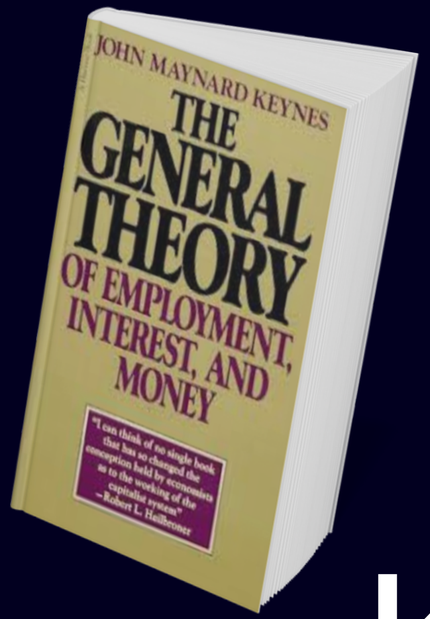
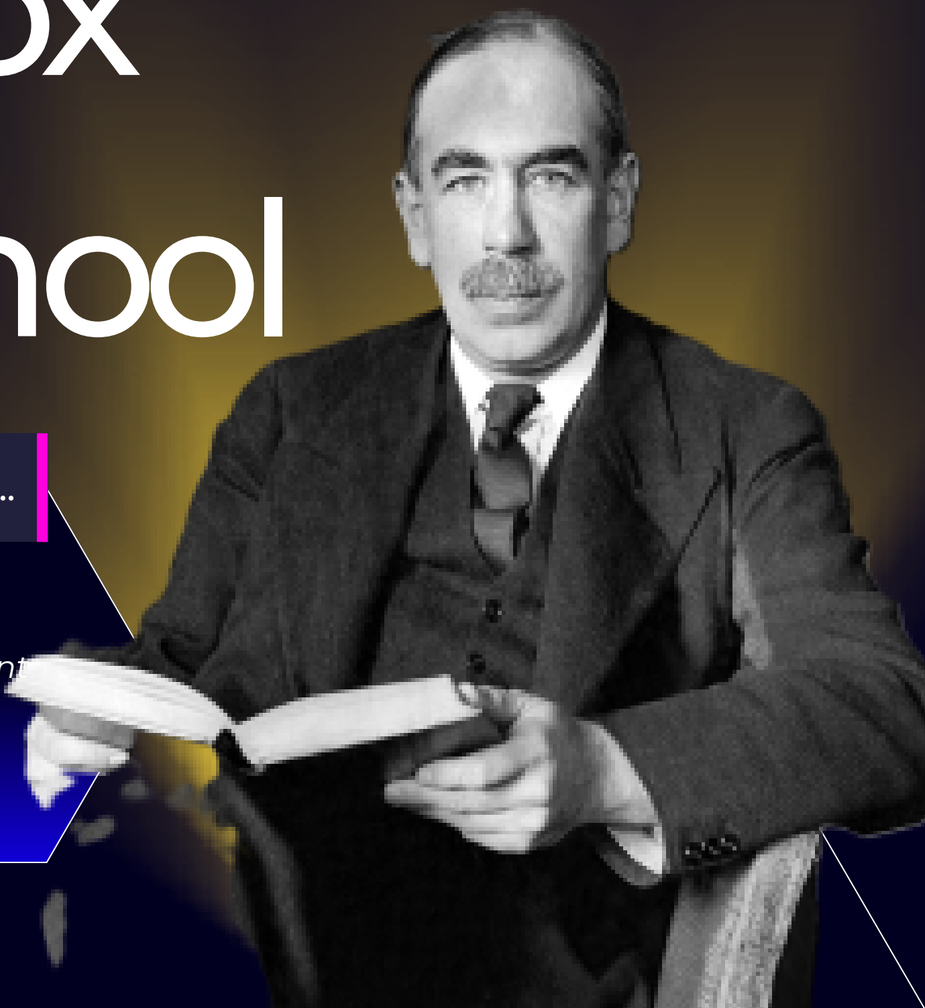


The orthodox Keynesian school



AND THEN WE GO TO ORTHODOX PART...

The Keynesian revolution was the most significant event in 20th-century economic science.
(Samuelson, 1988)

* Nurkyz, Valerie, Zhibek, Zhazira, Nazima

Zhibek

- The Orthodox Keynesian School
- After General Theory
- Keynes vs Classical debate
- Neoclassical synthesis

Role in Economics

- Classical → long run
- Keynesian → short run
- Focus: aggregate demand
- Dominant until 1970

Instability of Economy

- Economy is unstable
- Shocks affect investment
- Business confidence changes
- “Animal spirits”

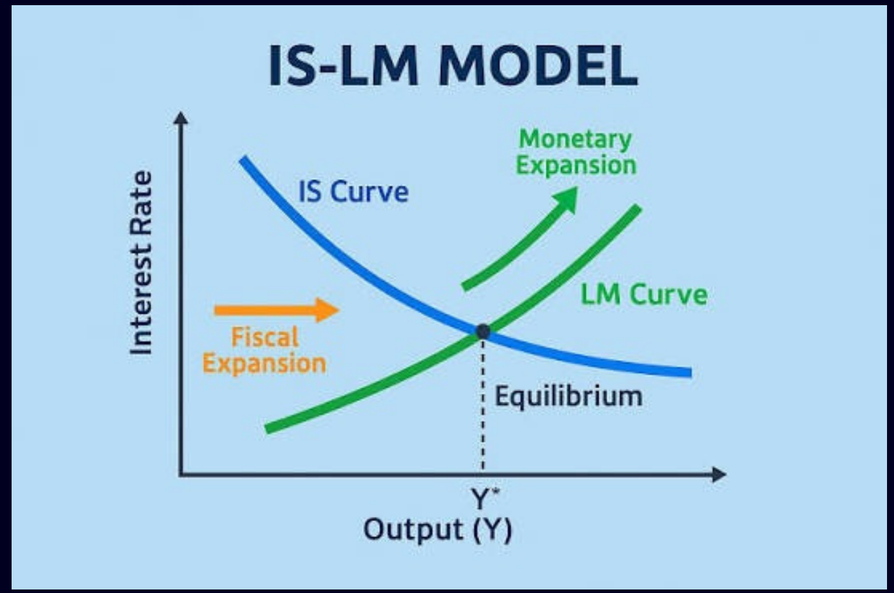
‘Animal spirits’, meaning expectations and emotions of investors.”

