

<p>Macroeconomics Keynes and the Classics</p> <p style="text-align: center;">Classical Model</p> <p>The <i>classical model</i> is just standard microeconomic theory.</p> <p style="text-align: center;">1</p>	<p>Macroeconomics Keynes and the Classics</p> <p style="text-align: center;">Price Adjustment</p> <p>Prices adjust quickly to equilibrate demand and supply. Excess demand in a market causes the price to rise, and excess supply causes the price to fall. General equilibrium prevails, as demand equals supply simultaneously in all markets.</p> <p style="text-align: center;">2</p>
<p>Macroeconomics Keynes and the Classics</p> <p style="text-align: center;">Full Employment</p> <p>The economy produces at capacity, on the production possibility frontier. There is no waste of capital and labor. There is no unemployment: any qualified worker who wants to work at the market wage can do so.</p> <p style="text-align: center;">3</p>	<p>Macroeconomics Keynes and the Classics</p> <p style="text-align: center;">Exogenous Economic Fundamentals</p> <ul style="list-style-type: none"> • Consumer preferences • Technology • Resource endowments <p>In the classical model, these fundamental factors determine the general equilibrium allocation of resources. They determine all real variables: real quantities and relative prices, including the real wage and the real interest rate.</p> <p style="text-align: center;">4</p>
<p>Macroeconomics Keynes and the Classics</p> <p style="text-align: center;">Government Microeconomic Policy</p> <p>Government microeconomic policy is another exogenous economic fundamental. Changes in what is taxed or in average and marginal tax rates have real effects. Decisions to spend more on the military and less on highways, etc. have real effects.</p> <p style="text-align: center;">5</p>	<p>Macroeconomics Keynes and the Classics</p> <p style="text-align: center;">Foreign Sector</p> <p>The foreign sector is another exogenous economic fundamental.</p> <p>Changes in exchange rates or in world prices (such as the world price of oil) have real effects.</p> <p style="text-align: center;">6</p>

<p>Macroeconomics Keynes and the Classics</p> <p style="text-align: center;">Neutrality of Money</p> <p>Money is <i>neutral</i>: money has no effect on real variables.</p> <p>Money serves only to set the overall price level. Doubling the money supply doubles the price level.</p> <p style="text-align: center;">7</p>	<p>Macroeconomics Keynes and the Classics</p> <p style="text-align: center;">Real Business Cycle Theory</p> <p><i>Real business cycle theory</i> explains the business cycle via the classical model.</p> <p>An exogenous change in the economic fundamentals changes the general equilibrium allocation of resources.</p> <p>The adjective <i>real</i> alludes to the neutrality of money.</p> <p style="text-align: center;">8</p>
<p>Macroeconomics Keynes and the Classics</p> <p style="text-align: center;">Supply</p> <p>The classical model focusses on supply, in the sense that the economy produces with full employment of capital and labor.</p> <p style="text-align: center;">9</p>	<p>Macroeconomics Keynes and the Classics</p> <p style="text-align: center;">Supply Shocks</p> <p>One refers to exogenous changes in the economic fundamentals as <i>supply shocks</i>.</p> <p>This terminology is peculiar, because these fundamental factors influence both demand and supply.</p> <p style="text-align: center;">10</p>
<p>Macroeconomics Keynes and the Classics</p> <p style="text-align: center;">Efficient Allocation of Resources</p> <p>In a general equilibrium with perfect competition, the allocation of resources is Pareto efficient. No one can be made better off without making someone else worse off.</p> <p style="text-align: center;">11</p>	<p>Macroeconomics Keynes and the Classics</p> <p style="text-align: center;">No Role for Countercyclical Government Macroeconomic Policy</p> <p>Since the allocation of resources is efficient, there is no role for countercyclical fiscal or monetary policy by the government.</p> <p>Using fiscal policy to expand employment and production is inefficient and wasteful.</p> <p>Monetary policy has no real effects, so its role is just to control inflation.</p> <p>Appropriate government microeconomic policy is useful, to provide public goods in an optimum way, to alleviate poverty, etc.</p> <p style="text-align: center;">12</p>

Keynesian Macroeconomic Model

In his famous book *The General Theory of Employment, Interest, and Money* (1936), Keynes rejected the classical model. In 1936 the world was in depression. The allocation of resources was not efficient, with much idle capital and labor. Instead the economy was in crisis.

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General Theory

Keynes argued that the classical model is not *general*. In the classical model, the foundation for the reasoning is notional demand and supply, which *assumes* market equilibrium.

Keynes argued that his theory was more general, by allowing for the possibility of disequilibrium, with excess supply of goods and labor. Effective demand and supply govern behavior.

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Rejection of General Equilibrium

Recession is not just a change in the general equilibrium allocation of resources. The cause is not exogenous changes in the economic fundamentals. In fact, these may be the same in both recession and boom.

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Aggregate Demand

Keynes introduced the concept of *aggregate demand*, the overall demand for goods and services in the economy.

Deficient aggregate demand is the cause of recession.

Production adjusts to demand; there is no reason to produce what cannot be sold. There is excess supply of goods and labor, as the economy produces inside the production possibility frontier.

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Psychology Affects Aggregate Demand

According to Keynes, optimism or pessimism about income and the economy has a powerful effect on aggregate demand.

Psychology has an independent influence on these attitudes.

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Founder of Business Cycle Theory

Keynes was the founder of business cycle theory.

Before Keynes, economic analysis was microeconomic, mostly focussing on individual markets.

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Persistent Unemployment

Keynes believed that unemployment might persist indefinitely. Keynes was skeptical that the economic forces of demand and supply push the economy to general equilibrium.

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Countercyclical Macroeconomic Policy

In recession, the government should take action to raise production and employment.

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Fiscal Policy

Increasing government spending or cutting taxes will increase aggregate demand.

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Money Not Neutral

With disequilibrium and unemployment, money is not neutral. Increasing the nominal money supply will reduce the real interest rate. Investment demand will then increase, and national income and product expands.

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Comparison

Classical

Equilibrium

Prices Adjust

Full Employment

Supply-Oriented

Efficiency

No Countercyclical Policy

Money Neutral

Keynes

Disequilibrium

Quantities Adjust

Unemployment

Demand-Oriented

Inefficiency

Countercyclical Policy

Money Not Neutral

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