

## The Keynes Effect

The so-called “Keynes effect” occupies a strategic position in macroeconomic debate: it bears on the question of whether or not a market, capitalist economy tends to recover automatically from a state of high unemployment, as in a recession or depression. Keynes held that there may be some mechanisms that work in the direction of “automatic” recovery, but they are weak, slow and unreliable. Given the high costs of unemployment and lost potential output, he advocated the use of expansionary monetary and/or fiscal policy to promote faster and more reliable growth of employment and output. Economists of some other schools—“Monetarists” and “New Classicals”—have contended that Keynes underestimated the recuperative powers of the unaided market system, and that expansionary government policies can make a bad situation worse.

Here is the Keynes effect in symbols:

$$W \downarrow \rightarrow P \downarrow \rightarrow M^d \downarrow \rightarrow r \downarrow \rightarrow I_p \uparrow \rightarrow Y \uparrow$$

And here it is in words: if wages,  $W$ , fall in response to high unemployment then prices,  $P$ , will tend to fall too. At a lower general price level there will be a lesser demand for money balances,  $M^d$ . If the available money supply remains unchanged (and the interest rate is above the “zero lower bound”) then the fall in the demand for money will lower the rate of interest,  $r$ . A lower rate of interest will tend to stimulate investment spending (also perhaps consumer spending on “big ticket” items such as cars). Via the multiplier, higher investment will raise the real GDP,  $Y$ . Producing a greater GDP requires more labor: employment will rise and unemployment will fall. So a reduction in unemployment follows automatically, if in a somewhat roundabout manner, provided that high unemployment leads to falling wages.

In terms of IS–LM, the Keynes effect involves the LM curve shifting down/to the right due to an increase in  $M/P$  (assuming  $M$  remains unchanged), while the IS curve remains in place.

Keynes discussed this mechanism, but not by way of saying, “This is how an economy will recover from recession automatically.” His take on the matter was, “This is what would *have to* happen, *if* falling wages were to be helpful in curing unemployment.” But he was skeptical: he saw several problems that could occur along the way, derailing automatic recovery.

What could go wrong? Let us count the ways.

1.  $W \downarrow \rightarrow P \downarrow$ : If wages fall, then indeed prices are likely to fall too (firms’ costs of production being lower). But the tricky part is getting wages to fall in the first place. Wage cuts are painful. No worker likes to accept a wage cut. Employers will cut wages if they absolutely have to, but they know they risk demotivating their employees and ending up with a discontented—and therefore less productive—workforce. In 2009 and the following few years, with high unemployment in the US, many workers saw their wages stalled (no raises, despite a continuing gradual increase in consumer prices) but relatively few saw an actual cut.
2.  $P \downarrow \rightarrow M^d \downarrow$ : This link is fairly reliable. People require less money for transactions purposes when prices fall, and so they will generally try to exchange money for “bonds” (interest-bearing assets). But wait. . .
3.  $M^d \downarrow \rightarrow r \downarrow$ : For the Keynes effect to go through, the reduction in the “transactions demand” for money has to lower interest rates. If we’re in the “liquidity trap,” at the Zero Lower Bound for the interest rate, that won’t happen. Besides being the medium of exchange (held for transactions purposes) money is also a store of value. If the interest rate on bonds looks good, money is not very attractive as a store of value and people with “surplus” money balances will try to move into bonds, hence raising their prices and lowering the interest rate. But if the interest rate has bottomed out, money and bonds

become close substitutes and there's no downward pressure on  $r$ . This was the situation of the US economy for several years following the financial crisis of 2008. In terms of IS–LM, the LM curve can't shift down; it's already as low as it can go.

4.  $r \downarrow \rightarrow I_p \uparrow$ : We generally reckon that a lower interest stimulates investment spending, other things equal. But for firms contemplating investment, arguably what really matters is the *real interest rate*; that is, the nominal interest rate,  $r$ , minus the expected rate of inflation. If the expected rate of inflation is actually negative (deflation, falling prices), the real rate is higher than the nominal rate, and it may not be falling as the nominal rate falls.
5.  $I_p \uparrow \rightarrow Y \uparrow$ : If we get this far, we're probably home and dry. The question is whether we get this far.

Besides potential problems with the links in the chain that is the Keynes effect, there are further issues with falling prices, as analysed by the American economist Irving Fisher under the heading of “Debt Deflation”. The thought here is: suppose the Keynes effect were operating more or less as advertised, at least in its first several links—might there not be other effects of falling prices working in the opposite direction? (That is, toward aggravating rather than solving the problem of high unemployment.)

In the background to Fisher's argument is the simple point that the economy has a history. People and firms took out loans in the past, at a time when they were not expecting deflation. Now deflation comes along. That means that the debts of borrowers become more onerous in real terms: the money they need to pay back is more valuable. Looking at it another way, the actual dollar amount they have to pay back is unchanged while their money incomes will be falling. A monthly mortgage payment, for example, becomes a larger percentage of monthly salary.

One might think that this is just a “distributional” effect: borrowers become poorer, but if lenders become richer to the same extent, isn't the net effect zero? Probably not. Borrowers (who are willing to pay interest to get hold of money money now) presumably have a higher propensity to spend than lenders (who are happy to part with their money now in exchange for the promise of more money later). So if deflation transfers wealth from borrowers to lenders the net effect is likely to be a reduction in the overall propensity to spend. In IS–LM terms, we could think of the IS curve shifting leftward, negating recovery.

Worse, if money incomes fall enough relative to existing debts borrowers will not just be poorer, they'll be unable to repay their debts. Mass bankruptcy would obviously be very unhelpful for macroeconomic recovery. And if the past borrowing was from banks, there's now a danger of bank failures as borrowers are driven to default. All of this tends to drive prices (and nominal incomes) lower, in a vicious spiral. For this reason, most macroeconomists today agree that deflation is dangerous for a capitalist economy in which borrowing and debt play a crucial role.

It's worth noting a further point made by Keynes. Even if we ignore Fisher's arguments—and assume we're not in the liquidity trap—how are falling wages supposed to help, again? The key link in the “Keynes effect” is from lower wages and prices to a *lower interest rate*, which then stimulates aggregate demand. But, asks Keynes, if what we need to promote recovery is a lower interest rate, why not produce that effect directly, using expansionary monetary policy? Why wait for the painful process of wage-cuts to do something that can be done much more easily?

*To recap:* In what came to be called the “Keynes effect,” J. M. Keynes set out a mechanism that could, in principle, make the macroeconomy “self-adjusting”: high unemployment would not persist provided wages and prices were flexible. However, his point was not that capitalist economies *are* self-adjusting in this way. Rather, the Keynes effect served as a sort of benchmark, “best case,” scenario against which he was able to identify the serious difficulties that stand in the way of such self-adjustment.