Compare the theory of economic downturn of Wicksell and Keynes. In your comparison, be sure to include a discussion of money, uncertainty, interest rates and financial institutions. (4/10/12)

A. Wicksell

Wicksell [1898] wanted to refine the Ricardian quantity theory of money in economic discourse in order to explain price changes relative to a "natural rate" of interest. Money would be neutral only at this "natural rate", this represents monetary equilibrium. The natural rate of interest is when the marginal productivity of the capital structure of the economy (the roundaboutness of society's production processes, as proxied by an "average period of production" or, K/T, [1898]) is equal to capital's profitability. This would be the interest rate for capital in a moneyless barter economy or in a society without a monetary authority influencing the interest rate.

[Due to unreceptivity of the "natural rate" Wicksell later introduced the "normal rate" where demand for new capital is exactly covered by simultaneous savings. I will continue to refer to the natural rate in this essay as that is perhaps what Wicksell is best known for. We should also note that Nell 1967 finds that Wicksell confusingly has two definitions of the "natural rate", the one I use above is from Ohlin's introduction to Wicksell [1898] 1936].

When the monetary authority (who influences the "market rate" or the "money rate" of interest) allows a market rate of interest to differ from the natural rate this results in relative cumulative price changes. When the market rate is held below the natural rate for prolonged periods of time this results in cumulative price increases and an economic boom. The overheated economy then leads to the market rate becoming higher than the natural rate (due to banks reaching their reserve limits), choking-off further lending and investment and leading to the downturn. It follows then that Wicksell's policy prescription is that the monetary authority should attempt to equate the market rate and the natural rate.

Professor Ohlin in the introduction to Wicksell ([1898] 1936) differentiates Wicksell's theory of the business-cycle from the later one by L. v. Mises (1912) in that the interest-rate policies are not the cause of the business-cycle. Wicksell believes that technical and commercial progress cannot proceed "evenly" and in fact proceed "sporadically". Wicksell uses a rocking-horse metaphor for the economy. The economy (business cycles) rocks back-and-forth and the monetary authority might only be able to prevent this rocking from becoming "violent".

[Blaug 1997 in his section "Keynes and Wicksell" writes that Wicksell "paid no attention to changing expectations", yet this seems inaccurate as will be shown below.]

Wicksell uses a Walrasian general equilibrium framework in the sense that decisions are based upon expected prices all across the economy. It is these price expectations which in turn influence decisions about credit, employment and factor inputs. Ignorance and deficient foresight can lead to crises of confidence for long-term projects in the economy. Sufficient legal tender reserves on behalf of the monetary authority can buffer a "general lack of confidence" [Wicksell 1907] effecting the velocity of money.

B. Keynes

Keynes 1936 is interested in equilibrium unemployment. Keynes uses a Walrasian general equilibrium circular-flow model where firm production is equal to household income which is equal to household purchases of goods and services. However, some household income can be leaked from the flow as savings (international trade and taxes also represent potential leakages but in this essay we are focusing on the savings and investment relationship). If savings is equal to investment then the leakage is captured and the flow is complete.

Keynes' approach to monetary theory was in the "Cambridge cash-balances tradition". If an exogenous monetary authority sets the interest rate too high, where people's expectations are that the interest rate will decrease, then people will hold less cash for bond speculation ("liquidity preference" is decreased). This leads to an excess of savings over investment, which in turn can lead to an economic downturn, due to the leakage.

The leakage can lead to a downward spiral. Aggregate demand is less than aggregate supply due to the savings leakage of the circular flow model. Producers find themselves with excess inventories and then this is carried-over into their expectations (there is uncertainty as to the ability to sell inventory) for the next period, leading to reduced investment and reduced household incomes. However as income becomes lower savings is reduced in greater proportion. Savings and investment become in equilibrium however at a reduced level of economic output. The end result is prolonged under-unemployment.

There is a limit to what the monetary authority can do. It is ineffective to try to encourage investment through prolonged expansionary monetary policy. People expect that the interest rate will rise so they hold more speculative monies ("hoard" cash), reducing savings and choking-off investment. It is for this reason that Keynes recommended government deficit spending during the downward portion of the business cycle to "absorb" the excessive savings which aren't being channeled into investment.

Keynes changed conventional economic wisdom at the time by saying that interest rates don't influence the level of savings as much as does the aggregate level of income. Keynes introduced the consumption function, and the marginal propensity to consume, where people's level of consumption (thus inversely saving) was related to their level of income to describe how levels of savings are determined.

Heilbronner and Milberg (1995) describe Keynes as departing from Marshall by introducing ignorance to the logic of choice and where the liquidity preference (demand for cash-balances) is non-rational. Expectations ("animal spirits") determine investment (and aggregate supply) which in turn determine household income levels in the circular flow. Through the consumption function, household income levels determine consumption (aggregate demand). The economic "law" is propensity-driven AD interacting with expectations-influenced AS.

C. Comparison between Wicksell and Keynes

Similarities

From our above discussions we can summarize first the similarities between Wicksell and Keynes. They both were interested in evaluating investment in society and investment's role in economic business cycles. They both did not assume that savings and investment where in equilibrium. In addition they both used an analytical lens involving a monetary authority which could influence investment through manipulation of the interest-rate. For Keynes, the monetary authority could tend to encourage (over-) savings by holding the interest rate too-high, resulting in leakages and economic downturn. For Wicksell the monetary authority distorting a "natural rate" would tend to create cumulative inflationary or deflationary periods, distorting societal time-preferences for allocating capital towards longer-term projects**.** In both Wicksell and Keynes we can find a notion of "hoarding", for Wicksell when the market rate is above the natural rate, for Keynes when the interest rate is expected to go down. We find too that both use a Walrasian economy-wide analytical lens and that both have expectations about the future (uncertainty) as influencing investment decisions.

Differences

Wicksell was interested in monetary authority effects on relative prices (inflation and deflation and relative capital structures effects), related to a natural rate of interest and society's time-preferences. Keynes was not as interested in inflation and "did not have a systemic treatment of inflation" (H&M 1995). Keynes thought monetary policy ineffective in reducing the downturn beyond a certain point and thus called for a more activist fiscal policy. The most important difference between the two is that Wicksell believed that the "overproduction" theory of business cycles was "purposeless" whereas Keynes made it a basis for describing prolonged under-employment.

In "The Enigma of Business Cycles" (1907) in fact Wicksell takes an approach which is directly opposed to that of Keynes (of course in advance of Keynes 1936). During the "bad" times the monetary authority should attempt to keep the money interest-rate below that of the natural rate for prolonged periods of time, and that "overproduction" be encouraged in that "accumulated stocks of commodities" are a precondition for the "good" times. Commodity stocks get converted to capital investment during the good times.