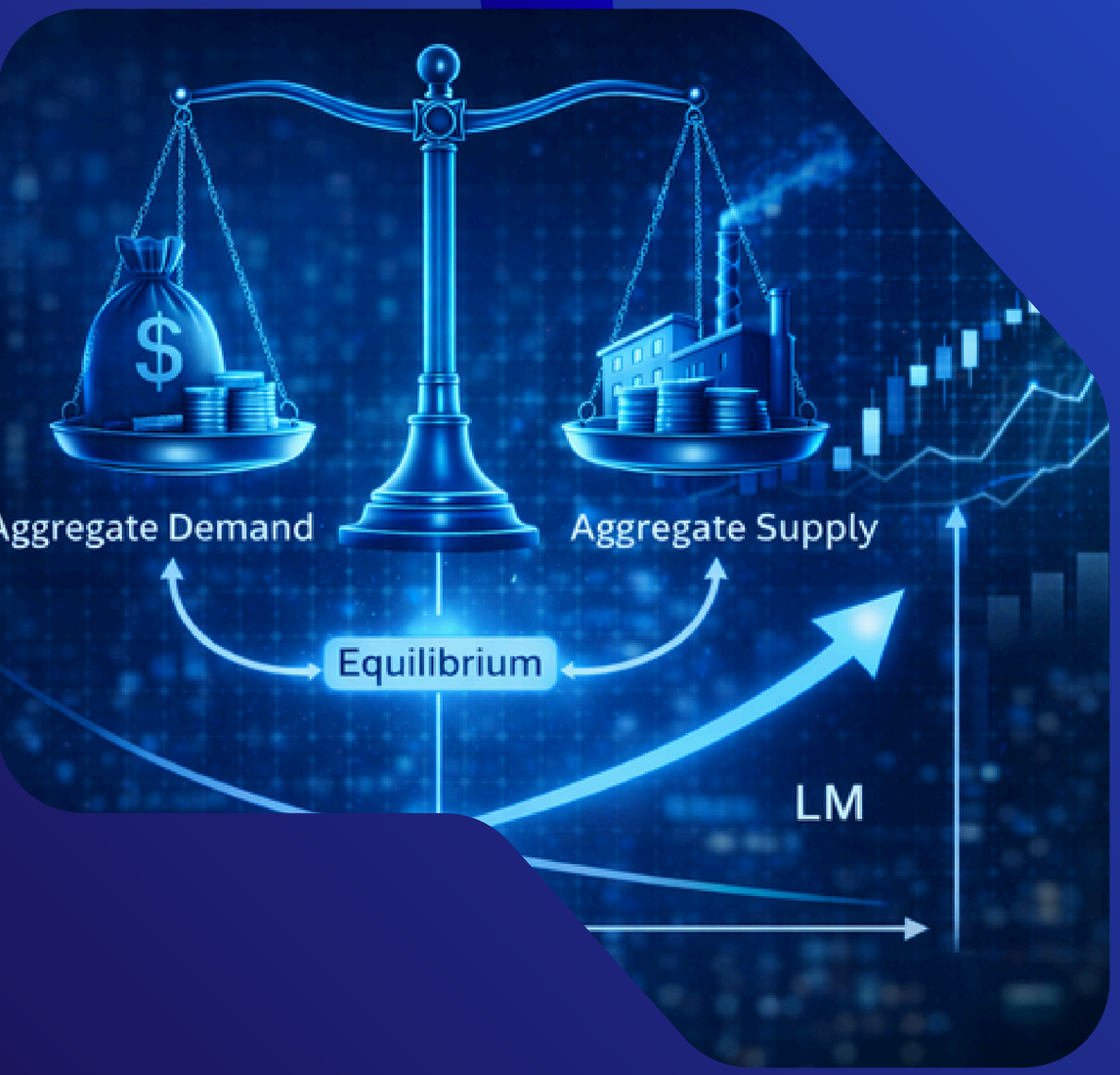
No Self-Correction

- Slow adjustment
- Long time to recover
- Not self-equilibrating
- Unemployment persists

Demand & Government

- Output = aggregate demand
- Government can influence demand
- Fiscal policy is preferred
- Direct and predictable effect
- Leads to IS–LM model

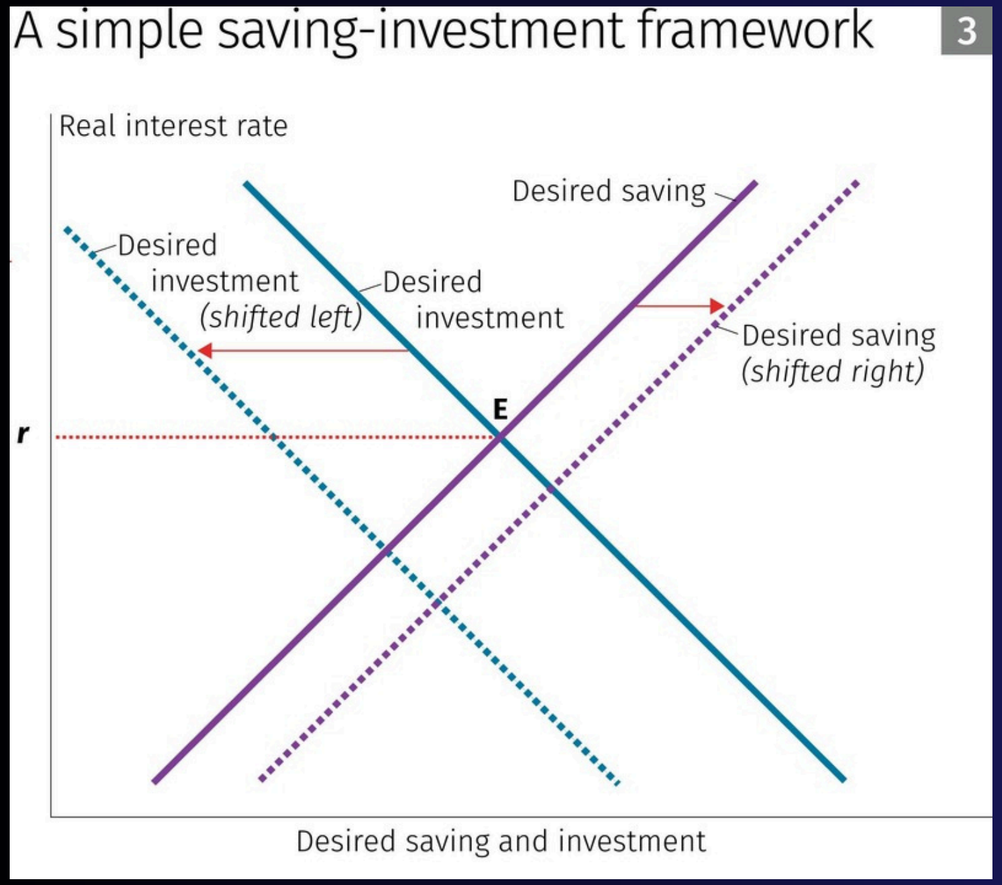




How is equilibrium formed in the economy?

IS–LM Model (Closed Economy)

- **Goods market (IS)**
- **Money market (LM)**
- **Equilibrium**



IS (Investment–Saving) represents equilibrium in the goods market.

It shows combinations of:

- interest rate (r)
- income (Y)

where investment equals saving.

The curve is downward sloping because:

lower interest rate → higher investment → higher income
higher interest rate → lower investment → lower income

LM (Liquidity–Money) represents equilibrium in the money market.

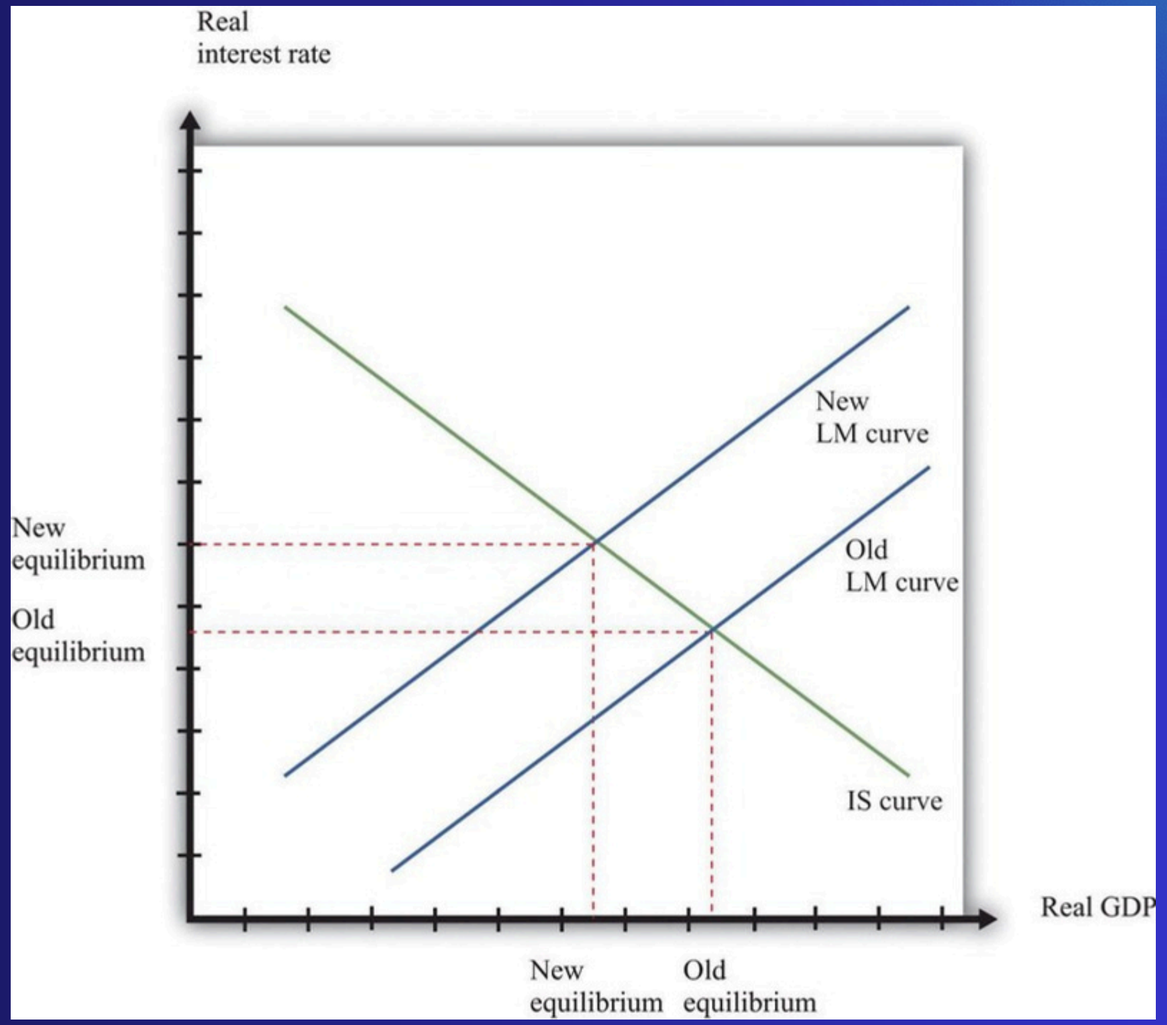
It shows combinations of:

