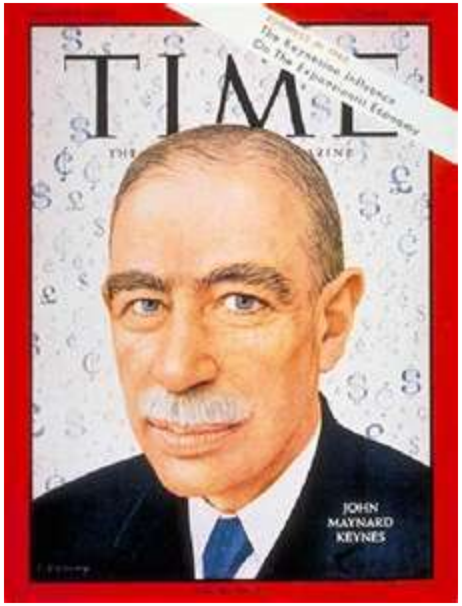


Chapter 16

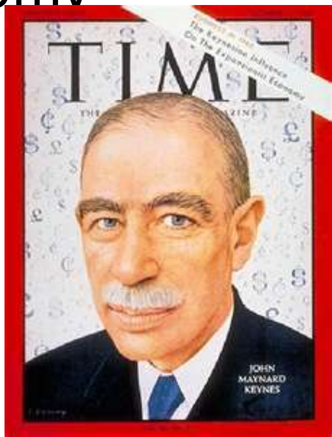
Macroeconomic Viewpoints: New Keynesian, Monetarist, and New Classical

Economics, 7th Edition

Boyes/Melvin

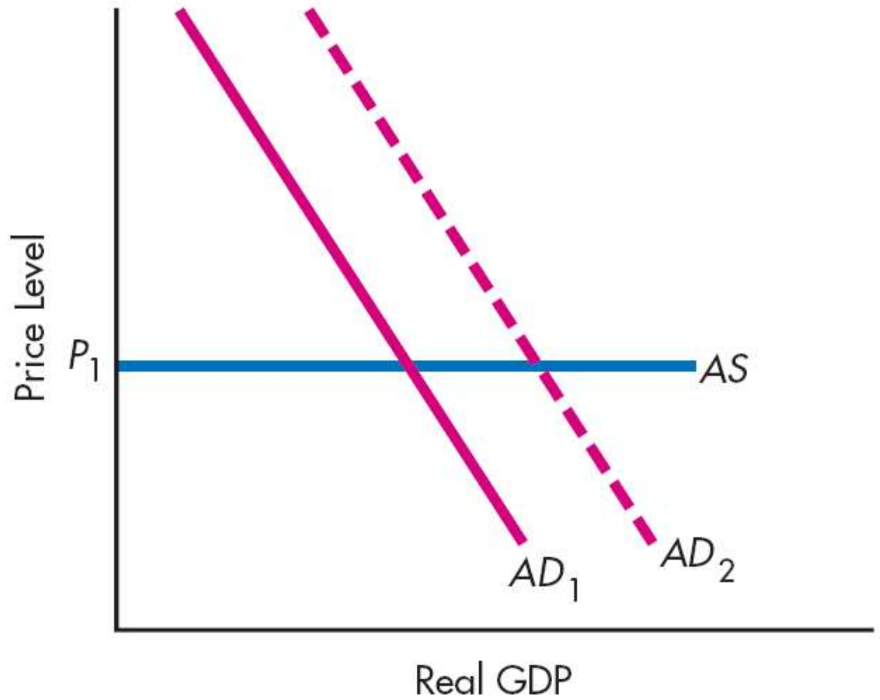
Keynesian Economics

- Follows the work of **John Maynard Keynes** and dominated the economics profession from the 1940s through the 1960s.
- "In the long run, we're all dead."
  - Aggregate demand plays a dominant role in the determination of GDP and employment.
  - Prices are fixed (horizontal AS) at all relevant levels of GDP.
  - Government is responsible for stabilizing the economy by managing aggregate demand.



The Fixed-Price Keynesian Model wages fixed in SR

FIGURE 1 **The Fixed-Price Keynesian Model**



In the simple Keynesian model, prices are fixed at P_1 by the horizontal aggregate supply curve, so that changes in aggregate demand determine equilibrium real GDP.

