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The Classical-Keynesian Paradigm: Policy Debate in Contemporary Era

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Abstract

For almost a century, the famous C-K paradigm (formally known as Classics – Keynesian Paradigm) has been the apex of economic debate and research. The paradigm represents two schools of thoughts which, somehow, have prevailed till now. Economists who believe in either of the two schools have been at loggerheads, and they still are, to prove one theory better than the other. Numerous economic scholars of present era believe that with the changes that have occurred in the economic system, the world is turning back to classical model. But, there are others who believe that Keynes theory is still alive and valid. In this paper, we have tried to draw a brief comparison that highlights the major differences between the two theories with specific reference to the economic, political and social environment prevailing at time when these theories were generated. Paper also discusses the relevance of unending policy debate about these theories in the current era with special emphasis on policy implications with a view to draw pertinent lessons for the present and future.

Keywords: Classical, Keynesian, economics, theories, policy, debate, implications.

JEL Classification: B10, B11, B12, B15, B22, E12, E65, N10.

Introduction

The Classical Model was prevailing with full popularity before the Great Depression of 1930. It portrays the economy as a free-flowing, with prices and wages freely adjusting to the ups and downs of economy over time (Barro, 1983). In other words, the model reflects a pendulum which fluctuates such that when times are good, wages and prices quickly go up, and when times are bad, wages and prices freely adjust downward. It idealizes the economy at full employment, meaning that everyone who wants to work is working and all resources are being fully used to their capacity (Blanchard, 2011). Classical economists believed that the economy is self-correcting and self adjusting, which means that when a recession occurs, it needs no help from anyone.

The second model is called the Keynesian Model. This model came about as a result of the Great Depression of 1930. Economist John Maynard Keynes founded this model on the basic principle that the economy is neither self adjusting nor it remains always at full employment (Cameron, 2003). In other words, the economy can be below or above its potential. For example during the Great Depression, unemployment was widespread, many businesses failed and the economy was operating at much less than its potential (Mishkin, 2004). Keynes believed that in the bad times government and monetary leaders are required to do something to help the economy in the short run, or the long run may never come. In fact, he is quoted as saying “In the long run, we are all dead” (Goodwin, 2008).

Most of us can simply identify the idea about applicability of the two models when we think about the economy today. We are well aware that economy fluctuates; sometimes the economy is strong and sometimes it's weak. This is exactly what these theories recognize. The economy may remain in a state of balance in which everyone is fully employed, but when weaker demand temporarily pulls the economy below the full employment level, economists call that a recession (Mankiw, 2009). This all happen even in the current era. Therefore, before commenting on the validity or superiority of one theory over the other, it will be prudent to discuss their historical perspective.

The Emergence of Capitalist Thought

Classical economics emerged against the philosophy of mercantilism which is associated with the rise of nation state in 16th and 17th centuries (Barker, 1977). The famous mercantilists were Thomas Mun (1571-1641), Montchretien (1576-1621) and Von Horneck (1638-1712). All of them believed in eerie idea of bullionism which emphasized stockpiling of precious metal (silver and gold) for wealth and power of nation (Eichengreen, 1992). They also advocated the state intervention as essential tool to direct the development of economic system. Adherence to bullionism led to secure an excess of export over imports in order to earn gold and silver through foreign trade (Howey, 1982). This, had it been prevailing for a bit longer than it actually did, would have turned the world into storage of silver and gold. The very concept was based on the greed and self centism and welfare totally neglected or subsided, the least. Fundamental for the mercantilism was the strength of his country. This was the end to which all means were subservient. A mere indication of the spatial and temporal frontiers of mercantilism is a significant warning against the old error in the view (which perhaps still survives) that mercantilism is the current orthodoxy before it was attacked by other theories (Barker, 1977). This economic environment prevailing at that time, put survival of the poor at stake and social discrimination took deep roots in the society. Therefore, something solid and comprehensive was required to be done to help rescue and survive the economic system. It was this milieu when Adam Smith (1723-1790), a Scot philosopher appeared on the scene, though a bit late. He is considered as the founder of “modern” economics, in spite of the fact that his theory was named as “classical”, the two words almost opposite to each other. Let us see why Smith and his followers were known as classicals? Who termed them so? Were they really classical? The first time they were termed classical was by John Maynard Keynes in 1923, two centuries after the appearance of Adam Smith (Howey, 1982). Before this they were known as “Capitalists”; the name which was fairly logical and aligned with the theory they proposed. Keynes termed them as classical because he wanted himself to be termed as “modern”. The word

“classical” has been intentionally avoided in paragraph heading for this section, although for ease and convenience it has been used in remaining of the paper.

