

Comparing the Keynesian and Neoclassical Models

	Keynesian (short run focus)	Neoclassical (long run focus)
What ultimately determines GDP?	Aggregate Demand: essential to 'get spending flowing' to spark growth	Aggregate Supply: e.g. firms are always planning and reacting to expected changes in input prices (hiring?)
How stable is Aggregate Demand?	Unstable because private sector spending can vary A LOT; Fiscal and Monetary policy are necessary (G → offsets business cycle movement)	AD is relatively stable but can/will respond to expansionary and contractionary policies—but they are not necessary (freer markets, small gov't role in economy)
How responsive are wages and prices to changes in demand?	Wages and prices adjust slowly as aggregate demand changes	Wages & prices will adjust relatively quickly in responses to changes in aggregate demand. BUT they are <u>flexible in the I-run</u> , that is why AS is the key GDP/output determinant
Gov't role: Intervening in the economy	Government SHOULD be slowing the economy in boom times—with AD tools like F.policy and M.policy—and stimulating it in recessionary times.	Governments should be as 'hands-off' or fairly limited in their role in any policy aimed at 'stabilization.' e.g., prices should be allowed to work (without winners/losers being 'picked' by governments)
Short Run policy implications	Managing the economy should be actively done—gov't should be expected to use fiscal and monetary policy to eliminate unemployment by managing Aggregate Demand.	Economies are self-correcting and fine-tuning an economy with F.policy and/or M.policy makes problems worse not better. Less intervention is almost always best. Best policy? Make wages less sticky! (mkt. reforms)
Long Run policy implications	Keynesians believe fiscal and monetary policy in the long run should be devoted to increasing potential GDP. Tax cuts on business investment can help, as well as investing in public-use infrastructure.	<i>Neo-classical:</i> believe fiscal (MAINLY tax cuts) should be devoted to increasing physical and human capital (i.e., AS, LRAS). Many, given a choice, would prefer monetary policies over fiscal policies (re-if they encourage supply). Here, AD stimulus is ONLY a s-run solution—at best!— and will likely only drive further inflation.

Strengths of Monetary Policy (possibly?)

-interest rates need to be carefully timed—often their real impact is not felt for one or two years , some can be instant
-considered very flexible, interest rates can be adjusted often and gradually if necessary (eg. 0.25% at a time, or less)
-policy decisions can be reversed if it is obvious that the original decision has not had the desired impact
- popular and used extensively throughout the world, monetary policies (related 'signals') are well understood and easily interpreted by domestic and foreign markets
-less yielding to political pressure & manipulation, central banks are typically independent- i.e. mandated to control inflation
-CAN BE a powerful demand-side tool in a floating exchange rate system ONLY (in a fixed exchange rate system r-changes have to be used to maintain forex rates****—almost exclusively)

Weaknesses of Monetary Policy (possibly?)

-there are VERY many factors that determine how successful a policy response will be—eg. central banks need to be credible
-central bankers need to be independent of government if they are mandated keep inflation rates low—often very difficult to do
-central bankers who 'flip/flop' with policy can lose credibility—if investors see them as weak they lose vital <i>moral suasion</i> powers
-consumer and business confidence do not depend only on interest rates. eg. heavily indebted firms/hhlds will not borrow even if r-rates are low (m-policies can fail & make things worse) ***
-financial markets are global and borrowing can come from almost anywhere—this can dampen the effectiveness of m-policy
- time lags , though generally shorter than for fiscal policy, can create a lot of uncertainty— eg. banks may not respond to policy changes quickly or not at all (i.e. lend less not more when r decreases). - Generally r-rates impact firms within a year, hhlds after about 2yrs.

Strengths of Fiscal Policy (possibly?)

-has a direct impact on AD (national income increases by G); can be sharply targeted ---at specific regions, industries, or even goods
-decreases in taxes can ALSO have benefits on S-side ; eg. incentives to work more AND invest (re- tax savings)
-deep recessions, when interest rates are at/near zero often NO OPTIONS except fiscal policy (M-policy is ineffective)
-unemployment benefits and progressive income taxes provide automatic stabilizers , already helping fiscal policy planning
- fiscal stimulus has great benefits if infrastructure (roads/bridges/harbours etc.) and health/edu'n impact S-side too
-Tax/fiscal policies <u>already exist</u> so Gov't priorities can shift tax policy (regressive → progressive, or G-spending on sustainable GREEN technologies... provide for long-run environmental benefits)

Weaknesses of Fiscal Policy (possibly?)

