Economic Importance of Keynesian and Neoclassical Economic Theories to Development

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Introduction
This paper aims to explore the economic importance of the Keynesian and the neoclassical economic theories towards economic development. The first part of the essay will give an introductory overview on fiscal and monetary policies for a better understanding of the debate. Part two will focus on the general knowledge behind the Keynesian economics theory, part three will further examine the neoclassical theory and part four will give an overview on the economic importance of both theories. Part five will be the conclusion.

In all aspects of human endeavors, the study of economics becomes a very important tool in analyzing how the various part of our economy behaves. The rising cost of commodities and the fluctuating interest rates in the financial sector can be best understood well through economic analysis. Economics is the study of the production and consumption of goods and the transfer of wealth to produce and obtain those goods. It explains how people interact within markets to get what they want or accomplish certain goals. Since economics is a driving force of human interaction, studying it often reveals why people and governments behave in particular ways.

Microeconomics focuses on the actions of individuals and industries, like the dynamics between buyers and sellers, borrowers and lenders. Macroeconomics on the other hand, takes a much broader view by analyzing the economic activity of an entire country or the international marketplace. It further analyze how a country uses its resources, how much time laborers devote to work and leisure, the outcome of investing in industries or financial products, the effect of taxes on a population, and why businesses succeed or fail. In this regard, Savings and investment becomes a very important part of every economy, as this ensures sustainable development of our economy for accelerated economic growth. Before I proceed to analyze Keynes Economic theory and that of the Neoclassical, for better understanding of the factors underlying both schools, I would give a wider picture about fiscal and monetary policies of an economy for easy understanding.

I. Fiscal and Monetary Policies of an Economy
Fiscal policy can be viewed as a government legislative measure to control the economy of a country. It is carried out by the legislature of a country. The main fiscal policy tools are the
government expenditures and taxation. Government collects taxes from the economy in order to finance their expenditures. Government expenditures as spelt out in the budget can be grouped into two, recurrent and capital budgets. Recurrent budgets include all government expenditures which all used to support the smooth running of a government. Capital budget will include all expenditures in infrastructure. A government plans for all its financial activities in the coming year through budgetary allocation. It can choose to do so by employing either a deficit or a surplus budget. The government is said to have used a deficit budget when all its expected expenditures for the year exceed the amount of revenues collected from taxes and other sources of government revenues. The deficit that is left unaccounted for will be funded from external or internal borrowing. The borrowing will be in form of fixed income securities both short term and long term. Accumulation of principal amount and interest of this borrowing and other finances will result to a national debt. Thus the government will be increasing its national debt when it uses a deficit budget to finance its expenditures. The other situation of budget surplus will exist when government revenues collected for the year exceed the total government expenditures for that year. The government through the fiscal policy can influence the market and this will result into either an expansionary measures.

On the other hand, the term monetary policy is used variously in economics to describe the steps and actions taken by the federal banks or any such government regulatory body to control the supply of money in the economy in order to achieve certain goals. Such goals include curbing inflation during times of high economic growth, and taking care of unemployment in times when the economy is not performing. Monetary policy should not be confused with fiscal policy. Although there is a close relationship between the two, fiscal policy is limited to taxes and government spending, and may not involve such bodies like a central bank, at least not directly.

II. Keynesian Economics Theory
Keynesian economics is an economic theory of total spending in the economy and its effects on total output and inflation in a given economy. Keynesian economics was developed by the British economist John Maynard Keynes during the 1930s in an attempt to understand the Great Depression. Keynes advocated increased government expenditures and lower taxes to stimulate demand and pull the global economy out of the Depression. Subsequently, the term “Keynesian economics” was used to refer to the concept that optimal economic performance could be achieved and economic slumps prevented by
influencing aggregate demand through activist stabilization and economic intervention policies by the government. Keynesian economics is considered to be a “demand-side” theory that focuses on changes in the economy over the short run. Keynes argued that the solution to the Great Depression at that time was to stimulate the economy "inducement to invest" through some combination of two approaches:

I. A reduction in interest rates (Monetary policy)
II. Government investment in infrastructure (Fiscal policy).

He argues that by reducing the interest rate at which the central bank lends money to commercial banks, the government sends a signal to commercial banks that they should do the same for their customers. Investment by government in infrastructure injects income into the economy by creating business opportunity, employment and demand and reversing the effects of the aforementioned imbalance. Governments source the funding for this expenditure by borrowing funds from the economy through the issue of government bonds, and because government spending exceeds the amount of tax income that the government receives, this creates a fiscal deficit.

Prior to Keynesian economics, classical economic thinking held that cyclical swings in employment and economic output would be modest and self-adjusting. According to this classical theory, if aggregate demand in the economy fell, the resulting weakness in production and jobs would precipitate a decline in prices and wages. A lower level of inflation and wages would induce employers to make capital investments and employ more people, stimulating employment and restoring economic growth.

