Keynes: The Propensity to Consume and Invest and the Multiplier Effect

Introduction to Political Economy

Prénom: Julian
Nom: Inquel

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Dr Rees

Sommaire :

I- Introduction

First of all, The Keynesianism is an economic theory invented by Jhon Maynard Keynes.
The Keynesianism is an economic theory that states that active government intervention in the economy and monetary policy is the best way to ensure economic growth

Founded by Keynes, a famous economist, who initiates many new ideas that began to be accepted after the Second World War. Thanks to his perseverance, Keynes was able to convince many governments to follow certain macroeconomic statistics more closely, such as interest rates or employment.

Principle of the Keynesian theory it is up to the government to mitigate the irregularities of economics cycles. Government intervention results in massive investment programs and tax relief to stimulate demand When the economy slows down.
Conversely, when the economy is doing well, the state reduces its spending and increases taxes in order to control inflation.

The Keynesianism is structured around six main features, three of which concern the functioning of the economy and three economic policies.

The three principles on the functioning of the economy are:

- Aggregate demand is erratic.
- Changes in demand have a greater influence on output and employment than on prices.
- Prices and especially wages react slowly to changes in supply and demand.

The three principles of economic policy:

- The usual level of employment is not ideal because it is subject to both the vagaries of demand and too slow price adjustments.
- It is necessary for the public authority to implement stabilization policies.
- Even less unanimous than in the previous point, supporting employment rather than fighting inflation.

In this theory, several factors are taken into account including the propensity to consume and invest but also the multiplier effect of the Keynes theory.
What is the relation between the propensity to consume and investment multiplier?
In order to be able to answer this question, in a first part we will see the propensity to consume and invest in the theory of Keynes and in a second part we will see the multiplier effect.

II- Propensity to consume and invest

A- Propensity to consume:

In Keynes' theory, the propensity to consume is the share of household disposable income that is devoted to consumption
A propensity being an «inner, innate, natural force, which spontaneously or voluntarily directs towards an action, a behavior» The propensity to consume is therefore a force that pushes individuals to consumption.

The marginal propensity to consume is the share of one additional unit of income devoted to consumption, that is, the ratio between the change in consumption and the change in income.
Since all income is either consumed or saved (Keynes considers saving as a residue of consumption, that is saving is what remains of income after consumption and the payment of taxes)

It is mathematically deduced that for an additional unit of earned income, consumption will increase but to a lesser extent than income. Keynes defines this phenomenon in his Basic Psychological Law.

The law of fundamental psychology is an economic law indicating that the absolute value of consumption is a growing function of income, but that consumption increases less rapidly than income.

B- The determining causes of investment:

The investment is determined by the rate of return on various potential projects and the cost of borrowing (or interest rate). The change in the rate of return tell us the level of investment demand (also called marginal investment efficiency). The cost of borrowing (or the interest rate) is determined by the money market. It is essentially the result of monetary policy.

Most companies determine their current investment plans using long-term planning and capital budgets. Future sales forecasts are the main determinants in these calculations.

In addition to the rate of return, the demand for investment is determined by the emergence of new technologies, the maintenance of equipment and the inventory of existing capital, but also by the anticipation of future sales.
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Historically, investment has been the most erratic component of overall spending and gross national product. In times of economic slowdown, it is often negative. It often goes back as soon as future sales expectations seem more promising.

III- The Multiplier Effect

The Keynesian Multiplier or investment multiplier is a theory developed by Jhon Maynard Keynes based on the "employment multiplier" of the English economist Richard Kahn. The idea is as follows: "If the propensity to consume in the various imaginable circumstances (as well as some other conditions) is taken as given and if it is assumed that the monetary or other public authority is taking measures to encourage or hinder investment, the change in the volume of employment will be a function of the net change in the amount".

The multiplier effect comes from the fact that a change in the overall expenditure forecast by households or businesses requires changing production by putting new employees to work. As a result, new revenues will cause a second stream of increased aggregate demand.

The theory of the "investment multiplier" can be presented as follows:

Corporate income= consumption + Investment

Consumption is a stable function of income, as shawn by statistical correlations, etc. Let's say, to simplify, that the variable "Consumption" is always equal to 0.8 times the "Income (of society)". In this case we obtain from the preceding equation:

Income = 0.8 Income + Investment; therefore 0.2 Income = Investment; or else

Income = 5 Investment

This "5" is the "investment multiplier". It is then obvious that to increase the monetary income of the company by a given amount, it is enough to increase the investment by one fifth of this amount; the magic of the multiplier will do the rest.

It has been shown to be mathematical fallacy because no matter where the money comes from, whether it's through borrowing, taxation, or bookmoney, government spending always pre-empts the spending that would eventually occur in the economy, since it is a transfer.

If the investment does indeed have an apparent multiplier, it is erroneous to believe that encouraging public investment will lead to positive effects.

In open economies, this mechanism is made even more inefficient by imports: very often the policies of revivals serve only to finance the purchase of imported goods and thus to support foreign economies while increasing the public debt. This was, for example, what happened with the socialist revival policy in France in the early 1980s, while the other developed countries were reforming.

IV- Conclusion

To conclude after having explained the subject well, from a personal point of view I find that this theory is rather intelligent, indeed Keynes does the opposite of what is «logical to do» which allows the economy to recover.
However, even if this theory has proved its worth, it is not 100% reliable. Which leaves me a little doubtful about its true function.

- Source

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