Lecture Notes on Keynesian & Austrian Business Cycle Theory

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Introduction

The purpose of this is to give you keywords you can use in your tests or discussions about Keynesian and Austrian business cycles. These are more or less in sequence. If you are writing an exam or simply want to discuss these ideas with friends, deploying these terms in your discussion gives your arguments more weight.

Both theories have explanatory value in answering why an economy has a recession or depression and how an economy can recover.

As much as the world has changed the ideas are universal. This is why we turn to theory.

The basic idea is the Keynesian school emphasizes shortfalls in aggregate demand caused by a decrease in consumption spending. To fix this, just get the money flowing. That is, government intervention to fix capitalism's weaknesses.

The Keynesian school see the aggregate as important. That is, the economy as a whole or even an average. They use empirical models to back up their ideas.

In contrast, The Austrians see people as individuals and their choices are what is important. Aggregation and mathematical models, which are abstractions that are not as applicable to a social science. The Austrian school of economics uses logic to test assumptions.

The underlying premise of the Austrian school is the centrally controlled interest rate, which is a price, gives wrong signals to individuals and entrepreneurs that are weighing capital formation decisions through time. False signals create investment and a boom, followed by a bust.

If certain firms or individuals take too much risk (and profit) during the boom, when the crash comes, should others who based investment decisions on real savings have to bailout the losers?

Ultimately it comes down to your philosophical view of justice. Do you feel you should make economic plans and economic choices for yourself or others should make it for you.

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https://political-economy.com/
https://www.youtube.com/econlessons/

Keynesian Business Cycle Theory

- Y=C=I+G is the basic aggregate equation, GDP=Consumption+Investment+Government expenditures
- Demand creates its own supply / contrast with Says law
- AD & AS curves — aggregate demand and aggregate supply curves
- AS is vertical LR
- Aggravate Demand is in flux and the prime diver
- C causes the flux
- C is the biggest component
- If aggregate demand is down then economy down Y=C+I for short
- Under consumption theory — people switch from C to S(or I)
- Animal Spirits = consumer confidence = a driver behind fluctuation
- Money Demand theory of interest and money hording
- Investment until Marginal Efficiency of capital = interest rate (cost of loan-able funds) makes I=S
- Hicks Hanson developed IS (goods) and LM (Money) curve
- Liquidity trap = Monetary policy not effective — horizontal LM curve

- Shifts from Equilibrium
- Sticky wages & Prices create inertia
- Movement back to equilibrium slow
- Information and coordination issues creates lag
- GDP falls
- Increase unemployment
- People Stop spending
- Paradox of thrift — people save instead of spend
- Multiplier: $k=1/MPS$
- Money multiplier
- Negative Multiplier
- $Y=C+I+G$
- Increase G - fiscal policy
- Deficits are good
- Increase Debt
- G feeds into C
- Positive multiplier
- AD shifts back to Equilibrium
- Approach tends to be empirical/econometric
- New Keynsians, Woodford the mathematical wiz, Krugman the political face, Mankiw the NNS — predominate mainstream theory
- Capitalism good but needs monitoring and correcting

Austrian Business Cycle Theory

- Money is organic and evolutionary
- Money satisfies the Double Coincidence of wants
- Money is the second 1/2 of every transaction
- There is no market for money - money's disequilibrium works out via all markets
- Ability to create disequilibrium Or stability — is there money neutrality?
- Monetary shocks cause shock to the real sector
- Quantity theory says - Increase Q increase P — V constant — But Austrians look at interest as a price of money/loan-able funds.
- Interest rate = price of money/Loan-able funds
- When the Natural rate of interest = market rate of interest in one version we have equilibrium. Problem can this be achieve with the government stranglehold on money?
- Austrian Business Cycle theory = GDP fluctuates when Natural rate not equal to market rate of interest and wrong signals are sent to capital formers

- How do we know the interest rate is high or low? How do we know the Interest rate is right? You need to compared to the natural rate to the market rate
- Natural rate is rate that brings I=S ex ante in equilibrium if a homogeneous return on mobile capital — hence Money macro equilibrium
- This means market rate high or low is relative to the natural rate. Can we see the natural rate in an economy where money is ubiquitous?
- Capital theory is the key to understanding the linkage between the monetary world and real world — Study captial theory in relation to time and interest
- Prices are information points that help this discovery process — Interest is the key point information point for capital formation — The key price here is interest
- Problem =Natural rate is unobserved because money is everywhere and the second half of every transaction. Can not econometrically filter this out.
- Fed equates R* with natural rate and distorts the capital structure with this assumption
- Can money be neutral?
- Multiple natural rates for different time and risk

- Interest rate is a price and prices are important signals that coordinate actions through time
- Inter-temporal
- People are forward looking the entrepreneurial discovery process — making investment plans
- Therefore, central control with a singular rate creates distortions in capital structure
- Central Bank, OMO (FF) disc, RR + other tools.
- Rule based better than discretionary but many political and discretionary actions and constant interventions
- Money Macro Equilibrium when money does not affect real economy and only facilitates as a medium of exchange — How to achieve?
- Counter model is free market banking e.g. Gold commodity stand
- Adjustments happen by themselves if markets left a long and free banking
- Boom Bust Cycle as central banks miss natural rate or misunderstand natural rate or basically have a monopoly on money.
- Low interest rates create a boom because expansion not based on real savings but credit
- Over expansion of money/ credit 'every one is a winner'

- This creates Capital malinvestment. Distortion of the entrepreneurial process. Wrong signals
- Distortions in the capital formation process b/c poor monetary policy
- Central bank estimates Natural rate and acts with monetary policy frequently and this exacerbates the cycle.
- 'Money pumping' increase Gini coefficient b/c money goes to money center banks
- Sets the stage for next cycle
- Two policy options: 1. adjust interest rates based on models (New Keynesian) 2. let the markets work (ABCT)
- What about inflation targets? 2% is arbitrary, because in a Growing economy you should see deflation because of efficiency — technology gains. Monetary deflation bad, efficiency deflation good.
- Can we equate equilibrium with price stability if the economy is growing an becoming more efficient?
- Approach tends to be praxeology or a priori
- Capitalism is good because we all act on 'enlighten' self interest, to find the best ways we can serve each other. Some want a night watchman others are more libertarian.