Macro Lecture 14

Classicals and Keynesians

FULBRIGHT
Economics Teaching Program

"[…] public works even of doubtful utility may pay for themselves over and over again at a time of severe unemployment, if only from the diminished cost of relief expenditure, provided that we can assume that a smaller proportion of income is saved when unemployment is greater; but they may become a more doubtful proposition as a state of full employment is approached.

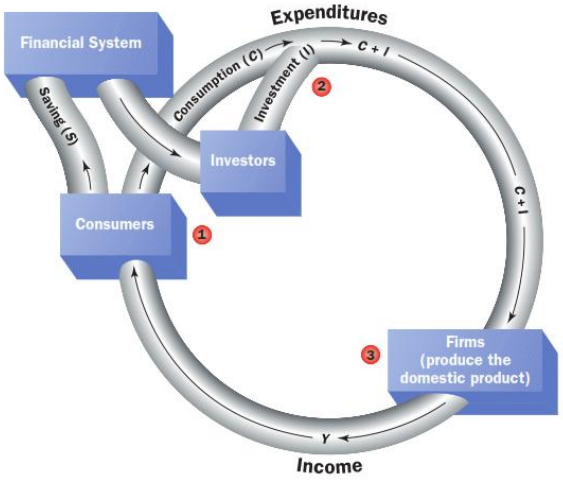
John Maynard Keynes

"[T]he basic flaw of Keynesianism is this: you have to ask where the government's money comes from in the first place. It can either tax, borrow, or print money. If the government taxes, then that's less money in people's pockets, so every dollar that the government spends is balanced by a dollar not spent somewhere else."

Classicals, New Classicals and Keynesians

Assumption	**Classical and New Classical**	**Keynesian**
Knowledge about the future	Perfect knowledge	Irreducible uncertainty
Investment	*Equal to saving, Say's Law*	Independent of saving, paradox of thrift
Interest rate	Natural rate	Liquidity preference
Consumption	Permanent income hypothesis	Multiplier
Asset prices	Efficient market hypothesis	Financial instability hypothesis
Asset bubbles	Impossible	Common
Money supply	Endogenous	Exogenous
Inflation	Cost-push and social conflict	Money growth