- interest rate (r)
- income (Y)

where:
money demand equals money supply

The curve is upward sloping because:

higher income → higher demand for money → higher interest rate



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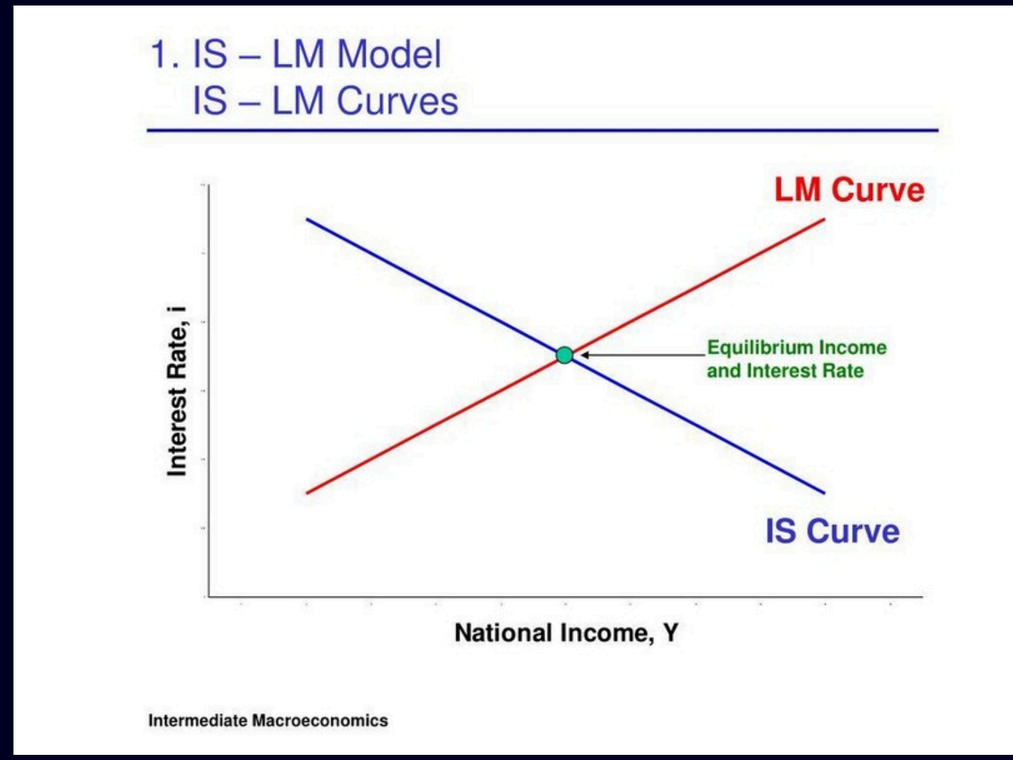
The intersection of IS and LM = general macroeconomic equilibrium

At this point:

1. Goods market is in equilibrium
2. Money market is in equilibrium

It determines:

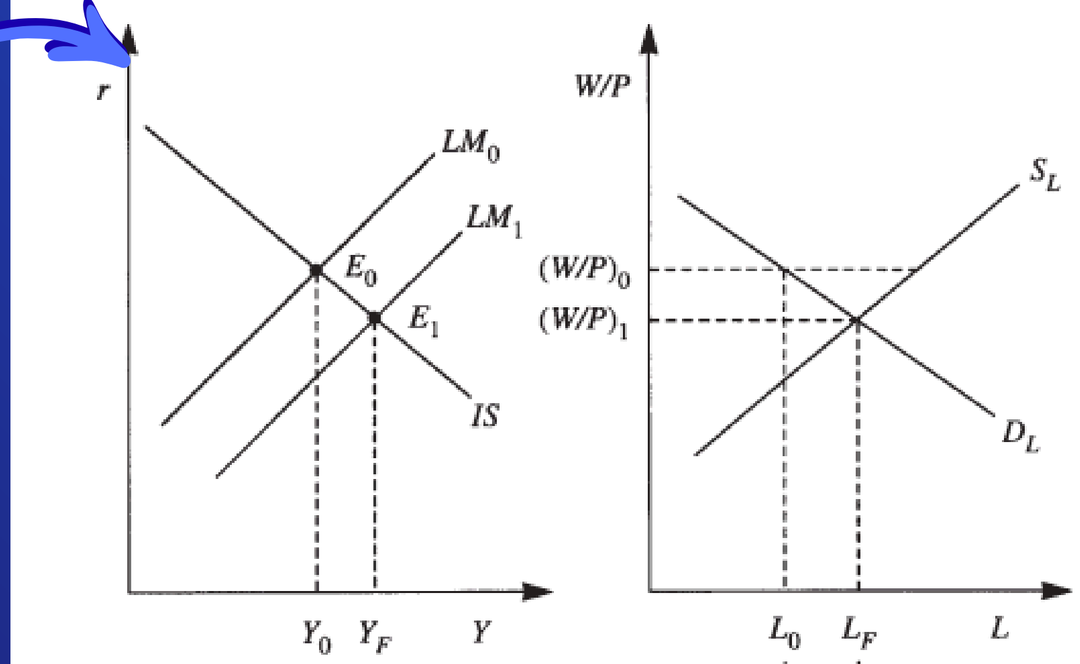
equilibrium income (Y*)
equilibrium interest rate (r*)



But does equilibrium always mean the economy is efficient?

3.4 Underemployment equilibrium in the Keynesian model

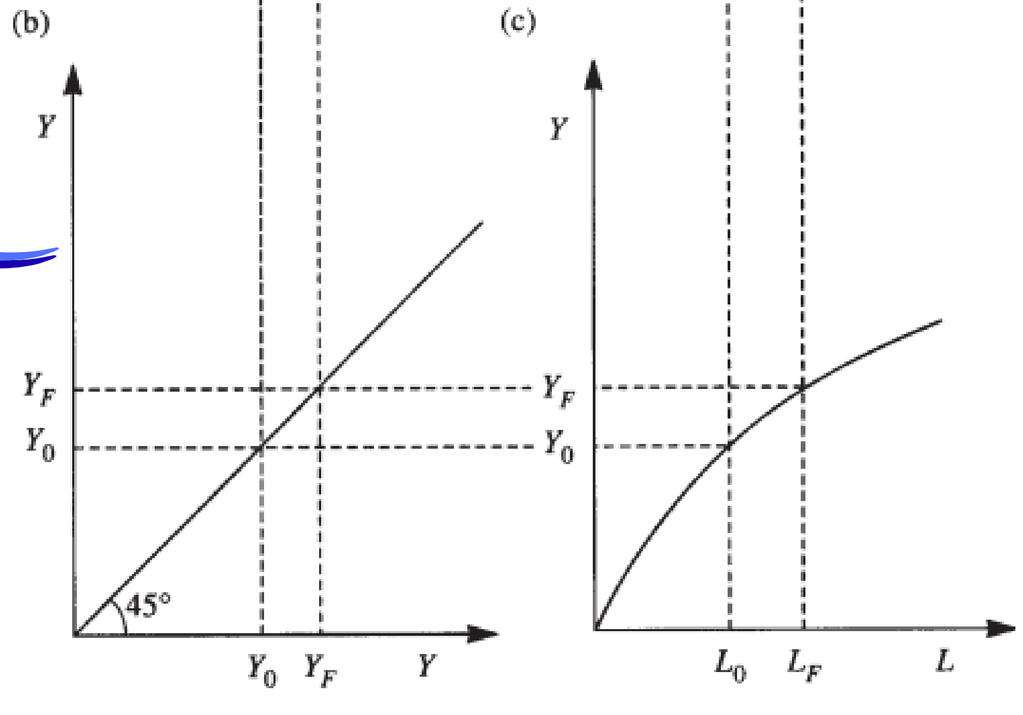
Standard IS-LM model



Labour market

the D/S of labour is neg/pos related to real wages (W/P)

