The Keynesian Theory Using AD-AS Model

The Classical Theory says the economy corrects itself in the long-run.

But after seven years of continuing depression, in 1936 John Maynard Keynes counters with the observation that *"in the long-run we are all dead"*.

Assumptions: Classical Theory vs.. Keynesian

Classical Assumptions

- All markets, goods, resources, and financial, are competitive. Prices go up and go down in all markets to make sure no shortages or surpluses exist.
- Governments have balanced budgets: G=T. Therefore government does not borrow.
- Households spend all their income unless interest rates are high enough to get them to save.
- Firms borrow just enough to finance I. The financial markets make sure S = I.
- There are no significant trade or flows with R.O.W.

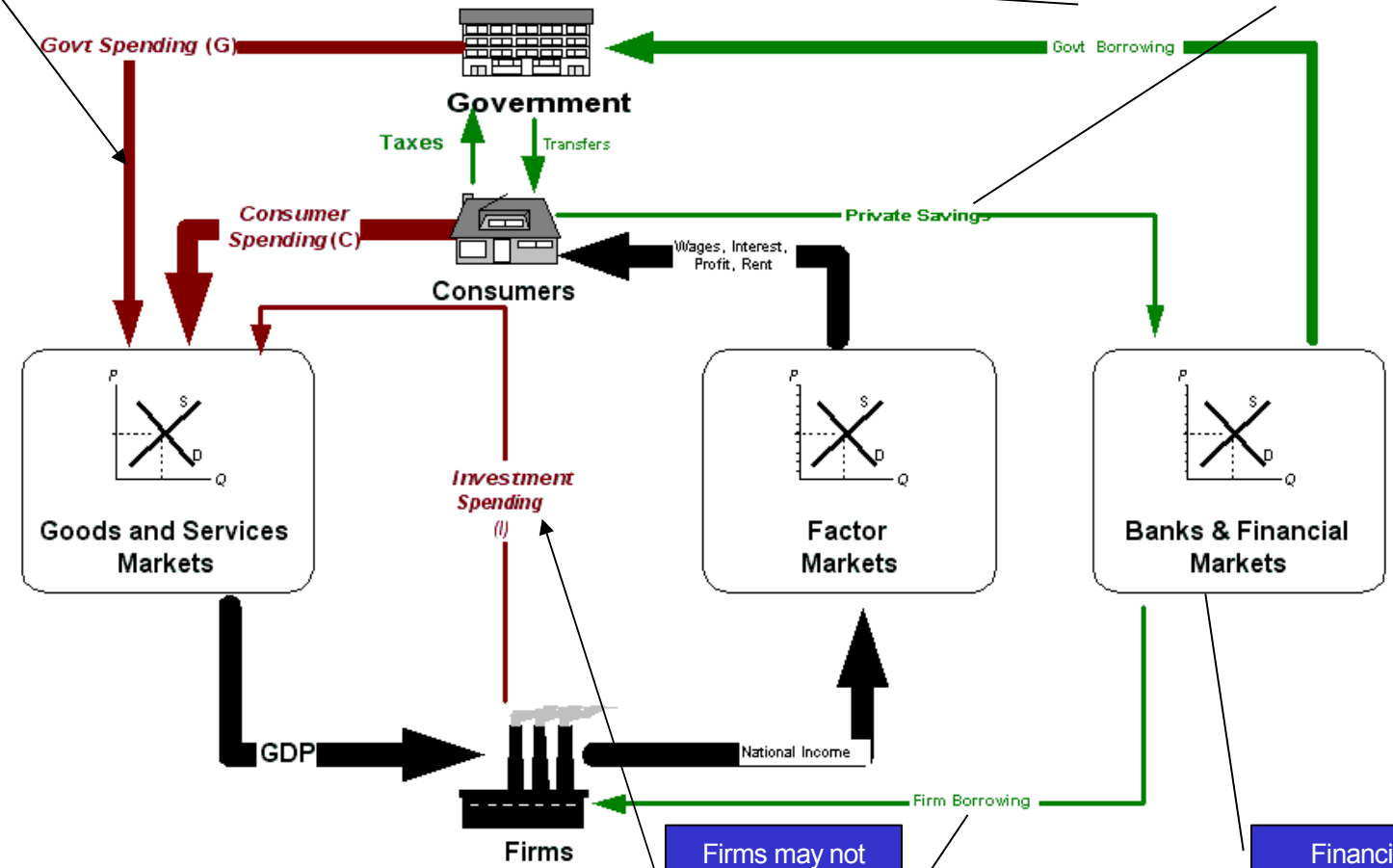
Keynesian Assumptions

- Goods & resource markets are NOT competitive. Prices & wages may go up, but they are ***sticky*** going down.
- Governments may run deficits and borrow, at least for a few years.
- I does not necessarily equal S.
  - Households save because of reasons besides interest rates.
  - Firms may not want to borrow, even if interest rate is low.
- Expectations may cause households & firms to increase/decrease spending.
- No significant trade or flows with R.O.W. *(more sophisticated Keynesian models include R.O.W., but we assume a closed economy).*

A Circular Flow view of the Classical Economy.