Adam Smith’s philosophy was an all encompassing study of human society in addition to an inquiry into the nature and meaning of existence. Deep examination of the world of business affairs led Smith to the conclusion that collectively the individuals in society, in his or her own self-interest, manage to produce and purchase the goods and services that they as a society require (Cameron, 2003). He called this mechanism “the invisible hand,” in his groundbreaking book, “The Wealth of Nations”, published in 1776, the year of America's Declaration of Independence (Ekelund, 2007).

In making this discovery, Smith founded what was then known as “modern” and later “classical” economics. The key doctrine of classical economics is that a laissez-faire system will allow the “invisible hand” to guide everyone in their economic endeavours, create the greatest good for the greatest number of people, and generate economic growth (Barro, 1983). Smith also delved into the dynamics of the labor market, wealth accumulation, and productivity growth. He believed in non intervention of government and economic independence of the individual. Through economic independence, poor individual was made free from the clutches and claws of so called “sovereign” state. Smith believed in economic flexibility (prices and wages) and portrayed economy as self correcting, self adjusting and ensuring full employment. His work gave generations of economists plenty to think about and expand upon. Smith was followed by a group of economist like David Ricardo (1772), J.B. Say (1767), J.S. Mill (1806), Alfred Marshall (1920) and A.C. Pigou (1933) who expanded the work of Smith. JB Say in particular expanded the theory towards goods markets and expounded “supply creates own demand” owing to creation of income in the shape of wages, interest and profit. Income earned is spent as consumption and investment. Saving made in the process was regarded as another form of investment. And, production creates markets for goods (Blanchard, 2011). Say’s Law is shown by a cyclical analogy in figure 1.

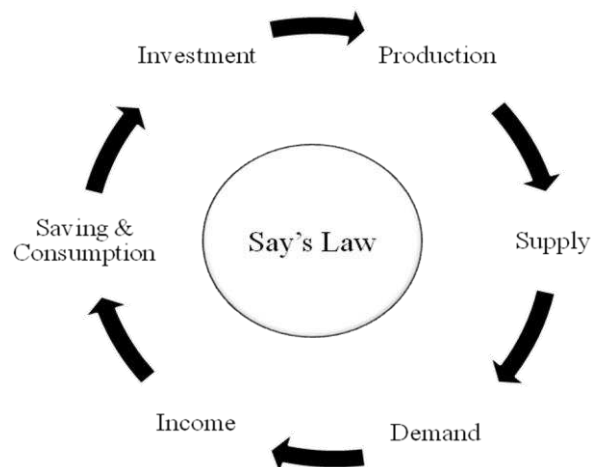


Figure 1: Explanation of Say’s Law

Classical economists believed in importance of real factors of production and free market mechanism. Money was given the role of facilitating transaction with no intrinsic value; a fact in contrast to mercantilism (Medema, 2003). Money was, however, given driving seat in

determining the prices, as prices were considered to be directly proportional to supply of money in the market (Mishkin, 2004).

Classical economics dominated the study of economics for more than 150 years, and continues doing so even till now. Over this period, classical economics was improved conceptually, refined theoretically, and enhanced in scope. This theory served as philosophical guide to government policies in the early 1900s. Later the theory was blamed with a role in the length and severity of the Great Depression of 1930 (Snowdon, 2005). In fact, the onset of the Great Depression and the resulting problems that persisted throughout the decade refuted the basic full employment implications of classical economics and paved the way for the emergence of Keynesian economics (Froyen, 2006).