Simplified circular flow diagram



Corporate savings

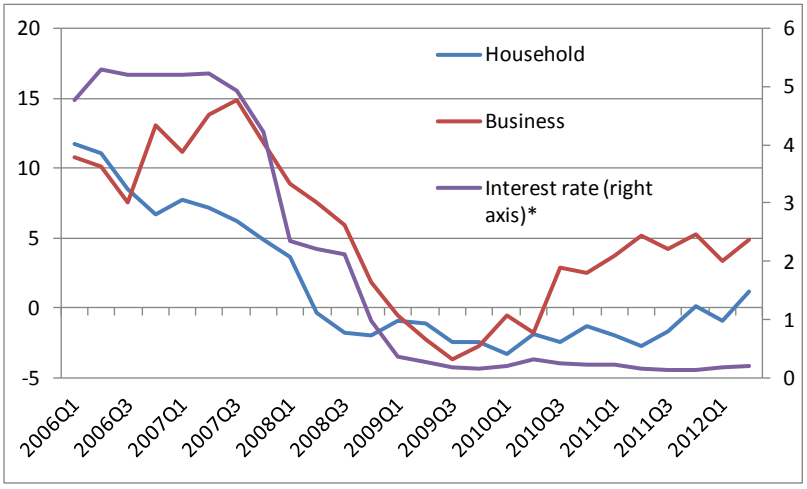
Dead money

Cash has been piling up on companies' balance-sheets since before the crisis

Nov 3rd 2012 | WASHINGTON, DC | from the print edition

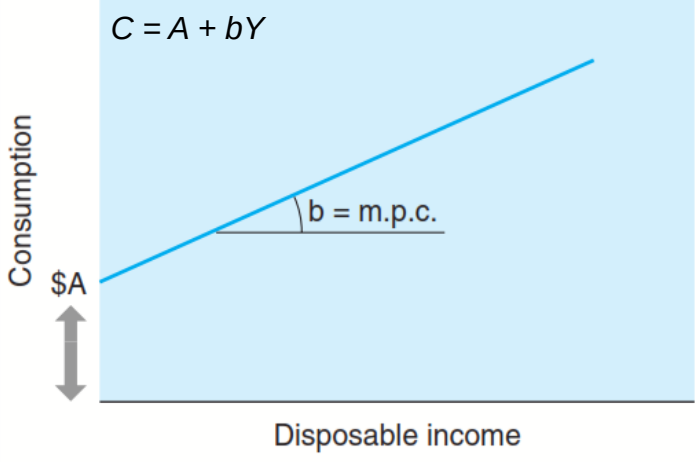
MONETARY stimulus gets you only so far. In America, third-quarter profits and revenues for companies in the S&P 500 index appear to have fallen year on year for the first time since 2009, according to Thomson Reuters. Profits for roughly half the firms in the European Stoxx 600 have fallen short of expectations so far.

Loan growth, US



Source: Federal Reserve. Interest rate refers to 3-mo commerical paper rate

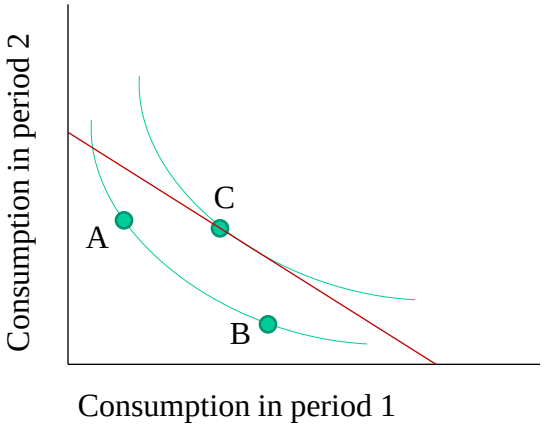
The consumption function and the marginal propensity to consume



The multiplier

- $Y = C + G + I$
- $Y = (A + bY) + G + I$
  - *A is the y intercept, or spending when disposable income is equal to zero.*
- $Y – bY = A + G + I$
- $Y(1-b) = A + G + I$
- $Y = (A + G + I)/(1-b)$
- The multiplier is $1/(1-b)$
  - For example, G increases by 100 and b=0.8
  - then Y increases by 500, not 100

Permanent income hypothesis



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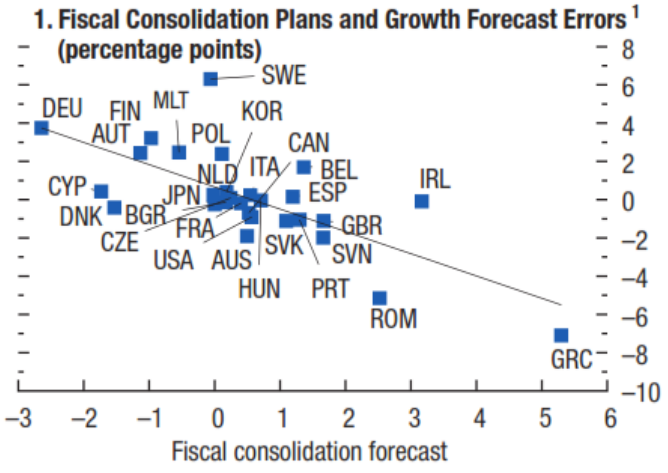
1. Fiscal Consolidation Plans and Growth Forecast Errors [1]
(percentage points)
SWE
DEU
FIN
MLT
KOR
AUT
POL
CAN
NLD
ITA
BEL
IRL
CYP
JPN
ESP
DNK
BGR
GBR
FRA
CZE
SVK
USA
AUS
SVN
HUN
PRT
ROM
GRC
8
6
4
2
0
−2
−4
−6
−8
−10
−3
−2
−1
0
1
2
3
4
5
6
Fiscal consolidation forecast