Govt may run deficits or surpluses. Meaning G may be greater than T. In other words, G may add more to GDP spending than T reduces C.

Households may save even though interest rates are low because they fear bad times ahead ("save for a rainy day").



In Keynesian theory, modern monopolistic & industrial markets don't let prices/wages go down easily. Thus markets may not reach equilibrium and Supply may exceed Demand.

Closed economy: Ignore ROW.

Firms may not want to borrwo & spend on I, no matter how low interest rates are, if they expect no growth in the future.

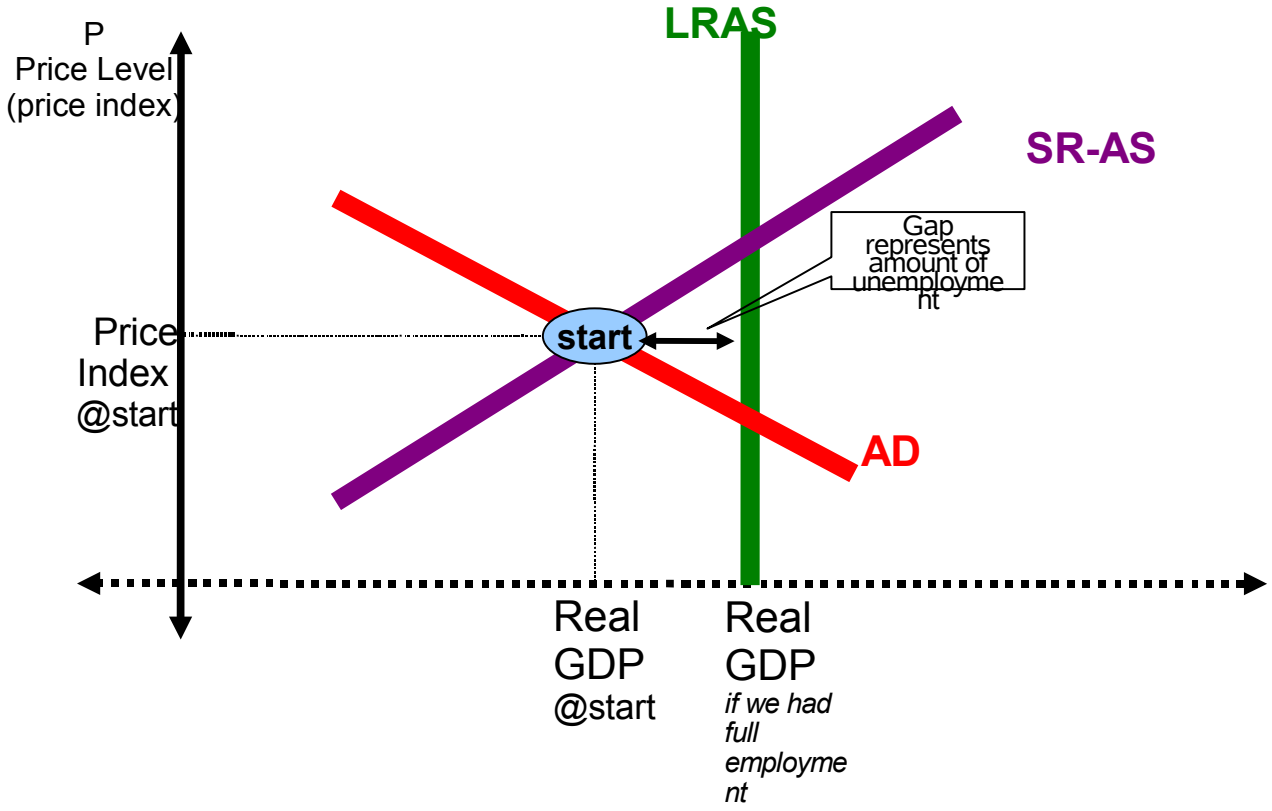
Financial markets may not reach equilibrium. S may exceed firm Borrowing (I).