The Appearance of Interventionist Thought

Without question, the greatest advancement in economic thinking in the twentieth century have been associated with the name and work of John Maynard Keynes (1883-1946). His most important contributions were produced in the years of the Great Depression, 1930 (Snowdon, 1994). The reorientation of approaches to economic policy in the past three decades has, in large measure, been shaped by Keynesian economic analysis. John Maynard Keynes, a British economist and financial genius, examined capitalism and came up with some extremely critical and influential views about the validity of classical economics. In 1936, he published his “General Theory of Employment, Interest, and Money” which elucidated the thoughts of Keynes as economist (Froyen, 2006).

Keynes seriously questioned the validity of self adjusting and self correcting economy as portrayed by classical theory. In his opinion, if it was so then why the economy was facing Great Depression? Why there was a wide spread unemployment? The existence of Great Depression was taken as negation of the classical theory (Mankiw, 2009). The very concept of classical theory was smashed to rubbles and ashes under the crises of Great Depression. Keynesian economics has actually emerged from the ashes of classical theory to; once again, rescue the economic system in a particular prevailing socio-economic environment.

The larger significance of Keynes's work lies in the view he put forth about the role of government in a capitalist economy (Markwell, 2006). Keynes believed that the only way out for the survival of economy was for the government to start spending in order to put money into private sector pockets and get demand for goods and services up and running again (Dwivedi, 2001). Keynesian economics is, thus, an approach to economic policy that favors using the government's power to spend, tax, and borrows to keep the economy stable and growing (Nasar, 2011). His views about role of money as prime factor for determination of price level, as claimed by the classical, can be well conceived by following few quoted sentences from his one of his speech,

“Lenin is said to have declared that the best way to destroy Capitalist System was to debauch the currency.....Lenin was certainly right. There is no subtler, no surer overturning the existing basis of society then to debauch the currency. The process engages all the hidden forces of economic law on the side of destruction, and does it in a manner which not one man in a million is able to diagnose” (Mankiw, 2009).

Thus, Keynes was strong opponent of capitalist thought. He advocated that instead of emphasizing on supply, aggregate demand should be focused. He explicitly pronounced that demand creates supply and not the vice versa (Medema, 2003).

The validity and desirability of Keynes's prescription for a sluggish economy; using government spending to prime the pump; are still debated today. Keynes also played a key role in the founding of the International Monetary Fund and in other political economic measures taken at the end of World War II (Markwell, 2006).

Ironically, after four decades of dominance, flaws in Keynesian economics were revealed by another macroeconomic phenomenon, stagflation. During the 1970s, supply-side shocks to the economy, especially caused by higher oil prices, caused economic instability with the simultaneous occurrence of both higher unemployment rates and higher inflation rates (Reinhart, 2009). This contradicted the basic implications of Keynesian economics and led to the formation of modern aggregate supply – aggregate demand (AS-AD) analysis as a synthesis and advancement of both classical economics and Keynesian economics. Before going further, let us first see the glaring differences between the two theories (Pressman, 2006).

Academic Comparison of the Two Theories

Classical economists stressed the self-adjusting tendencies of the economy (Warsh, 2006). They expressed that if there are no government policies, economy would achieve full employment and full potential (Garrison, 2001). Classical economists were noninterventionist in that they did not favour active monetary and fiscal policies by the government to stabilize the economy. Such policies would have no effects on output or employment given the supply determined nature of those variables in classical system. On the other hand, Keynesians view the economy as unstable as a result of instability of aggregate demand, primarily due to private investment component (Phelps, 1990). Aggregate demand does affect output and employment in Keynesian view. Consequently, swings in aggregate demand will cause undesirable fluctuations in output and employment in short run. These fluctuations can be prevented by using monetary and fiscal policies to offset undesirable changes in aggregate demand. Keynesians are interventionists, favouring active policies to manage aggregate demand. A summary of the differences between the two theories is shown in table 1.

