

## Keynes's Critique of the Neoclassical Theory of Saving and Investment

1. In Keynes, since consumption is a function of disposable income, and saving is income not spent, saving is also primarily a function of disposable income. S is a passive residual, determined by disposable income and the marginal propensity to consume. Keynes did not believe it was legitimate to hold income constant when analyzing aggregate saving, as in neoclassical theory. He also disagreed with the neoclassical belief that saving is primarily a function of the rate of interest.
2. Historical experience of the Great Depression (interest rates very low, no investment).
3.  $S = I$  is the macroeconomic equilibrium condition in both Keynes and neoclassical, but in Keynes  $I \Rightarrow S$  through changes in  $Y$  and in neoclassical  $S \Rightarrow I$  through changes in  $i$ . In addition, in Keynes the two may be equal at a whole range of potential levels of output and income, only one of which is full employment, while in neoclassical the two may be equal only at full employment.
4. Keynes did not believe it was legitimate to hold the state of investor expectations constant in analyzing aggregate investment, as in neoclassical theory. He also disagreed with the neoclassical view that investment is primarily a function of the rate of interest. Expected profitability of investors **and** lending institutions both required for investment to take place.
5. Keynes distinguished between risk, which is calculable, and uncertainty, which is not conducive to statistical probability. He believed most important determinants of investment described by uncertainty, not risk. In neoclassical theory, uncertainty in this sense is not recognized. Also, even under risk, the

confidence of whether one will 'beat the odds' is subject to unpredictable variation. Mass psychology subject to waves of optimism and pessimism.

6. Business and political climate will influence investment decisions, as will many other factors, not all of which appear immediately relevant, at least on the surface.
7. In a modern capitalist economy with high-tech financial institutions and advanced instruments of credit, a 'pool' of saving is not necessary to finance investment. Banks are private, profit-maximizing institutions and will not pass up the chance to make profits if they believe a loan will be profitable. They will always make a loan and worry about reserve requirements at the end of the day (often borrowing themselves to meet their requirements).
8. In Keynes, the rate of interest is not determined by S and I, but by the supply and demand for money. This is Keynes's liquidity preference theory (more on this later).
9. Separation of ownership and management means those who own do not necessarily know the business well, and those who manage may have different interests and incentives than if they also owned.
10. Speed of asset revaluation increasingly faster and faster. Assets are revalued within the space of seconds, and ability to react immediately, without having to wait to see if a change is a temporary deviation, creates instability. Self-fulfilling prophecies become a characteristic of the system (for example, people think an asset's value is going to go down, so they sell and because people sell, the value goes down).