Equality in incomes



Short-run production function

Level of <income(Y)> depends on level of <employment(L)>

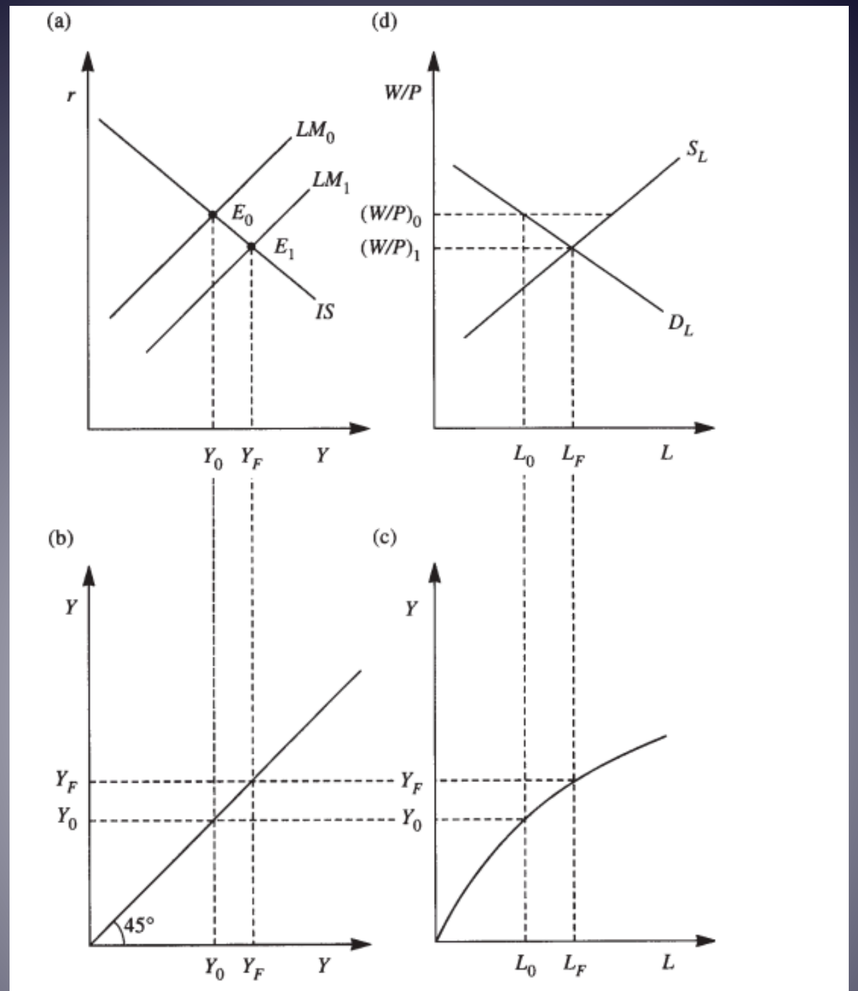


Figure 3.6 The general case with the Keynes effect

Underemployment Equilibrium with Wage Rigidity

Underemployment Equilibrium	Equilibrium where (Y < Y_F) and (L < L_F)	Persistent unemployment despite equilibrium in goods and money markets
Wage Rigidity	Money wages do not fall in response to excess labour supply	Prevents labour market from clearing

The Keynes effect

Falling P → Increase in M(real) → Lower r → Higher Investment → Higher Y and L

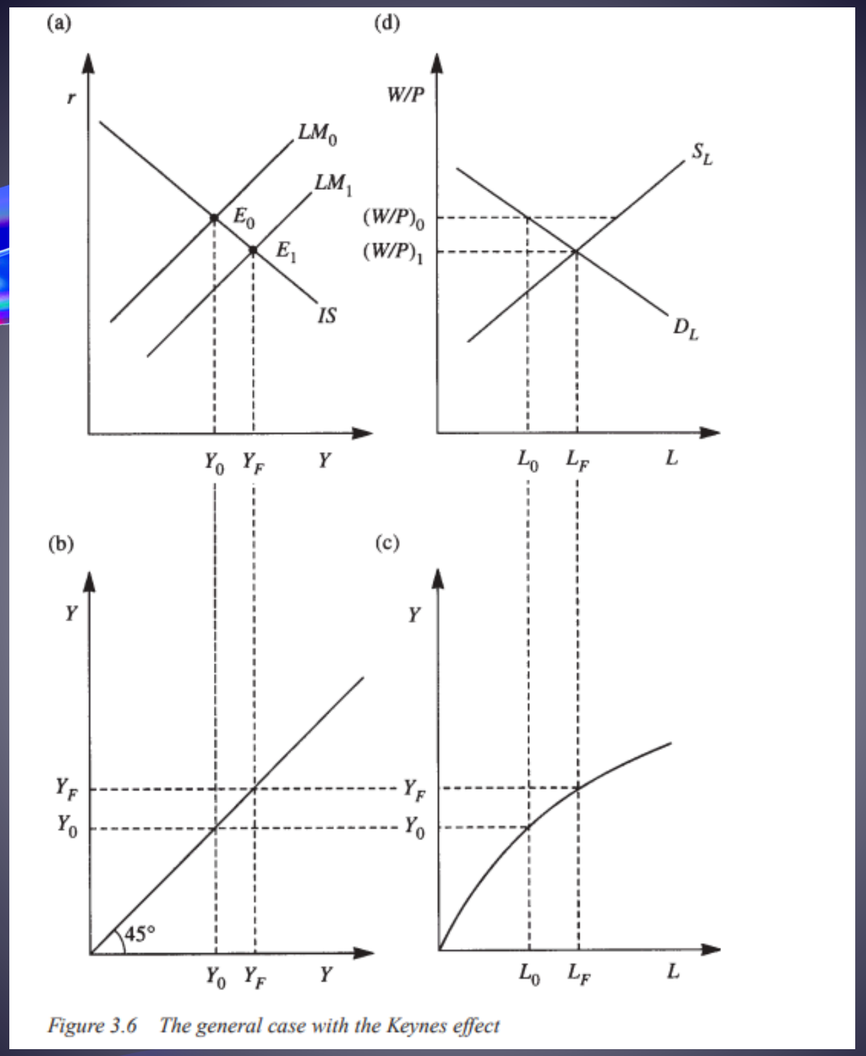


Figure 3.6 The general case with the Keynes effect

IIt is this increase in aggregate demand that ensures the restoration of full employment in the classical case of flexible wages and prices

(prices and money wages are perfectly flexible)

Two special cases

The liquidity trap case

Liquidity Trap	Demand for money is **perfectly elastic** at the interest rate **r***.	Additional real balances are held as **idle or speculative balances** instead of being invested in bonds.	**Interest rate does not fall**, remaining at **r***.
Failure of the Keynes Effect	The interest rate cannot decline to $\mathbf{r_1}$.	Investment does not increase because borrowing costs remain unchanged.	**Aggregate demand does not rise**.
Balanced Deflation	Prices and money wages fall proportionately.	Real wage $\mathbf{(W/P)_0}$ remains unchanged and above equilibrium $\mathbf{(W/P)_1}$.	Labour market does not clear.
Persistent Underemployment Equilibrium	Output and employment remain below full-employment levels.	Insufficient aggregate demand.	**Involuntary unemployment persists**.
Effectiveness of Monetary Policy	Central bank increases money supply.	Ineffective in reducing interest rates within the liquidity trap.	**Monetary policy becomes impotent**.
Effectiveness of Fiscal Policy	Government increases spending or reduces taxes.	Directly shifts the **IS curve to the right**.	**Fiscal policy becomes all-powerful** in restoring full employment.