Table 1: Comparison of Classical Theory and Keynesian Theory

Features	Classicals	Keynesians
View	Long run	Short run specially recession
Wages	Flexible	Sticky / rigid
Prices	Flexible	Sticky / rigid
Employment	Full employment (under employment is voluntary and temporary)	Unemployment and under employment are possible
Output	Supply determined (Say's Law: Supply creates demand)	Aggregate demand determined (Demand creates supply. Model based on concept of aggregate demand)

Economic System	Laissez faire policy , self adjusting and self stabilizing	Discard Laissez faire and approves stabilizing measures by the government
Intervention	No government intervention	Government intervention is necessary for stabilization of economy
Policies	No faith in fiscal and monetary policies	Faith in fiscal and monetary policies as stabilizing tools
Budget	Balanced budget	Deficit budget
Credit	Saving and investment equilibrium through interest rate	Saving and investment equilibrium through income levels
Supply Curve	Vertical	Upward sloping
Demand Curve	Downward sloping	Downward sloping straight line
Money	No intrinsic value just a medium of exchange Money supply is proportional to price level	Has intrinsic value as well as medium of exchange

Let us now focus on the aggregate supply and demand curves as shown in figure 2. The classical aggregate supply schedule is vertical, whereas the Keynesian aggregate supply schedule slopes upward to the right. The classical aggregate demand schedule depends only on the level of the money supply; it is a downward sloping hyperbola (Froyen, 2006). In the Keynesian system, aggregate demand depends also on the levels of fiscal variables (level of investment, income and other variables). It is also downward sloping, but straight line.

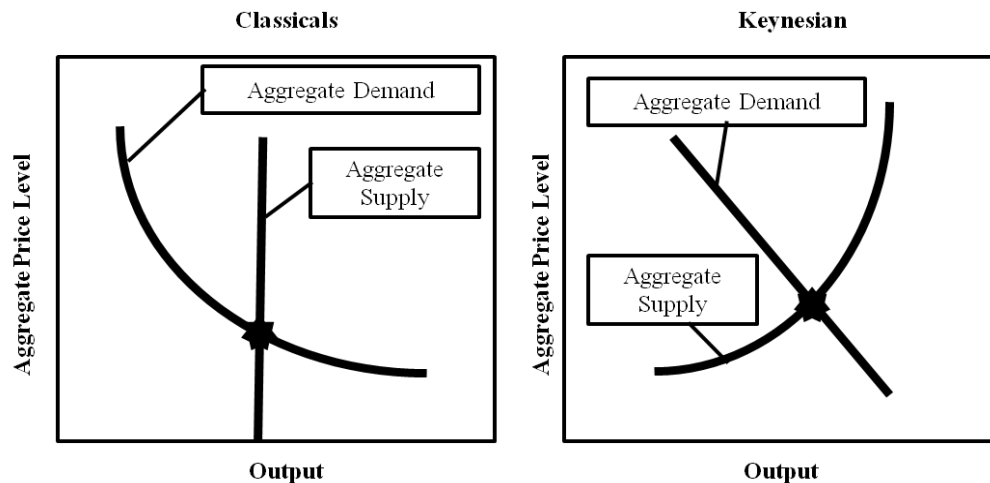


Figure 2: The aggregate supply and demand models of the two theories

Interest rate Interest rate played a stabilizing role in the classical model (De Long, 2000). Saving is synonym of supply in Classical Theory. Saving is directly proportional to the rate of interest. Investment is synonym of demand and is inversely proportional to rate of interest. However, Keynesians Theory tended to achieve saving and investment equilibrium through income levels.

The gap between saving and investment was filled through government spending which was not there in the Classical Theory (Friedman, 1953).

Keynesian Cross (figure 3) occupied a central place in Keynesian Theory (Markwell, 2006). It describes the relationship between aggregate expenditure and output. It shows that intersection of the 45-degree line and aggregate expenditure (AE) line is equilibrium. At which the aggregate expenditures on production is equal to aggregate production. There is neither a surplus nor a shortage of aggregate production. Keynesian Cross can be rightly called as uncontroversial segment of the Keynesian Theory as no literature can be sighted against this segment of the Keynesian Theory (Lawson, 1996).