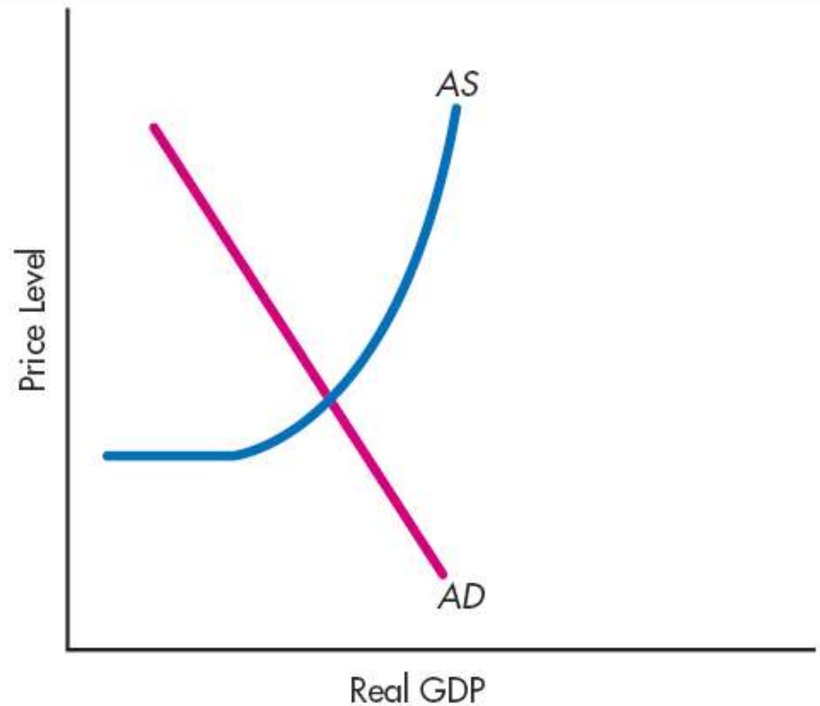
New Keynesians

- Similar to traditional Keynesians:
  - Prices and wages are rigid ("sticky") in the short run. (And likely sticky downward always)
  - Disequilibrium prevails.
  - Recognize the role of money in creating inflation.

The Modern Keynesian Model: inflation not a problem when unemployment is high.

FIGURE 2 **The Modern Keynesian Model**

Modern Keynesians typically believe that the aggregate supply curve is horizontal only at relatively low levels of real GDP. As real GDP increases, more and more industries reach their capacity level of output, and the aggregate supply curve becomes positively sloped.



In both Keynesian theories….

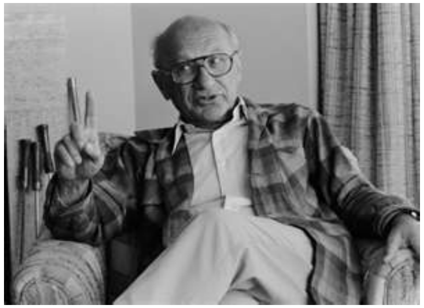
- G should play an active role.

Monetarism

Follows the work of Nobel Prize winner **Milton Friedman**.

- Changes in the money supply determine equilibrium, real GDP, and price levels.
- Discretionary monetary policy is bad, creates business cycles.
- Inflation is caused by monetary policy

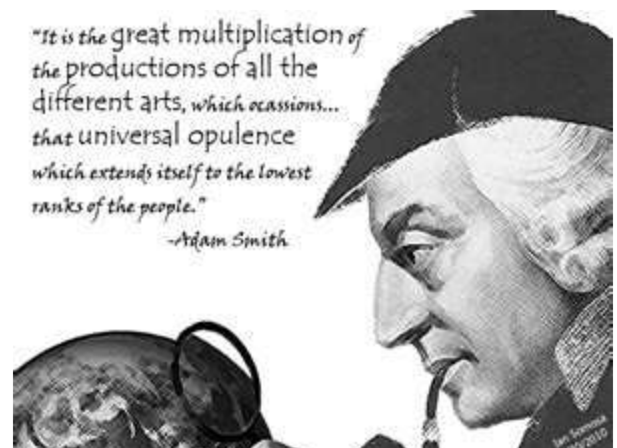
- Because lags are variable and unpredictable, timing is impossible.



