While the subject-matter of the last chapter is fresh in the reader’s mind it is worth pointing out that we may derive the output multiplier equations for the Keynesian, New Cambridge and a fourth mainstream view, the Post-Keynesian view, as variants of the reduced-form equation (4.20) for output:

\[ Y = \frac{G + I_0 + X - M_1 + \beta W}{\psi + \frac{\alpha \gamma}{l}} + \frac{MS/P}{\frac{\psi d}{\alpha} + \gamma} \]  

(4.20)

Dealing first with the Keynesian and New Cambridge views, both schools argue that money and other financial assets are very close substitutes (i.e. \( l \) is very large: the \( LM \) curve is nearly horizontal), while financial assets and real assets such as investment goods are not (i.e. \( \alpha \) is very small: the \( IS \) curve is nearly vertical). Letting \( l \to \infty, \alpha \to 0 \) in the above equation, we obtain:

\[ Y = \frac{G + I_0 + X - M_1 + \beta W}{1 - b(1 - t_d) + t_i + m} \]  

(5.1)

where \( \psi = (1 - b(1 - t_d) + t_i + m) \).

Thus the money supply may still influence real output via the wealth effect (which shifts the vertical \( IS \) curve rightwards). However, these two schools also believe that wealth effects on (consumer) spending are small and with \( \beta = 0 \) we obtain the familiar Keynesian or New Cambridge reduced-form equations for output (equations (2.9) and (3.28) respectively). Of course Keynesians and New Cambridge theorists disagree about the size of the government expenditure multiplier but both agree that government expenditure has a long-run effect on real output, which in turn has a direct effect on the level of employment. In addition these two schools do not believe that excess demand is an important determinant of either price or wage inflation and therefore an increase...
in government expenditure under fixed exchange rates (when there is excess capacity in the economy) does not lead to inflation via a Phillips curve mechanism.

We wish to characterise the Post-Keynesian view as one which in certain respects lies between the Monetarist and Keynesian or New Cambridge views. Post-Keynesians believe that the degree of substitutability between money, financial assets and real assets is neither particularly high nor low; hence $l$ and $\alpha$ are of the same order of magnitude and (according to equation (4.20) above) both government expenditure and the money supply have a substantial effect on real output over a number of years. We also characterise the post-Keynesian view as one in which excess demand influences wages and prices. But although the long-run Phillips curve is steeper than the short-run curve, it is not vertical, and therefore both money supply and government expenditure can be used to reduce the level of unemployment in the long run, albeit at the cost of incurring some additional inflation.2

At the risk of confusing the reader with a plethora of schools of thought it is worth mentioning another school which one may label as ‘rational expectations monetarist’. Like the Monetarist they believe in a stable demand for money function and the labour-market analysis underlying Figure 4.1 (p. 112), but in addition they adhere to the strict form of the ‘rational expectations hypothesis’. The latter implies that actual and expected inflation are always equal and therefore unemployment does not diverge from its ‘natural rate’ even in the short run. Very radical policy conclusions follow from this view. First, the current (1978) U.K. rate of unemployment of about 6 per cent is the ‘natural rate’ (apart from a random error, which since unemployment has been fairly constant over the last year we can probably take to be fairly small). Second, monetary policy (or fiscal policy) cannot be used to alter this level of unemployment even in the short run and therefore demand management is a non-starter. Third, the rate of growth of the money supply determines the rate of inflation directly, by altering everyone’s ‘rational expectations’ formed on the basis that the Monetarist model is the ‘correct’ model of the economy. Thus, while Keynesians, New Cambridge theorists, Monetarists and Post-Keynesians talk the same language in that they can, for example, argue about the size of various structural coefficients and the speed of adjustment in various markets, the