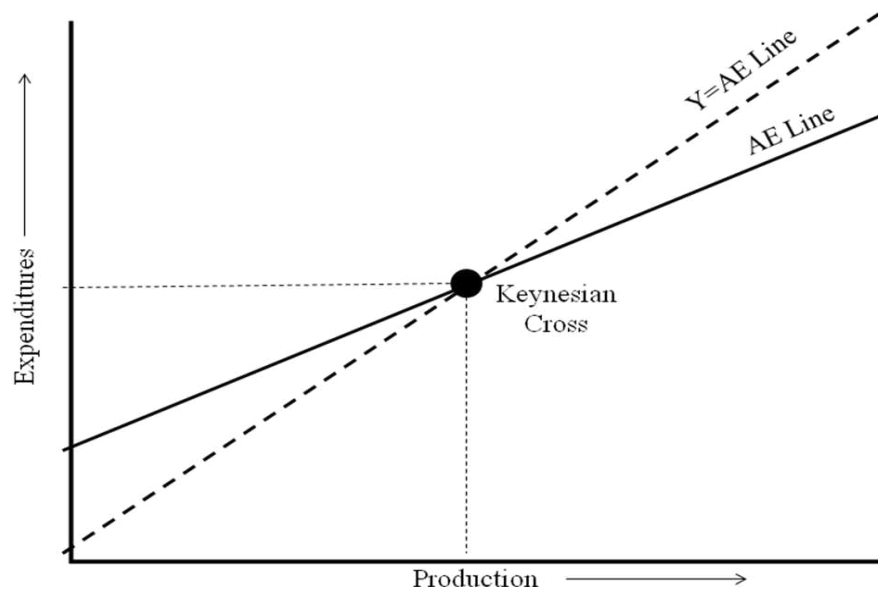


Figure 3: Explanation of Keynesian Cross

Philosophical Strands of Policy Debate

So, we have two theories; the Classical Theory and the Keynesian Theory. Which theory is the correct theory? We need to first understand why these theories emerged? Since ages economic thoughts have passing through evolutionary process. A careful analysis of history of economic thought reveals that creation of new economic theory has always been an attempt in realm for the rescue and survival of the decaying economic system (Boettke, 2001). This process is described in figure 4. From the figure, it is evident that creation of a new theory actually emerged from the failure of the previous theory to address the economic problems. It is chain process and this chain could not be broken till now. Capitalist thoughts emerged when mercantilism failed as a system and people were in deep problems, likewise Keynesians thought surfaced when economy was facing great depression and economic system needed immediate recovery and rescue (Weintraub, 1999). Thus, each theory was the need of the time, environment and system prevailing at that time. If this logic is accepted than one will arrive at the conclusion that there is no problem with any of the theory created so far, but it is not that simple. Let us proceed ahead and see some more important strands.

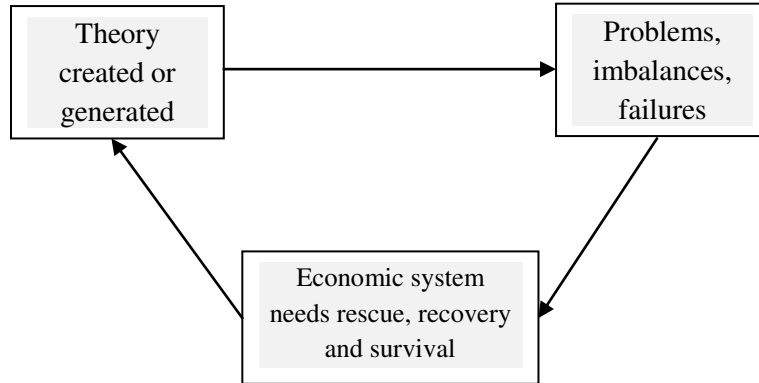


Figure 4: Process of creation of economic theory

Since we are analysing Classical theory and Keynesian theory we will focus for the time being just focus on the single factor which differentiates the two theories. This single factor is, let's say, supply and demand. Classical puts more weight on supply side while Keynesians put more emphasis on demand side. The whole debate is, thus, revolving around a balancing mechanism to balance supply and demand. Now, consider figure 5, 6 and 7.