- Monetarists believe:
- Increase Ms slightly each year. Don't use monetary policy to fix economy.
- Let the free market fix problems. Laissez-faire.

Classical Economics

- **Classical economics** is a school of thought popular before Keynes:
  - Real GDP is determined by AS, PL is determined by AD
  - Changes in AD only change PL



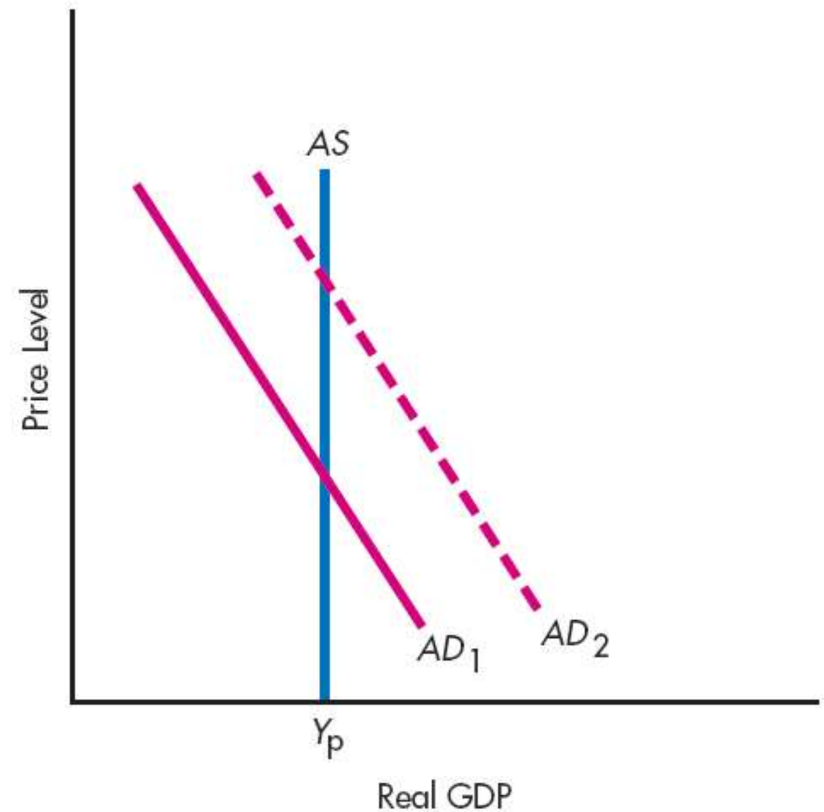
Classical

- No fixed contracts
- Perfectly flexible wages and prices
- People have perfect information

The Classical Model: no SRAS

FIGURE 4 **The Classical Model**

The vertical aggregate supply curve indicates that equilibrium real GDP is determined strictly by the determinants of aggregate supply.



Real GDP is determined by aggregate supply, while the price level is determined by aggregate demand.

New Classical Economics

- **A response to the problems of meeting economic policy goals in the 1970s:**
  - Wages and prices are perfectly flexible.
  - Markets are always in equilibrium.
  - Rational expectations: people know basic econ info and respond accordingly
    - Changes in fiscal or monetary policy must be unexpected in order to work.

New Classical Policy

- Follow predictable and stable monetary and fiscal policies for long run employment and price stability.

