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Seminar: Winter Term 19-20

Modern Political Economics

Session 5.1

Handout distributed in paper

Session 5.2

Bastard Keynesianism and proceedings

1. Naïve Keynesianism calibrated and another brain teaser.

You may remember 5.1, the simple equilibrium Keynesian plus growth model? It can be calibrated to empirics. Let's take Germany as example. Recently two think tanks, one close to German employers, the other to trade unions, came up jointly with a proposal to increase investment up to around € 435 Mrd) Euros within the next 10 years, say around € 43 Mrd. per year. You are asked by government to assess the proposal with regard to its impact on the economy from a macroeconomic perspective like employment and inflation. They want a quantitative estimation as well as an economic valuation about success.

You start with the empirics. In 2018 the GDP of Germany added up to € 3.35 Billion, (German Notation), fixed capital accounted for € 19.8 Billion. The average propensity to consume was 0.8, employment amounted to 42.4.Mill. Your calculation shows that additional investment per year mentioned above will have an overall effect on demand per year of € ?????? if earnings are spent domestically only. The effect on employment will be ?????? given unchanged labor productivity per head. Additional labor needed will meet ?????? unemployed people which creates some tightness of the labor market expressed by a drop of the unemployment rate from 5.0 to ?????? given an unchanged labor supply. This change will create a simple Phillips-curve inflation impulse of factor 0.8 which will add to the current inflation rate of 1.8 %. Your assessment of the change of overall welfare is based on the average of the change of unemployment and inflation rates with a slightly higher weighting of inflation as compared to the unemployment rate by factor 1.8 because of political reasons. Your final recommendation (to or not to, please decide) implement the policy suggested will be based on this benchmark. Or do you prefer a reduction of taxes to stabilize the economy against a recession like Markus Söder and the CSU? Your economic valuation of success is grounded on reasoning (a) about the structure of qualifications available versus needed on the labor market, (b) about the decision of companies and people not to spend additional earnings on the domestic market only, (c) on the use of additional earnings within the Eurozone or worldwide and the corresponding reaction of exchange rates and (d) on financing additional public investment by increasing public debt or taxes in the light of price stability and intertemporal equity as suggested by, say, Ricardo.

2. The Phillips curve and choosing the menu

Naïve Keynesian reasoning assumes a stable Phillips-curve and, consequently, a choice of the inflation-unemployment combination as a second-best welfare solution. The theory of rational expectations (Lucas) has shown that a Phillips curve is stable in the short run only, given a specific set of expectation of the pattern of an economy. If current expectations are disappointed they changing expectations of the link between the rate of unemployment and inflation will push the Phillips to the right. The economy may end in a state of stagflation.

3. Growth and a fable for growth men

Keynes himself did not agree with communist ideas but hoped for smartly managed capitalism. While sketching economic budgetary policies he has not cared about what the future will be like in the long run because "in the long we are all dead". A formal theory of growth, having been touched upon by Ramsey already, was built on the quite famous Harrod-Domar-model linking the short-run-demand Keynesian model with the supply-side capacity enlargement effect of investment by introducing a capital-enlargement coefficient as the link between investment and production. This original concept of a lasting effect regardless of the speed of capital accumulation was successfully challenged by Solow who proved that the capital coefficient is not independent of investment because of the link between capital intensity of production and capital productivity. As a consequence long run economic growth is dependent not on physical capital accumulation but on technological progress. This reasoning has also led to a lasting debate on the link between human capital, education and technological progress and a rather witty fable for growthmen in search of an optimal rate of investment (Phelps).

2. Intergenerational equity and soft money constraints

If government lacks money to improve the well-being of their constituency public debt is a nice way to out of the bottleneck. Increasing taxes or reducing transfers to households or/and subsidies to companies is much less an attractive policy to convince people of a well-doing government. The expansionary effect is much higher as well. Problem is that public debt may be too high to be paid back easily in times of trouble, especially if it is debt to be paid back in a foreign currency. Domestic public debt is easier to handle if the Central Bank is supportive with quantitative easing. But even then limits exist to ensure the validity of the national currency. In some cases - like the EU -legal restrictions have been set (3% /60% of the annual GDP or the ratio of the total debt to GDP, Germany add. Art. 109 GG). However, those are soft budget constraints which are linked to the debate of intergenerational equity and the urgency of a problem as perceived by parliament. Which brings us to the role of money again and international economic policies, the full story of next week`s session.