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CRISIS IN KEYNESIAN ECONOMICS

- Introduction:- Keynesian economics consists of various macroeconomic theories about how in the short run, and specially during economic output is strongly influenced by aggregate demand. In the keynesian,aggregate demand does not necessarily equal the productive capacity of the economy, instead it is influenced by a host of factors and sometimes behaves erratically affecting production, employment and inflation.

- Explanation:- Keynesian economics developed during and after the Great Depression from the ideas presented by keynes in his 1936 book "The General Theory of Employment Interest and Money". Keynes contrasted his approach to aggregate supply-focused classical economics that preceded his book. The interpretations of Keynes that followed are contentious and several schools of economic thought claim his legacy. Keynesian economics served as the standard economic model in the developed Nations during the later part of the Great Depression World War II and the post-war economic expansion(1945-1973), though it lost some influence following the oil shock and resulting stagflation of the 1970s. The advent of the financial crisis of 2007-08 caused a resurgence in tension thought which continues as new keynesian economics.

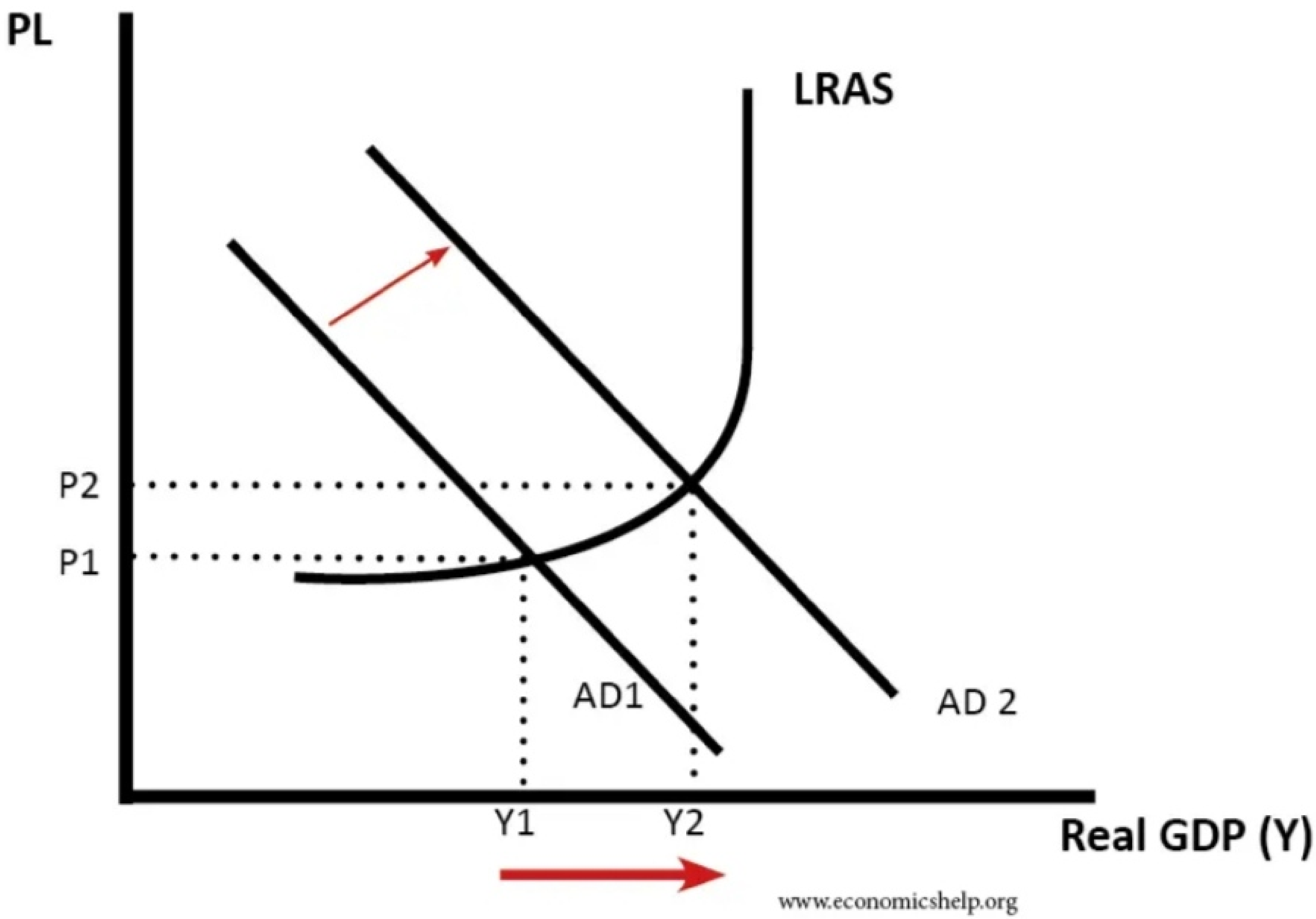
Crisis in keynesian economics:-

The main crisis of keynesian Economics can be summarised as follows:-

a.) Borrowing causes higher interest rates and financial crowding out. keynesian economics advocated increasing a budget deficit in a recession. However it is argued, this causes crowding out. For a government to borrow more, the interest rate on bond rises. With higher interest rates, this discourages investment by the private sector.

b.) If the government borrows to finance higher investment, the government is borrowing from the private sector and therefore, the private sector has fewer resources to finance private sector investment.

c.) A problem of fiscal expansion is that it often comes too late when economy is recovering anyway and therefore it causes inflation.



d.) An assumption of keynesian economics is that it is possible to know how much demand needs to be increased to deal with output gap. However the output gap can vary. For example, if there is an unexpected fall in productivity then the negative output gap may become very low- despite low rates of economic growth. In this situation, the appropriate response is not increasing demand, but for supply - side reforms to boost productivity.

e.) There is an argument that if the government pursue expansionary fiscal policy, example, cutting tax is financed by borrowing, then people will not spend the tax cut- because they believe that taxes will have to rise in the future to pay off the debt, therefore, expansionary fiscal policy has no effect.

f.) In a recession government increase spending but after reception government spending remains leading to high tax and spend regimes. Milton friedman quipped- "nothing was so permanent as a temporary government programme". Government spending projects may be designed for the short-term, but once started it creates powerful political pressure groups who lobby the government to hold on to them.

g.) It takes a long time to change

aggregate demand. By the time aggregate demand increases it may be too late and it leads to inflation.

h.) In the 1950 and 60s, keynesian demand management was in vogue- as governments appear to have a choice between unemployment and inflation. However in the 1970s, there was a period of stagflation. It appeared to critics of keynesian demand management that policies to boost demand were only aggravating inflation and not reducing unemployment in the long term. To Monetarist critics, says Milton

Friedman, the better Policy was to target low inflation - and accept there may be a temporary period of unemployment. Friedman and other 'supply-side economists' tended to focus on supply- side reforms to increase market efficiency and reduce imperfections in labour markets (such as minimum wages and labour markets).

Chart 5: **The Phillips Curve Shifts, 1970-79**

Source: U.S. Bureau of Labor Statistics

Conclusion:- From the above detailed analysis we got to know about the gist of crisis in Keynesian economics. This economics proved to be beneficial during the Great Economic Depression during 1929-30 and years after that. But with the passage of time, it started losing its applicability in the real world scenario that gave the reason to rise of Monetarism.