Recessionary Gap: High unemployment

In a recessionary gap, there is high unemployment and a surplus of resources.

Classical theory says firms should lower wages & hire more workers. Firms should lower prices to sell the surplus, moving SRAS right.

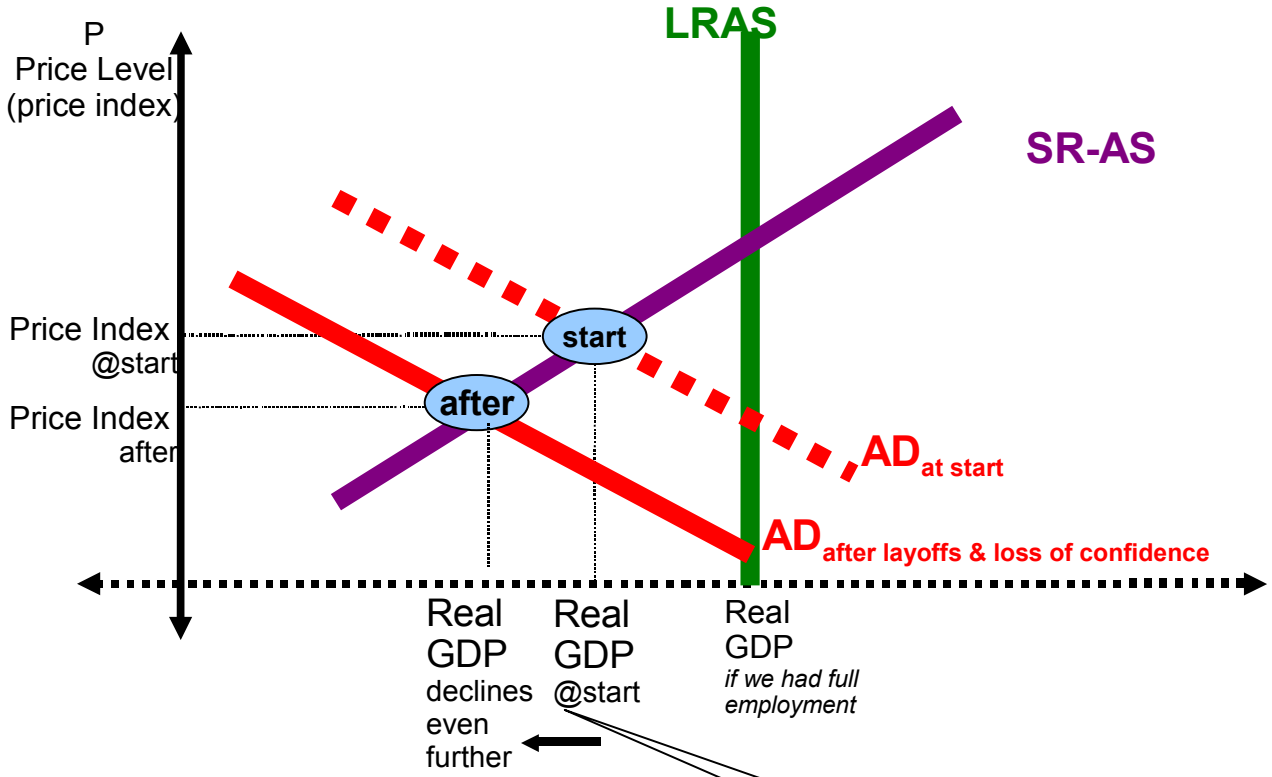
BUT, Keynes observes that wages are "sticky", instead of lowering wages, firms lay-off extra workers & keep prices the same – ***SRAS stays where it is.***



Recessionary Gap shifts AD

Since the SRAS stays where it is and firms lay-off workers, the recession deepens. Laid-off workers cut-back on their spending. Even employed workers get nervous about the future and begin to save more and spend less. Firms see low sales and stop Investing. Both C and I decline, lowering real GDP.

RESULT: AD shifts to the left, making the recessionary gap worse.



Real GDP declines further instead of recovering. The economy moves AWAY from full employment.

Conclusions from Keynesian Model - Recession

A modern industrial ***economy can get "stuck" in a long recession*** with very high unemployment. The economy will NOT automatically correct itself.

Note that this described The Great Depression rather well.

Conclusion: The economy gets stuck in a high-unemployment recession because firms and households become pessimistic about the future and reduce their spending. Savings replace Consumption, and firms refuse to Invest.