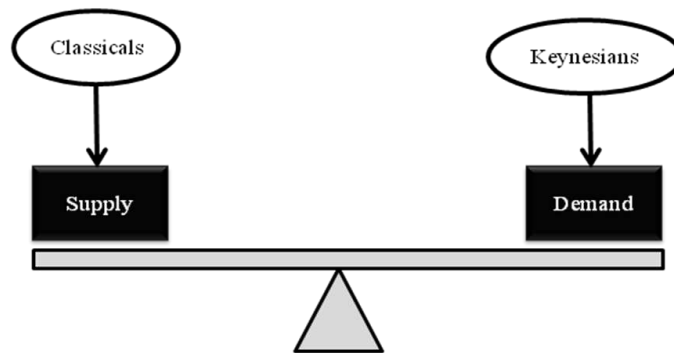


Figure 5: Showing desirable balance between demand and supply

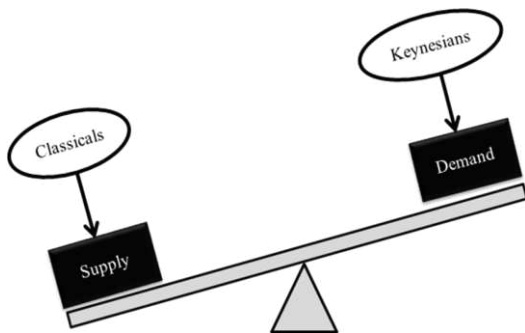


Figure 6: Showing Classical Theory (more weight on supply side)

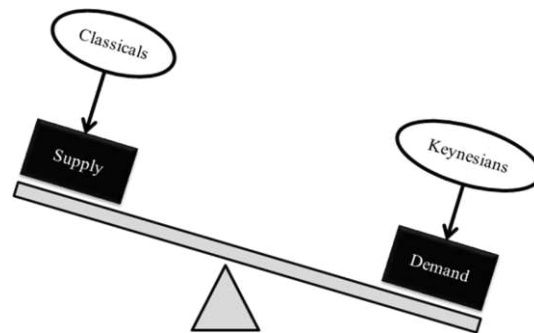


Figure 7: Showing Keynesian Theory (more weight on demand side)

Figure 5 shows the desirable balance between supply and demand which could not be achieved so far by any of the theory. To rescue the economic systems from the claws of mercantilism and address the issues prevailing at that time, Classical theory put more weight on supply side (figure

6) but it created imbalance and resulted into Great Depression of 1930. Again, to recover the economic system, Keynesians theory was created which put more weight on demand side (figure 7) which again created imbalance and new mechanism had to be evolved in the shape of monetarism and supply side economics for survival of the economic system.

The Classical Theory' argument that supply creates demand is not true because some income is always saved and not consumed which causes reduction in demand (changes in demand). Similarly, some income is always saved and not invested. This amount will not be available for production which causes reduction in demand. "Savers are saving and investors are investing" but not in the same proportion (Rate of saving \neq Rate of investment). The gap between saving and investment should be filled through planned investment by government, but classicals don't believe in the government spending. Consumption expenditure and investment expenditure are not necessarily equal to cost of product. Investment in long run is also affected by changes in technology and population growth. These aspects were ignored by classical. Similarly, Pigou model of employment is not applicable as cut in wage rate will reduce the income of workers which will reduce their power to purchase and consume. This will ultimately reduce the aggregate demand. Equilibrium between saving and investment is achieved through interest rate in classical model, while Keynes believes that this equilibrium can be achieved through income levels (Chari, 1996).

As the argument of the General Theory had demonstrated, the power of the monetary authorities to influence the rate of interest (and thereby to affect investment spending) was limited. It was most seriously handicapped, of course, during periods of depression. But this was not the only point at which reliance on monetary policy was attacked. No less important was the Keynesian argument that reductions in the rate of interest, though desirable as stimulants to investment, might be more than offset by increasing bearishness within the business community. If full employment and economic stability were to be achieved, it was imperative to assign a much more active role to fiscal policy. Classical theory emphasized that governments should operate with balanced budgets, Keynes called for deliberate deficits to swell aggregate demand (Coleman, 2002).

Keynes called for a re-thinking of the instruments of economic policy and for the rejection of the policy prescriptions associated with classical analysis. Not only did he warn against excessive reliance on monetary controls, but he also attacked vigorously the view that unemployment could be cured through measures aimed at the inflexibility of wages. He maintained that wage cutting offered no cure for unemployment (Lee, 2009). Such tactics were more likely to aggravate the problem by curtailing effective demand still further. Similarly, price cutting was likely to have depressing effects on expectations and would increase the real burden of outstanding debt (Horwitz, 2000). Investment on the scale required to restore full employment might thus be discouraged.

