

Keynesian Economics: short run

Demand is central to model

Multiplier Effect

Equilibrium condition $Y = AD$. For a closed economy:

$$Y = C + I + G$$

Stabilization policy

Cuts and deficits (multiplier works both ways)

$$\frac{\partial Y}{\partial G}$$

Lags in policy implementation

Open economy

Permanent Income Hypothesis

Automatic stabilizers

Government budget constraint

Over long run:

Sum of revenues equals sum of gov expenditure:

$$T_1 + T_2 + T_3 + \dots = G_1 + G_2 + G_3 + \dots$$

Structural balance

Cyclical balance

Supply side economics

Tax rates affect incentives

Laffer Curve

Corporate tax rate in Ireland is a good example

Progressive/regressive

Tax base

Average/marginal tax rate

Example: Labour Hours in Europe

Transition to long run

Keynesian output effect; then prices move

The further you are from potential, the greater the price adjustment (like a spring)

Money-nonneutrality: we can see how money is nonneutral in short run, but neutral in long run

Example

Increase in money supply

First, output increases

Second, costs rise, inducing firms to raise prices

Third, as prices rise, output falls back to potential Y_n (and unemployment reverts to NAIRU)

Natural rate hypothesis

When $Y > Y_n$, P rises, and vice-versa

LRAS; $Y = AK^\alpha L^{1-\alpha}$.

For instance, a raise in NAIRU would shift line to left.

Supply is independent of price level (P not in production function)

AD curve:

- Real exchange rate
- Wealth effects
- Interest rate
- Intertemporal Substitution

Assume money growth and output growth are zero, so steady state inflation is zero

AD multiplier effect

Fiscal and Monetary policy shift AD curve, as does any other exogenous increase in demand; e.g., “animal spirits” raising investment demand.

SRAS or Price Curve: At the fixed price level, firms will supply as much as demanded