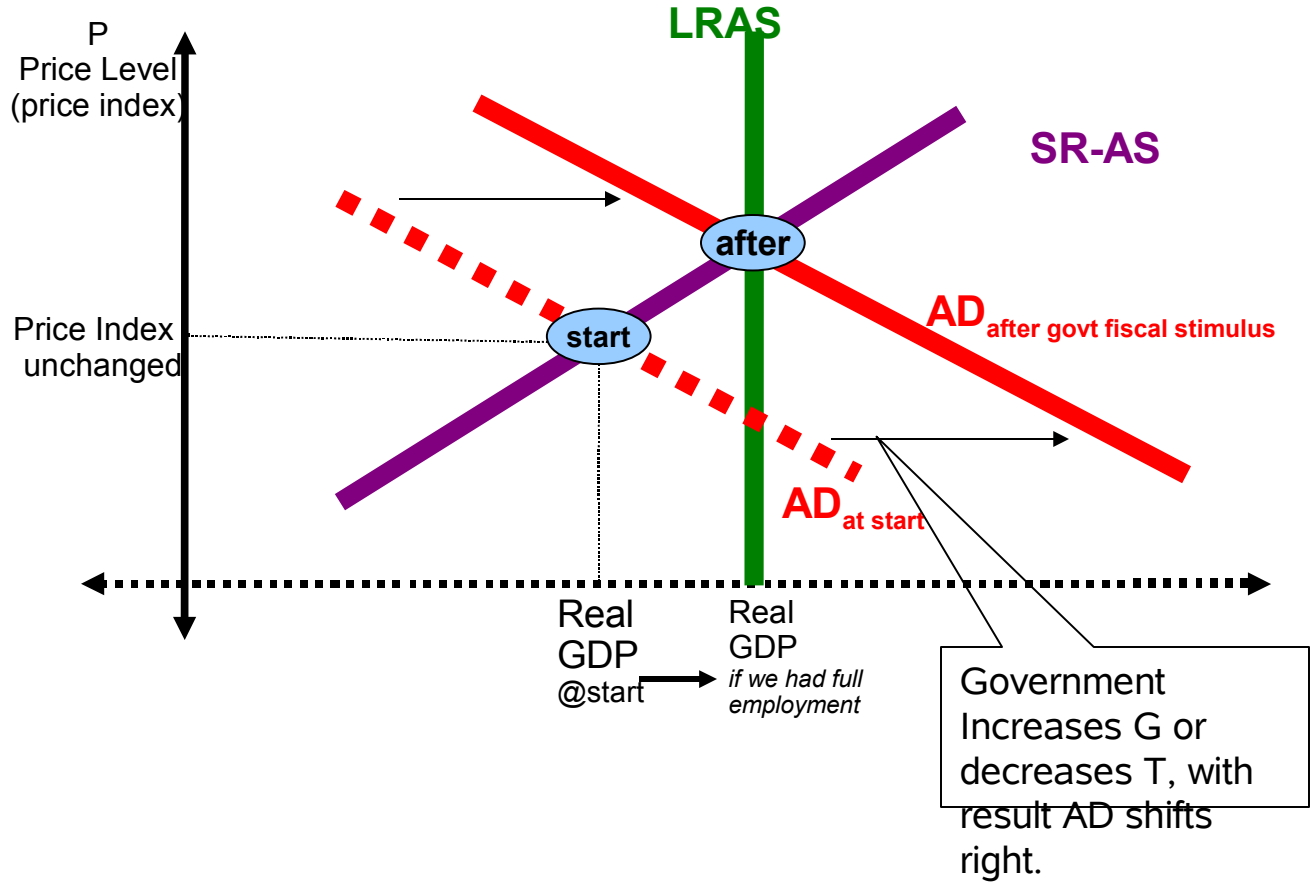
THE Rx: Government policy to "manage" Aggregate Demand.

Recessionary Gap: Keynesian Policy Rx

Keynes recommends Government offset the decline in C and I spending by either: Raising G spending, or cutting T taxes which causes households to spend more C.

Either way, AD shifts to the right, closing the recessionary gap.