The message of the Keynesian theory was sharply critical of unregulated laissez-faire. Keynes's critique of laissez-faire rested on quite different foundations (Lawson, 2006). The burden of his argument was to demonstrate that an unregulated market system was likely to be chronically unstable and incapable of assuring the full utilization of productive resources. He emphasized the need for active government intervention in the economy (Coleman, 2002).

Some critics regarded Keynes's doctrines as dangerously radical and as a threat to the perpetuation of a capitalist order (Buchholz, 1989). A considered judgement of the content of Keynes's thought supports quite the opposite conclusion. Revolutionary though, the General Theory was in its approach to economic analysis, the policy recommendations derived from it were largely prompted by conservative considerations. Keynes hoped that the essential features of the capitalist system could be preserved (Heijdra, 2002). But its virtues could be safeguarded only if the social unrest generated by mass unemployment could be eliminated by appropriate reforms. Laissez-faire, as he had demonstrated, was essentially a fair weather system. It was capable of remarkably productive performance when conditions were favourable, but it was also inherently unstable (Dwivedi, 2001). Governments had a major responsibility for regulating the economic climate in ways that permit the market system to achieve its full potential.

In large measure Keynesian teaching has been absorbed into economic thought and policy in most Western countries. Indeed, the adoption of a Keynesian approach by Western governments has been the factors responsible for the high degree of stability exhibited by their economies in the years since the Second World War (Boettke, 2001).

However, Keynesian theory could not achieve the desired success and was soon put to rigorous test in 1970 when economy was in recession. The most important question in 70s was can we tackle the problem of recession and inflation simultaneously while managing the aggregate demand. There are two implications. First, the expansion of aggregate will raise the level of output, improve the recession but will also raise the inflation. Second, the contraction of aggregate demand will reduce the inflation but will also reduce the level of output and worsen the recession. We need to have some mechanism to change the aggregate demand and supply when confronted with problem of recession and inflation simultaneously. Keynesian approach has only provided tool to manage the aggregate demand (Davis, 2008). Consequently, 1980s economists tried to find tools for management of long neglected supply side which is known as supply side economics (Chari, 1991).

The two models could be simulated with an interesting analogy. Just think about the expressway for a moment. If you observe the expressway for a long time, you will notice that from time to time, too many cars enter the expressway at once at an interchange entrance, and traffic is congested and slows near the interchanges. But away from interchanges, traffic returns to its potential speed without any help. However, when there is some accident and if the police and the tow trucks do not show up, it could take really long time before traffic returns to its potential speed. In this example, the traffic congestion and slowing down is like an economic issue which is resolved automatically in the long run (Classical Theory) like the traffic is restored away from the interchanges. However, accident on the expressway is like depression of economy and in this case the government intervention is necessary (Keynesian Theory) like police and tow trucks are essential for restoration of the traffic.

When it comes to these two economic models, both of them are correct, because they are describing the economy at two different points in time. The Classical Model does a great job of describing the economy in the long run where resources are fully employed and everyone is working. The Keynesian Model does a great job of describing what happens when there is a recession and people are out of work or when the economy is temporarily overheating and a shortage of workers takes place. These theories were generated in a specific socio-economic

environment and both have served the intended purpose. At the same time both theories have failed, because both could not address the new problems faced by the people in a new set of environment and consequently new theories (supply side economics, Real Business Cycle Theory etc) had to be generated from 1970s onwards. We can safely conclude over here that there cannot be one recipe for all problems applicable in all environments. It has been a quick fix solution and it seems that it will be like this for the foreseeable future.

Philosophically, we don't have to abandon "good" things from the past just because something "more economically efficient" comes along. We don't have to accept "bad" things in the future just because they are "more economically efficient" than some "good" alternative. We can choose what we want to keep from the past and what we want to accept in the future. Economics is a creation of human beings. We simply cannot turn loose the thing we created for our benefit and allow it to exploit the very people it was designed to serve. It just does not make any sense (Blaug, 2001).