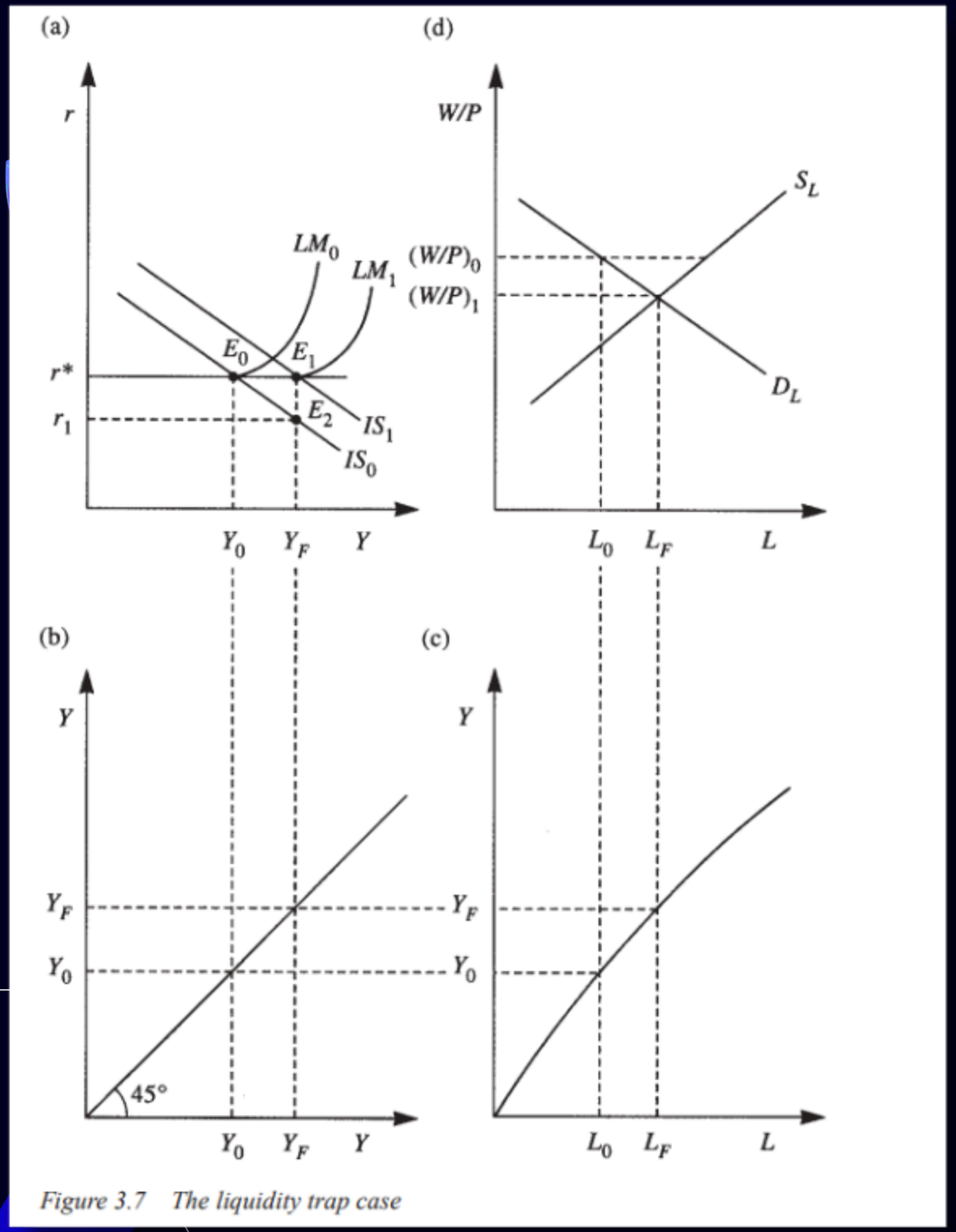


Figure 3.7 The liquidity trap case

The interest- inelastic investment case

Concept	Description	Economic Mechanism	Implication for the Economy
Initial Equilibrium (E_0)	The economy starts at the intersection of **IS_0** and **LM_0**.	Goods and money markets are in equilibrium.	Income **Y_0** is below full-employment income **Y_F**.
Underemployment	Employment **L_0** is below **L_F**.	Real wage **$(W/P)_0$** exceeds the market-clearing level **$(W/P)_2$**.	Persistent involuntary unemployment.
Excess Supply of Labour	Surplus labour leads to falling **money wages (W)** and **prices (P)**.	Firms' costs decline, initiating the **Keynes effect**.	Real money balances **(M/P)** increase.
Shift of the LM Curve	Increased real balances shift **$LM_0 \rightarrow LM_1$**.	Interest rate **r** declines.	Normally stimulates investment.
Interest-Inelastic Investment	Investment is weakly responsive to changes in the interest rate.	Even significant reductions in **r** produce little or no increase in investment.	Aggregate demand remains insufficient.
Need for Negative Interest Rate	Full employment would require a negative interest rate **r_1**.	Such a rate is generally infeasible in practice.	Economy settles at **E_1** with **$Y_1 < Y\_F$**.
Underemployment Equilibrium	The economy stabilizes at a level below full employment.	Insufficient aggregate demand persists.	Continued involuntary unemployment.
Policy Implication	Monetary policy alone is ineffective.	Expansionary fiscal policy is required.	Government spending or tax cuts can restore full employment.

