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IS-LM AND AGGREGATE DEMAND: A RESTATEMENT

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3.1 INTRODUCTION

There can be little doubt that the dominance of U.K. economic policy by supply side theorists has led to the neglect of aggregate demand. Policies such as cutting unemployment benefit, for example, are increasingly considered only in terms of their effects on labor supply. Any effect they may have on aggregate demand is neglected. On the other hand there is implicit recognition that demand is important. Over the cycle, we may await the return of consumer confidence and the upswing in exports to ensure that the green shoots of economic recovery grow into full bloom. The fact that they are 'awaited' implies not only that aggregate demand is important but also that is not to be hurried. Policies may be (and indeed are) designed to influence supply but apparently little or nothing can be done about aggregate demand.

It is asserted here that the dismissal of Keynesian economics is a mistake and that policies concerning the manipulation of aggregate demand should be used albeit in conjunction with supply-side policies.

The re-examination of aggregate demand is based largely on Rowan (1983) who in turn refers to Davidson and Smolensky (1965), who follow Weintraub (1958) and chapter 19 of The General Theory. One reason for reiterating what has already been said elsewhere is that many, if not most, modern macroeconomic texts offer unhelpful and arguably misleading accounts of the relationship between aggregate demand and the general level of prices in 'Keynesian' models. This tide of confusion and misrepresentation is pervasive and shows no sign of abating indeed it is becoming commonplace to refer to Keynesian economics (sometimes qualified as New-Keynesian) as a fixed (or sluggish) priced version of the more general classical model.
Some examples might help to illustrate this tendency to massage Keynes into the classical mold.

“One consequence of the Keynesian revolution of the 1930’s was the acceptance of a rigid absolute price level, as the starting point for analyzing short term economic change” (Friedman’s Nobel Lecture).

“Certainly the short run sluggishness of wages and prices was the key assumption of the consensus (Keynesian) view of the 1960’s. And the absence of an adequate theoretical justification for that assumption was one of the fatal flaws that undermined that consensus.” (Mankiw, J.E.L., 1990).

“Everyone knows that nominal price and wage rigidities are central to Keynesian theory.” (Blinder, Macroeconomics Under Debate, Wheatsheaf, 1989).

“New Keynesian economists all agree that these imperfections exist, are important and together can account better for Macro phenomena ... than alternative perfect market models.” (Stiglitz, Alternative Approaches to Macro. N.B.E.R., 1991).

This version of Keynesian economics is so close to the views of his more conservative contemporaries as not to admit the possibility of a Keynesian revolution. Yet, according to Leijonhufvud (Latis, 1976) there certainly was such a revolution. Its hallmarks (in line with Kuhn’s definition) were the breakdown of language—witness the bitterness in Keynes’ remarks on Pigou, the growth of knowledge—later to become Macroeconomics, and the Kuhnian loss—all value theory. This latter was, according to Leijonhufvud, too great a loss and was retained as Microeconomics.

It is intended here to examine the more commonly expressed versions of Keynesian economics and to compare them with what is in the General Theory. As is so often the case, the misrepresentation of Keynes is no well-specified, single-headed monster. However it is not intended here to dive too deeply into its many depths and folds but rather to construct a straw man—or, more accurately, matchstick man—in order to focus on a few main issues.

Many complexities are avoided by invoking the services of the auctioneer, thereby excluding any trading at false prices and removing problems of expectation formation. Furthermore all markets will be perfectly competitive, the economy is closed and there is an aggregate production function that satisfies the first and second order conditions for a maximum. These simplifications make the problems manageable—particularly on the supply side—and can hardly be said to bias things in favor of Keynesian models, on the contrary they should commend themselves to the neo-classicals.

Using this framework, section 2 of the chapter briefly rehearses what mainstream macro-economic textbooks have to say on aggregate demand curves; section 3 does the same for aggregate supply curves; section 4 offers a Keynesian aggregate demand curve with fixed money wage rates; section 5 extends this to cover flexible money wage rates; section 6 examines the effects of income redistribution; section 7 introduces the real balance effect and section 8 considers the wealth effects. Finally section 9 offers some conclusions.