Policy Implications for Pakistan

Does this kind of economics really make sense as a guiding philosophy and a model for the rest of human society? Do we actually believe that the greatest greed results in the greatest good? Let's now have a look at the Pakistan's economy which has certain peculiar characteristics. The unemployment / under employment is there in our country; rather unemployment is a major issue in Pakistan. The current unemployment rate is 5.70 % (State Bank of Pakistan, 2012). Effectiveness notwithstanding, there is government intervention in the shape of fiscal and monetary policies. There has been less reliance on interest rate as a stabilizing factor, it has been fluctuating. Currently it is 9.5% (State Bank of Pakistan, 2012). There has been price variation & inflation. Current inflation rate is 6.57 % (State Bank of Pakistan, 2012). Economy has been suffering from under production and it has never attained its full potential due to wide gap between saving and investment, energy crises and poor law and order situation (State Bank of Pakistan, 2012). Output and employment has never been supply determined Economy has been operating with government deficit; gap between spending and revenues getting wider and wider due to narrow based taxation policy, due to which there is heavy reliance on foreign loan.. All these conditions indicate that economy has not self adjusting.

The above characteristics clearly show that it is neither Classical nor Keynesian Model which is applicable to Pakistan's economy. Free market economy is not prevailing here. Rather, we can safely conclude that Classical, Keynesian and Monetarism and Real Business Cycle Theories are currently applicable to Pakistan's economy in some form or the other. Moreover, in Pakistan, the Islamic strands of economy have been embedded in the in the prevailing economic model. A diagrammatic interpretation of the Pakistan's economy is shown in figure 8.

Pakistan has been the experimental laboratory for all sorts of economic models and policies. Government and masses have been observed moving in almost different policy directions. Nonetheless, people are mostly in favour of economic freedom and independence. They have least liking for the government intervention especially in the shape of taxation. Though far from reality, the masses desire that economy should be at full potential with every one working. They agree to have flexible prices and wage rates. There has been a tendency of printing currency to increase the supply of money. Masses desire that government should not all the discretionary

powers. Therefore, we can deduce that people, more or less, are in favour of Classical Theory with Islamic strands and bounds.

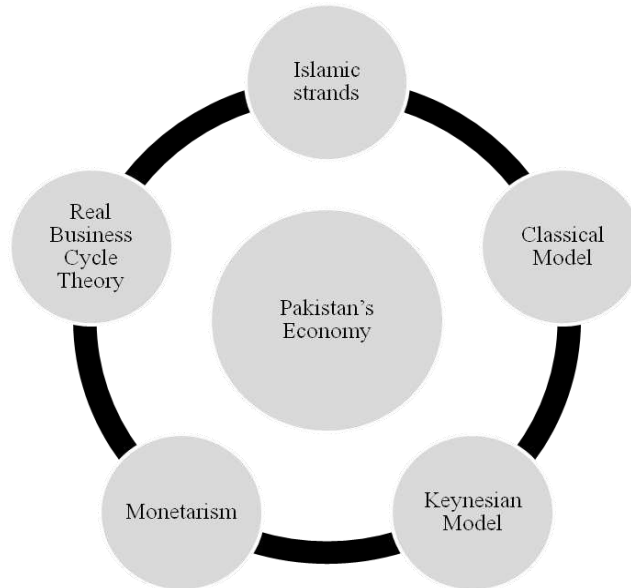


Figure 8: Compositional ring of Pakistan's Economy

Conclusions

The Classics were too preoccupied with questions of long-period economic growth. Keynes was suspicious of this attitude ‘in the long run, we are all dead’ he observed. As his thought took shape, economic analysis was reconstructed to bring short period aggregative problems to the centre of the stage. The microeconomic questions around which the classical tradition had been organized were pushed toward the wings. Keynes had move part way with the recognition that conventional laissez-faire was inadequate to the increasingly complex problems of industrialized societies.

When it comes to these two economic models, both of these are correct because economic theories are the babies of socio-economic environment and can be analysed in isolation. The transformation of human society from one driven by the economics of short run self interests to one of enlightenment does not happen overnight, and it may not happen without struggle and strife. But none the less, it must happen. The transformation may happen peacefully or may arise out of the turmoil of an economic collapse. It has already begun, although it may take decades to complete. But, each of us can begin the transformation for ourselves whenever we choose. New theories are bound to emerge with new problems of the new environment.

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