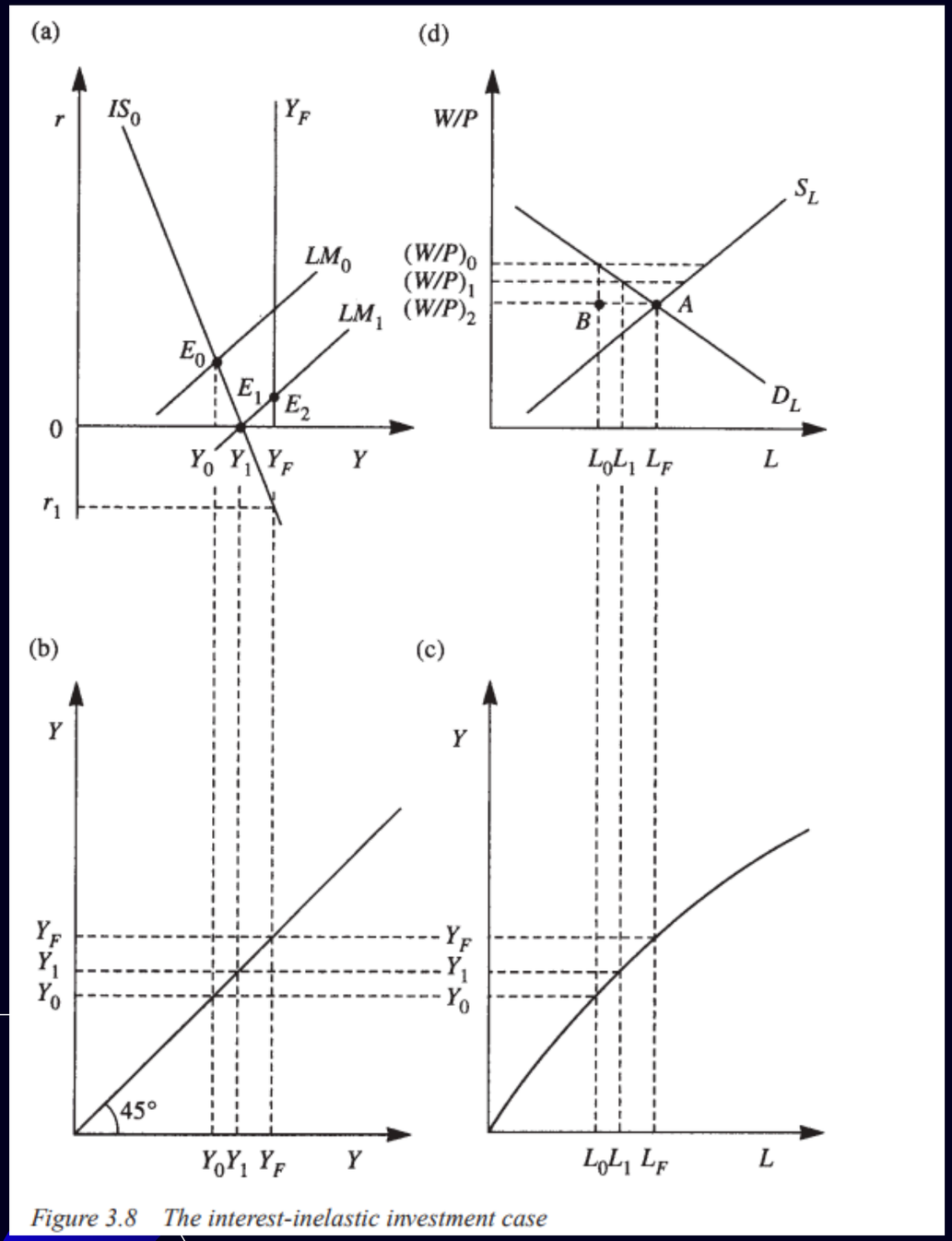


Figure 3.8 The interest-inelastic investment case

The Pigou Effect

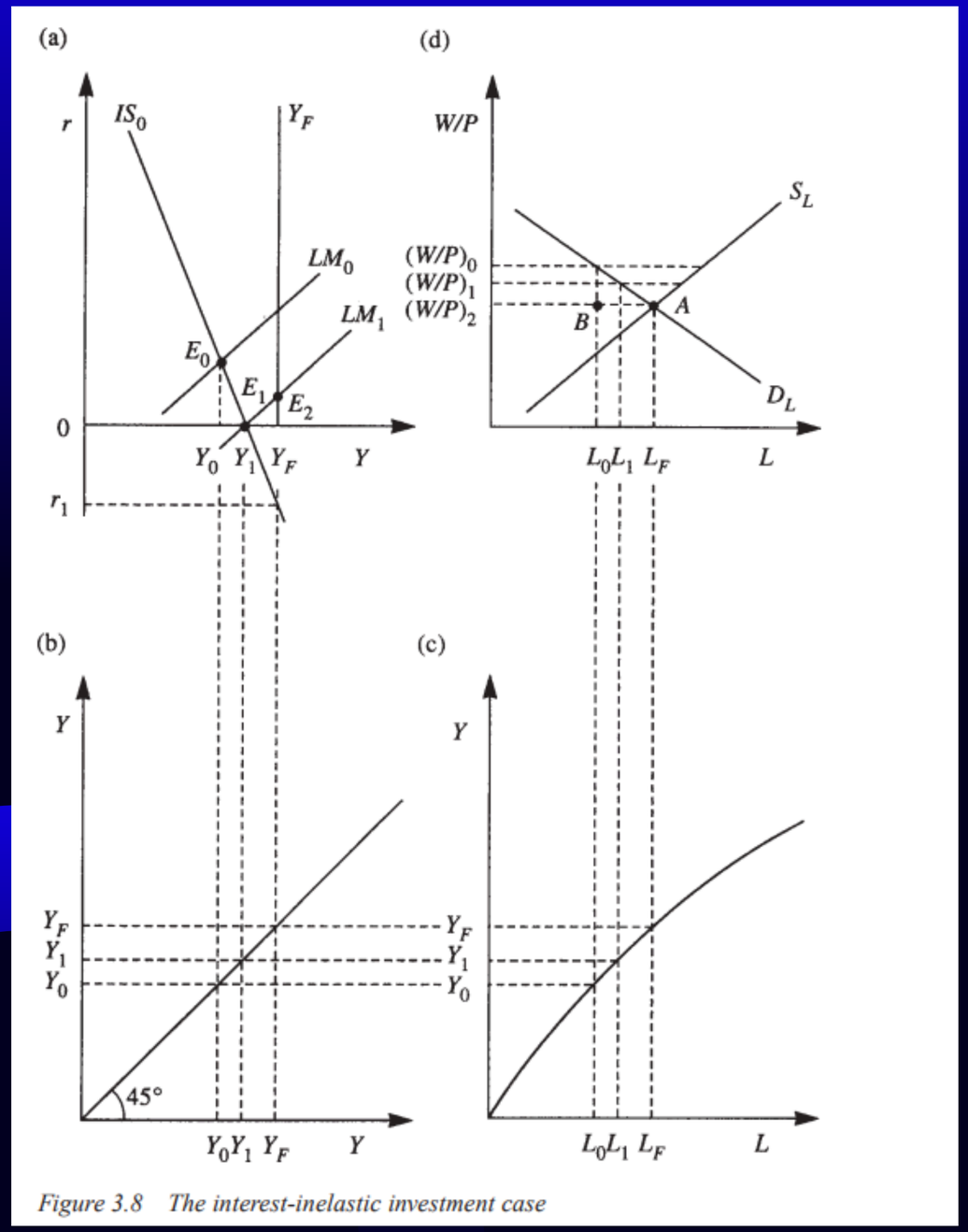


Figure 3.8 The interest-inelastic investment case

Falling prices → Higher real wealth → Increased consumption → Higher output and employment.

The Pigou Effect states that a fall in the price level increases the real value of money holdings, which boosts consumption and aggregate demand, helping to restore full employment.

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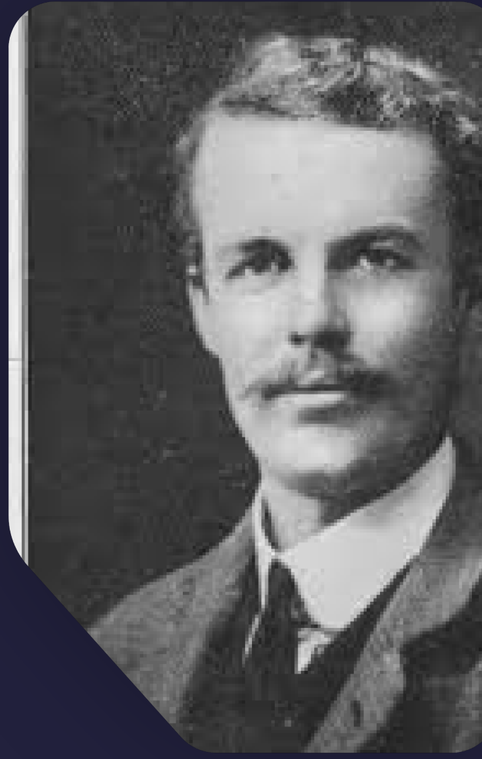
The neoclassical synthesis



is a consensus (1950-60s) combining classical long-run principles with Keynesian short-run policy prescriptions.

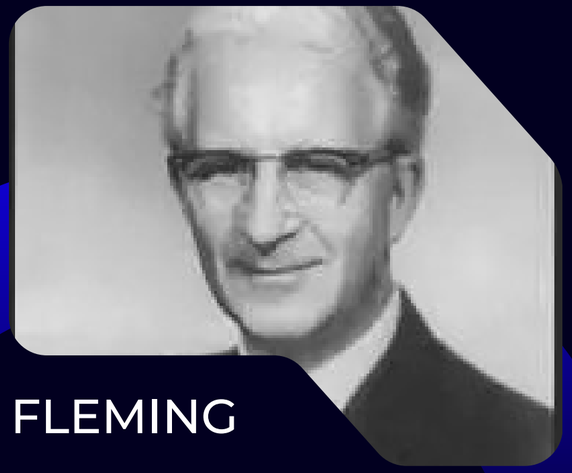
The neoclassical synthesis integrates classical long-run self-adjustment with Keynesian short-run stabilization policies, viewing Keynes's General Theory as a special case of the broader classical framework.

ROBERT MUNDELL

THE IS–LM MODEL

for an Open Economy

The effects of a change in fiscal and monetary policy depend on the degree of capital mobility and the type of exchange rate regime in existence