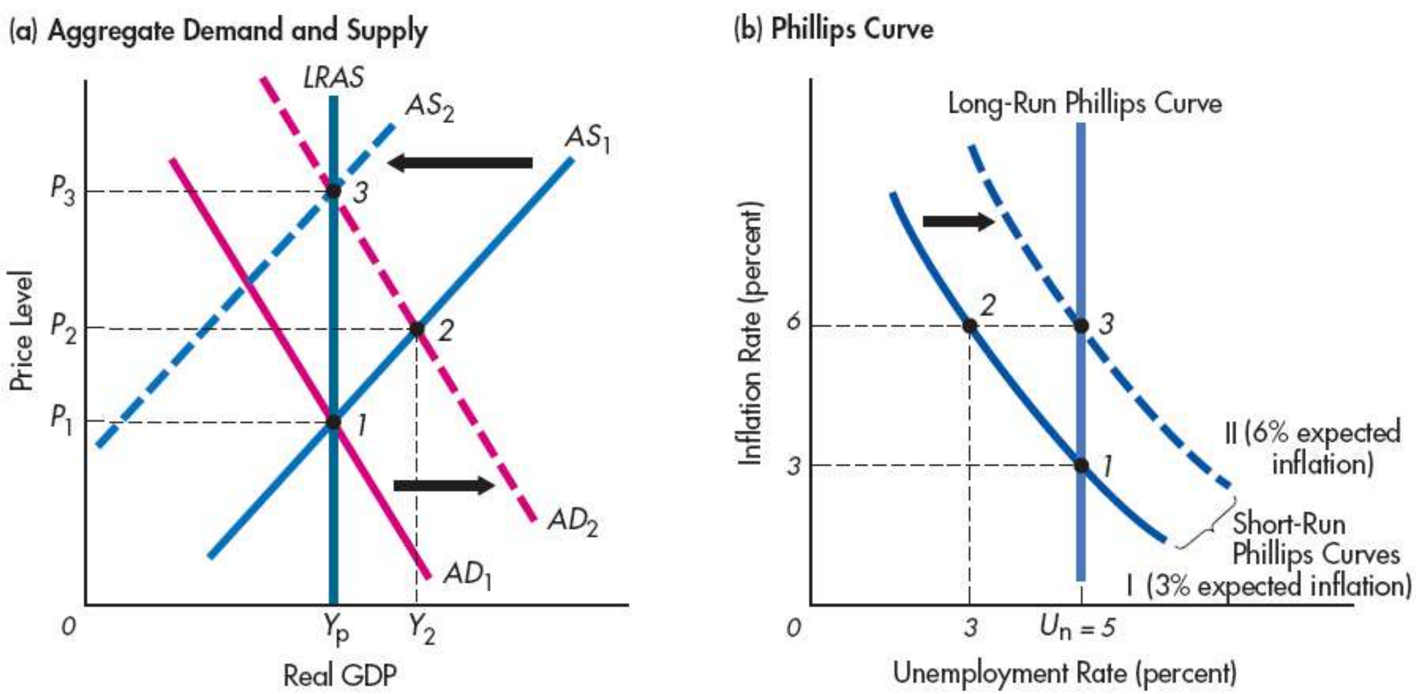
Robert Lucas

New Classical Economics

FIGURE 5 New Classical Economics

New classical economists believe that government-induced shifts in aggregate demand affect real GDP only if they are unexpected. In Figure 5(a), the economy initially is operating at point 1, with real GDP at Y_p, the potential level. An unexpected increase in aggregate demand shifts the economy to point 2, where both real GDP (Y_2) and prices (P_2) are higher. Over time, as sellers adjust to higher prices and costs of doing business, aggregate supply shifts from AS_1 to AS_2. This shift moves the economy to point 3. Here GDP is back at the potential level, and prices are even higher. In the long run, an increase in aggregate demand does not increase output. The long-run aggregate supply curve (*LRAS*) is a vertical line at the potential level of real GDP.

In Figure 5(b), if the expected rate of inflation is 3 percent and actual inflation is 3 percent, the economy is operating at point 1, at the natural rate of unemployment (U_n). If aggregate demand increases, there is an unexpected increase in inflation from 3 to 6 percent. This moves the economy from point 1 to point 2 along short-run Phillips curve 1. Here the unemployment rate is 3 percent. As people learn to expect 6 percent inflation, they adjust to the higher rate and the economy moves back to the natural rate of unemployment, at point 3. If the increase in inflation is expected, then the economy moves directly from point 1 to point 3 with no temporary decrease in the unemployment rate.



Theories change over time

- Theories develop over time in response to the economy:
  - Keynesian economics helped explain and resolve the Great Depression.
  - Monetarist economics explained rising unemployment and inflation in the U.S. in the 1960s and 1970s.
  - New classical economics suggested an alternative explanation for rising unemployment and inflation.