The depth and severity of the Great Depression, however, severely tested this hypothesis. Keynes maintained in his seminal book, "General Theory of Employment, Interest and Money," and other works, that structural rigidities and certain characteristics of market economies would exacerbate economic weakness and cause aggregate demand to plunge further. For example, Keynesian economics refutes the notion held by some economists that lower wages can restore full employment, by arguing that employers will not add employees to produce goods that cannot be sold because demand is weak. Similarly, poor business conditions may cause companies to reduce capital investment, rather than take advantage of lower prices to invest in new plant and equipment and this would also have the effect of reducing overall expenditures and employment1.

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To Keynes, excessive saving, that is saving beyond planned investment was a serious problem encouraging recession or even depression. Excessive saving results if investment falls, perhaps due to falling consumer demand, over-investment in earlier years, or pessimistic business expectations, and if saving does not immediately fall in step, the economy would decline. He further argued that saving and investment are not the main determinants of interest rates, especially in the short run. Instead, the supply of and the demand for the stock of money determine interest rates in the short run. Neither changes quickly in response to excessive saving to allow fast interest-rate adjustment. Finally, Keynes suggested that, because of fear of capital losses on assets besides money, there may be a "liquidity trap" setting a floor under which interest rates cannot fall. While in this trap, interest rates are so low that any increase in money supply will cause bond-holders fearing rises in interest rates and hence capital losses on their bonds to sell their bonds to attain money.

III. The Neoclassical Economic Theory

Neoclassical economics is a term variously used for approaches to economic focusing on the determination of prices, outputs, and income distributions in markets through supply and demand. It is often mediated through a hypothesized maximization of utility by income-constrained individuals and of profits by cost-constrained firms employing available information and factors of production, in accordance with rational choice theory. Neoclassical economic models are based on the assumption that investment is financed from household savings. Accordingly, they are of the view that capital accumulation will be maximized by policies aimed at increasing household savings rates and capital imports "foreign savings". These models also predict that capital should flow from rich to poor countries which draw a higher rate on returns.

In neoclassical models, the assumption of full employment prevents a fall in demand brought about by an increase in the savings rate, which amounts to saying that employment cannot fall because it is assumed that it cannot fall. In the closed economy version of the model, higher savings lead to an immediate reduction in the interest rate, and firms react by increasing their investment despite falling profits since they supposedly have perfect

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foresight and anticipate higher growth in the future. This implies that firms increase investment even as involuntary inventories rise and their capacities are not fully utilized.

IV. Importance of Keynesian and Neoclassical Theories on Economic Policies

The economic importance of the different theoretical approaches for economic policy could be similar. This is due to the very fact that when investment, output growth and employment are determined largely by profits of enterprises, economic policies have an important role to play in absorbing shocks and providing a conducive environment for investment. In the neoclassical model, there is little room for economic policy and where it does offer economic policy options, they point exactly in the opposite direction to those suggested by the Keynes’ theory. Where the neoclassical model sees the need for households "to put aside more money" or for developing countries to attract more "foreign savings" to raise investment in fixed capital, the Keynes-Schumpeter model emphasizes pro-growth monetary conditions, positive demand and profit expectations as incentives for domestic entrepreneurs, and the need for reliable and affordable financing for enterprises. Keynes convincingly argued that the decision "not to have dinner today" may depress the business of preparing dinner today without immediately stimulating any other business. The neoclassical Growth model shows why growth rate of per capita income cannot be maintained through continuous saving and investment. The explanation is that as capital per labor rises, marginal productivity of capital runs into diminishing returns. This means that output per worker depends only on capital per worker. That is, in the neoclassical constant returns to scale production function, as capital per worker rise output per worker rises at a diminishing rate. That is, marginal productivity of capital falls.

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V. Conclusion

Keynes's ideas became widely accepted after World War II, and until the early 1970s, Keynesian economics provided the main inspiration for economic policy makers in Western industrialized countries. Governments prepared high quality economic statistics on an ongoing basis and tried to base their policies on the Keynesian theory that had become the norm. In the early era of new liberalism and social democracy, most western capitalist countries enjoyed low, stable unemployment and modest inflation, an era called the Golden Age of Capitalism. A central conclusion of Keynesian economics is that, in some situations, no strong automatic mechanism moves output and employment towards full employment levels. This conclusion conflicts with economic approaches that assume a strong general tendency towards equilibrium. In the 'neoclassical synthesis', which combines Keynesian macro concepts with a micro foundation, the conditions of general equilibrium allow for price adjustment to eventually achieve this goal. More broadly, Keynes saw his theory as a general theory in which utilization of resources could be high or low whereas previous economics focused on the particular case of full utilization. This evidence suggests that sustained income growth needs proactive economic management so that there is a permanent tendency for planned investment to exceed planned savings. Such an environment enables vigorous economic expansion even if the propensity of households to save remains unchanged.
References