MARCUS FLEMING

The IS curve

goods market

$$Y = C + I + G + (X - M)$$

consumption - C
investment - I
government spending - G
export / import - X/M

The LM curve

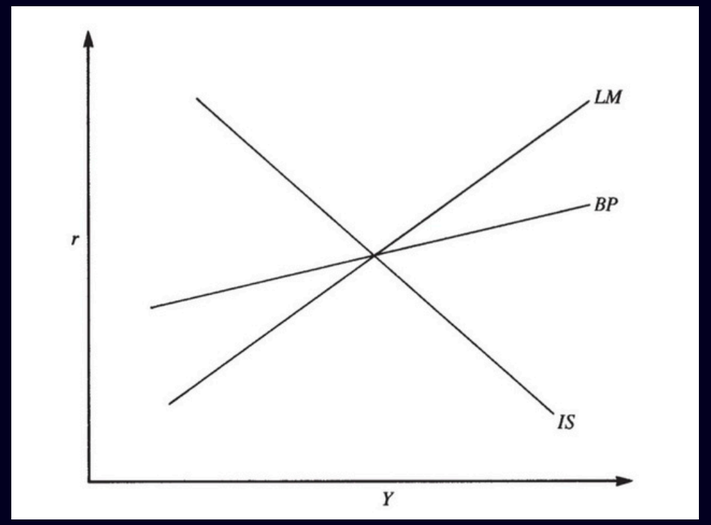
money market

Fixed exchange rate
Flexible exchange rate

The BP curve

BP - balance of payments

Current Account: Export / Import
Capital Account: Capital movement

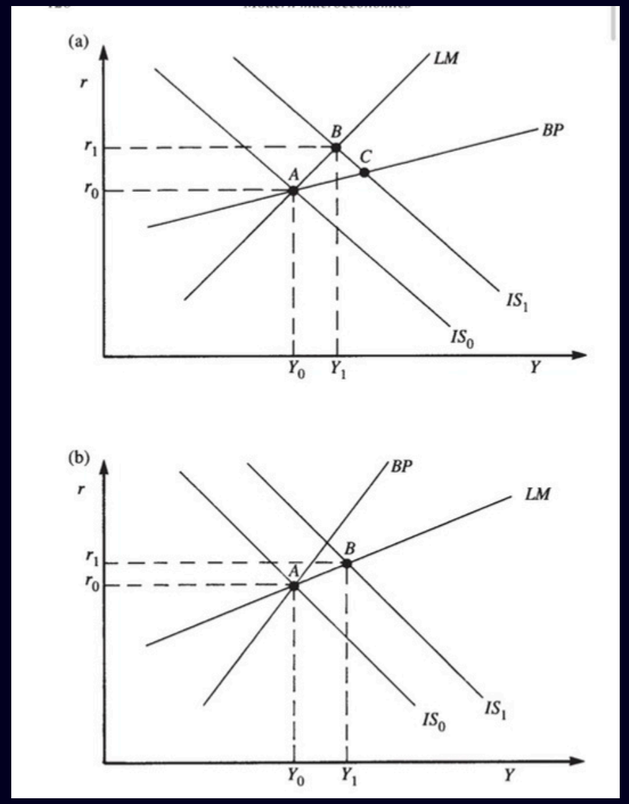


THE MUNDELL - FLEMING / KEYNESIAN MODEL

THE COMPLETE MODEL

Fixed exchange rate regime

The effects of fiscal expansion

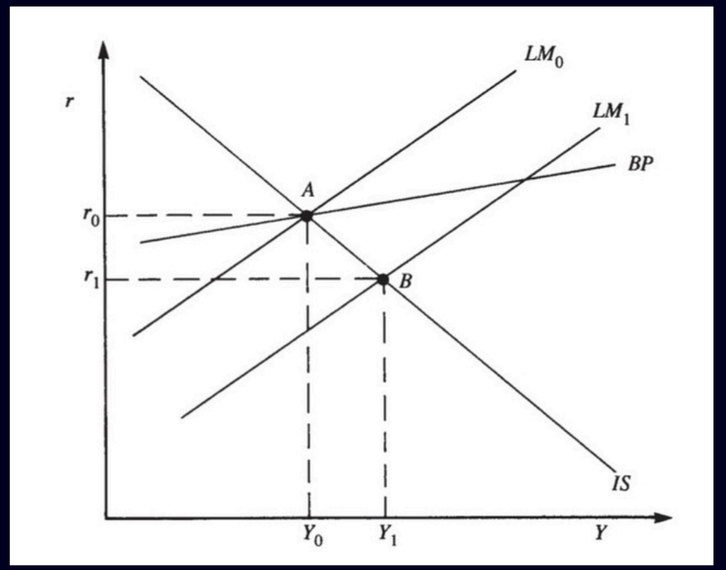


Surplus

Deficit

The effects of monetary expansion

Always deficit



THE COMPLETE MODEL

Flexible exchange rate regime

DEFICIT → CURRENCY FALLS → EXPORTS RISE
SURPLUS → CURRENCY RISES → EXPORTS FALL

MONETARY POLICY → STRONG
FISCAL POLICY → UNSTABLE

Capital mobility

The currency itself changes under the influence of supply and demand

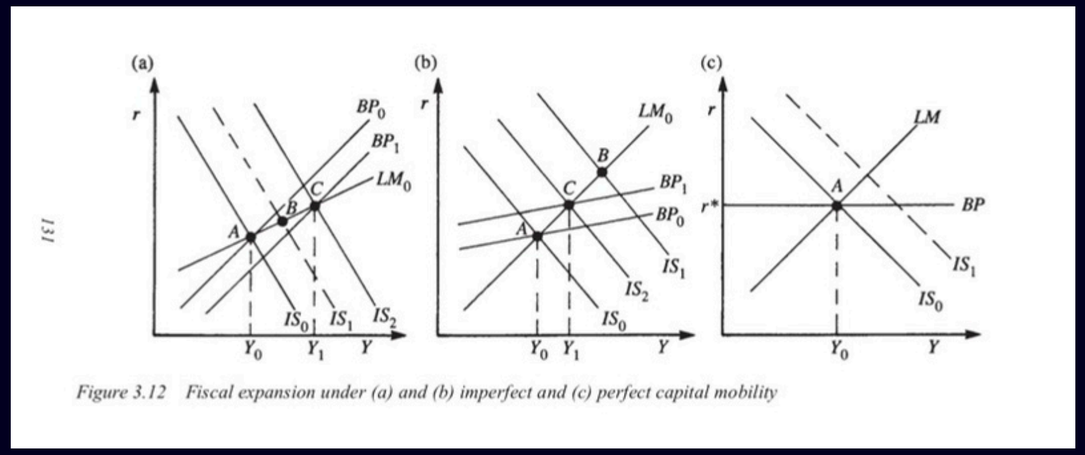


Figure 3.12 Fiscal expansion under (a) and (b) imperfect and (c) perfect capital mobility

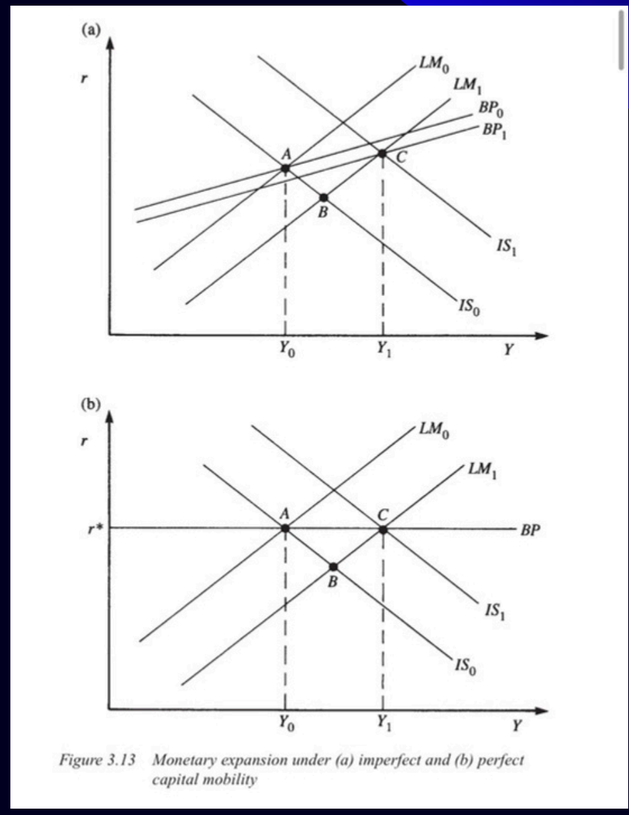
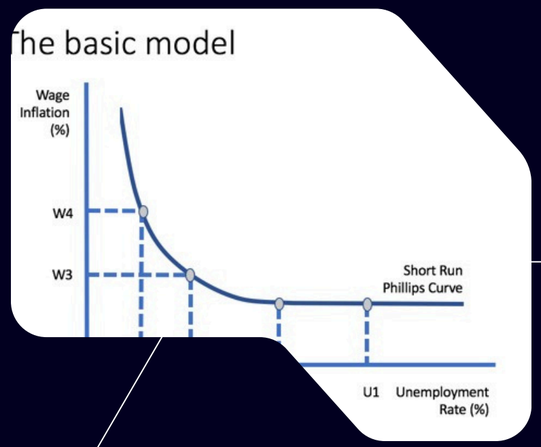
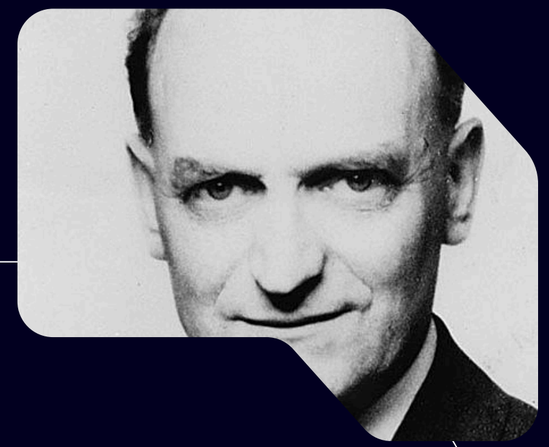


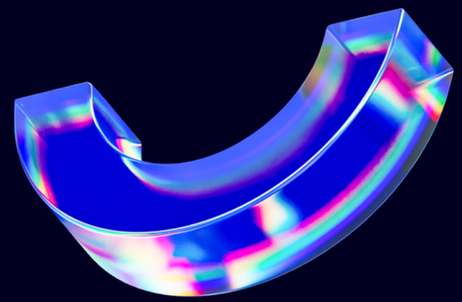
Figure 3.13 Monetary expansion under (a) imperfect and (b) perfect capital mobility

The Phillips Curve and Orthodox Keynesian Economics





The Phillips Curve



Irving Fisher in 1926

A.W. Phillips 1958

Richard Lipsey 1960

Hansen 1970

The first statistical investigation of the link between unemployment and inflation was done by Irving Fisher in 1926. However, the curve we know today was named after A.W. Phillips, He looked at unemployment (U) and the rate of change of money wages ($\dot{W}$). His key finding: the relationship is non-linear and inverse — a downward-sloping curve.

