income. He developed concepts such as: - MPC, MPM, etc.

(g) Liquidity Preference Theory:

People may prefer to hold their wealth in money form for three reasons: transactionary; precautionary and speculative reasons.

(h) Managed system of exchange rates:

He favoured a system of foreign exchange rates which could be 'managed' by the state rather than the gold standard.

2006 Question 3 (C)

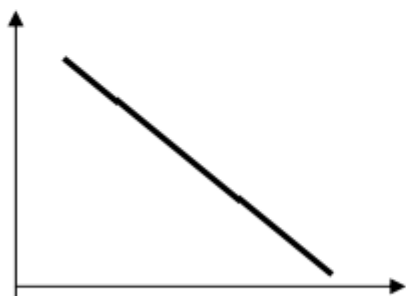
(i) State and explain Keynes's THREE motives for holding money:

Transactionary motive	Precautionary motive	Speculative motive
People desire to hold money for day-to-day expenses e.g. buying goods & services	People desire to hold money for emergencies/rainy day e.g. illness, house repairs.	People desire to hold money for any possible profitable future investment opportunities.

3 reasons (stated and explained) @ 5 marks each graded

(ii) Explain, with the aid of a diagram, Keynes's theory on the relationship between the holding of money and the rate of interest.

Motive	Rate of Interest
Transactionary	The demand for money for transactionary reasons is not affected by the rate of interest.
Precautionary	The demand for money for precautionary reasons is affected slightly (negatively) by the rate of interest.
Speculative	The demand for money for speculative reasons is greatly affected (negatively) by the rate of interest.



When the rate of interest is low, the opportunity cost (of the interest foregone) is low, so people prefer to hold money.

When the rate of interest is high, the opportunity cost is high – as it is now more costly to hold money – so now less money is held.