-there can be significant time lags in implementing these policies, they may even be destabilizing if its too late in biz cycle ('stop/go cycles')
- deficit spending could increase national debt load to unsustainable levels (shifts policy costs to future generations ?)
-policymakers have a ' expansionary bias '—especially in election years—often leads to irresponsible spend/tax decisions
-increased government expenditures can be hard to reverse if/when policies are increasing inflation & overheating the economy
-expansionary policy can widen trade deficits—higher incomes increase iMports & lower eXports, decreased competitiveness
-expansionary policies can lead to crowding out private investment (borrowing in Capital mkts. &/or purchasing in factor mkts.); even L-run (S-side?) benefits can have MAJOR s-run deficit/costs

Relevance: Post WW2 paradigm shift - Keynesian Revolution - acceptable for government to run deficit, more debt financing, post war boom - Wane in relevance during the New Classical revolution and 70s stagflation; widespread synthesis and Friedman himself said "We are all Keynesians now" (Time 1965) - Return to Keynesian prevalence during 2008 recession, prophetic with the animal spirits and uncertainty and slump theory

- Key to Keynes' theory is Marginal Efficiency of Capital, basically expected yield of capital for firms. He describes business cycle as the fluctuations in MEC, and low MEC causes low investment. Hence if MEC is low and interest rate cut, effect is weaker.
- Macro Goals: Macro Goals: low and stable inflation, economic growth, low unemployment, sustainable levels of government debt, equitable income distribution
- Keynesian AD AS Diagram - fiscal stimulus as intervention, defined as government involvement in economic markets.
- Key Assumptions: S-run AS is fixed. Since wages and prices are sticky during demand deficiency firms s-run cut output instead of prices, causing unemployment and creating cycle: low demand causes low MEC causes layoffs causing low demand.
- Key Assumption: AD is unstable due to capital markets determined by optimism and previously mentioned cycle (MEC) and uncertainty and low expected MEC.
- Key Assumption: Transitional markets are more important than equilibrium markets since "in the long run, we are all dead. [Economists only want to predict the flat seas after the storm.]" (Keynes *Tract* 80) -> deflationary gap = human suffering
- Zone 1 to Zone 2 has low inflation tradeoff (to rGDP) while Zone 2->3 has high tradeoff due to crowding out effect, fixed factor inputs
- Thrift paradox: if all consumers save, no one will have job due to no national expenditure
- Inflationary and deflationary spiral: expected inflation causes spending causing inflation, expected deflation causes saving causing deflation
- Liquidity trap: when MEC is low, interest rate effect is diminished, and monetary impact of lower and lower interest rates approaching zero becomes reduced due to lack of confidence. -> pushing on a string, monetary policy weak during recession
- labelled deflationary gap is unused capacity and underemployment of resources below potential output, the highest long-run sustainable rGDP.
- Keynesian theory suggests that during recession fiscal intervention is necessary and justified to restore rGDP and benefit firms, households (\wedge income, \wedge employment)
- Types of fiscal intervention: capital investment (allows long-run rGDP growth), transfer payments (equitable Y dist boosts demand in its own way - see next about MPC), tax cuts -> NOTE must be NEW spending not SUBSTITUTION
- Fiscal intervention is made cheaper on gov't by increased tax income + multiplier effect, reduced EI payments
- Keynesian Multiplier: For every \$1 invested national income increases by \$k due to successive rounds of spending (ie. employed people spend which allows for more employment) -> since $AD = C+I+G+nX$ G spending increases rGDP back to Zone 2
- Marginal Propensity to Consume: how much change in income affects change in consumption. Poor people spend more % of income, so redistributing income transfer payments are more effective than equal volume of tax cuts on the rich due to MPC.
- Employment - Inflation tradeoff - Zones 1, 2, 3 different leading to shape of Phillips curve