Result::
- increase in Real GDP
- return to full employment.
- one-time increase in price level (inflation)

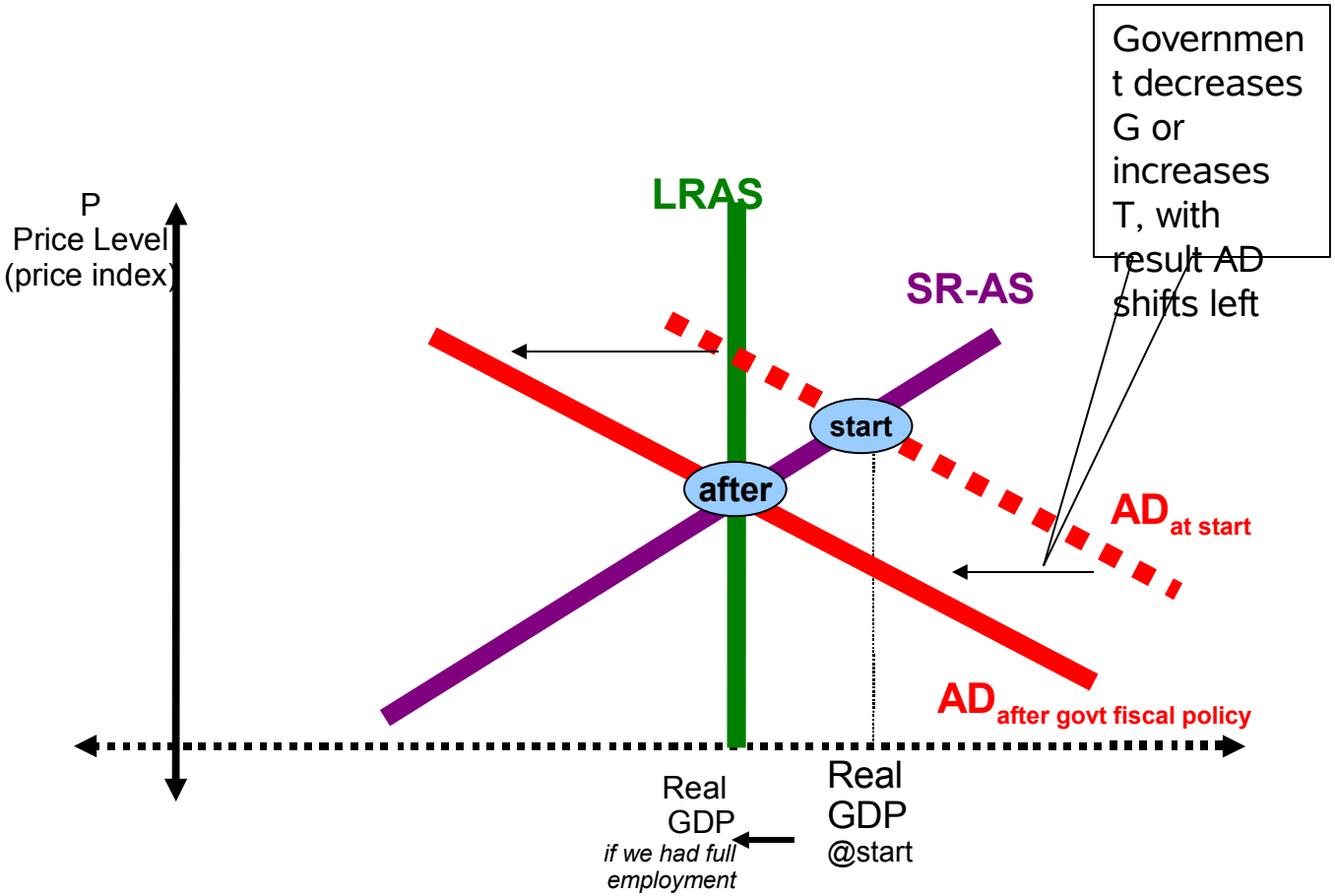


Inflationary Gap: Keynesian Policy Rx

Should an inflationary gap exist, Keynes recommends Government reduce AD (shift AD left) by either: Cutting G spending, or raising T taxes which causes households to spend less C.

Either way, AD shifts to the left, closing the inflationary gap.

Result::
- return to full employment.
- one-time decrease in price level (deflation)



Keynesian Model: Conclusion & Recommendations

The Keynesian model of a modern, complex industrial economy suggests that an economy will NOT automatically self-correct when in a recessionary or inflationary gap. Indeed, a long and deep recession with very high unemployment is very possible. Keynesians conclude that modern industrial market economies are inherently unstable.

Stability at full employment can be achieved though through counter-cyclical fiscal policy by the Government. In other words, the government should increase deficits in recessionary gaps and run budget surpluses in inflationary gaps. Government policy can achieve stable full employment.