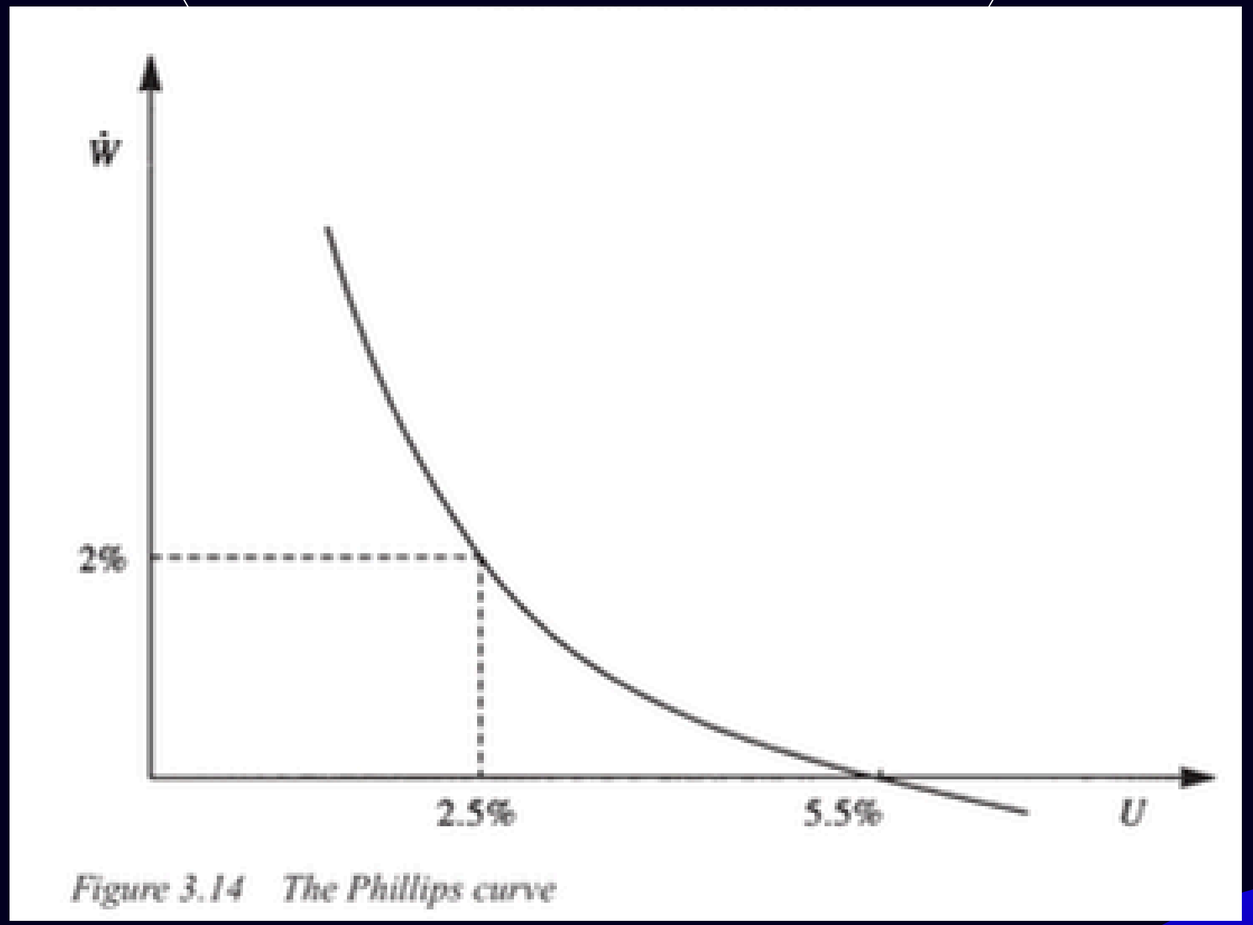
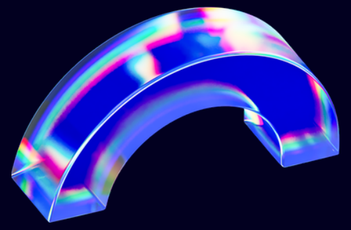


Figure 3.14 The Phillips curve

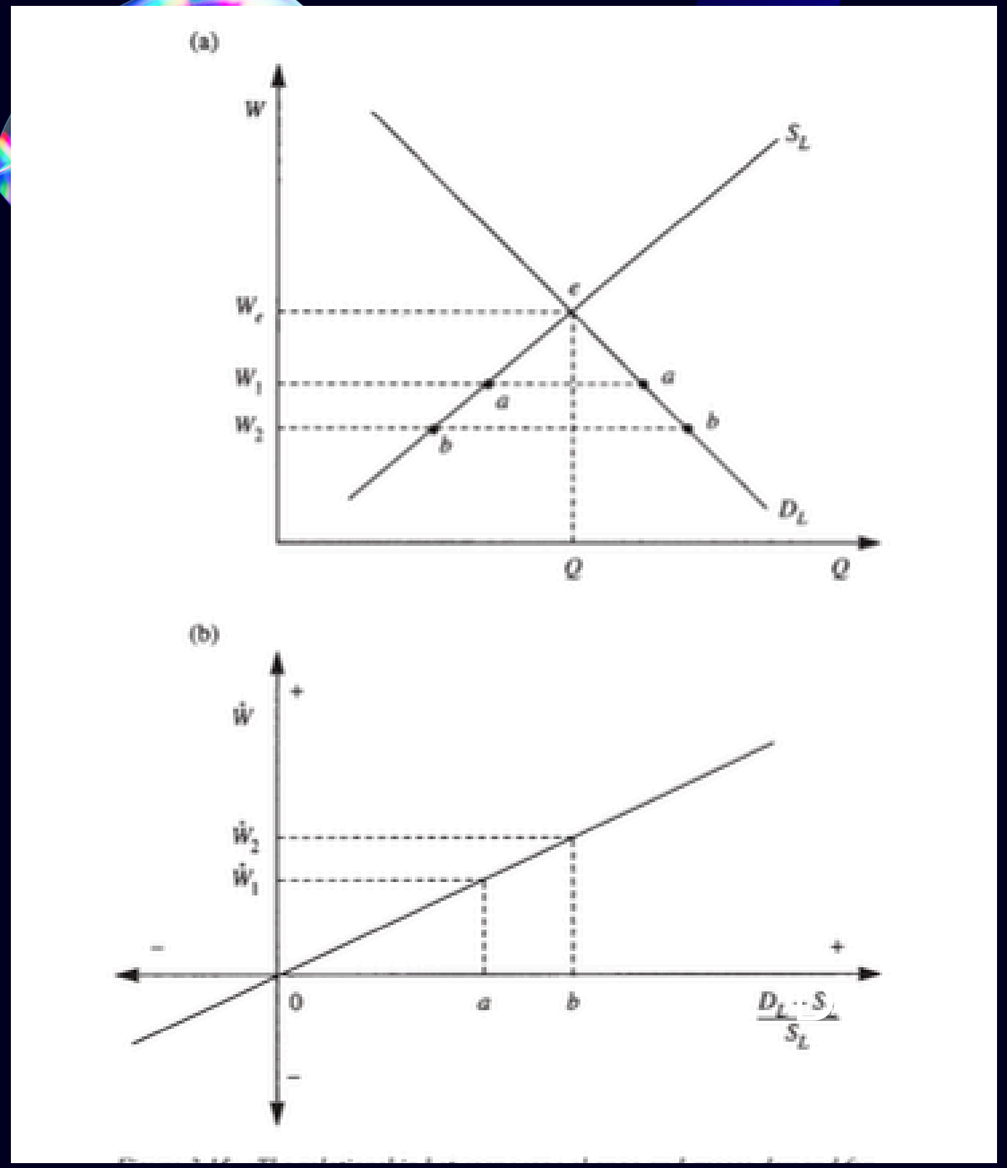
5.5% UNEMPLOYMENT, WAGE INFLATION IS ZERO.

AT 2.5% UNEMPLOYMENT, WAGE INFLATION RISES TO 2%.



This non-linear shape shows that reducing unemployment becomes increasingly inflationary.

Lipsey's theoretical explanation



1. a positive linear relationship between the rate of growth of nominal wages and excess demand for labour (XL);

$$\dot{W} = \alpha(X_L) = \alpha[(D_L - S_L)/S_L]$$

$$X_L = \beta(U)$$

2. a negative non-linear relationship between excess demand for labour and the unemployment rate.

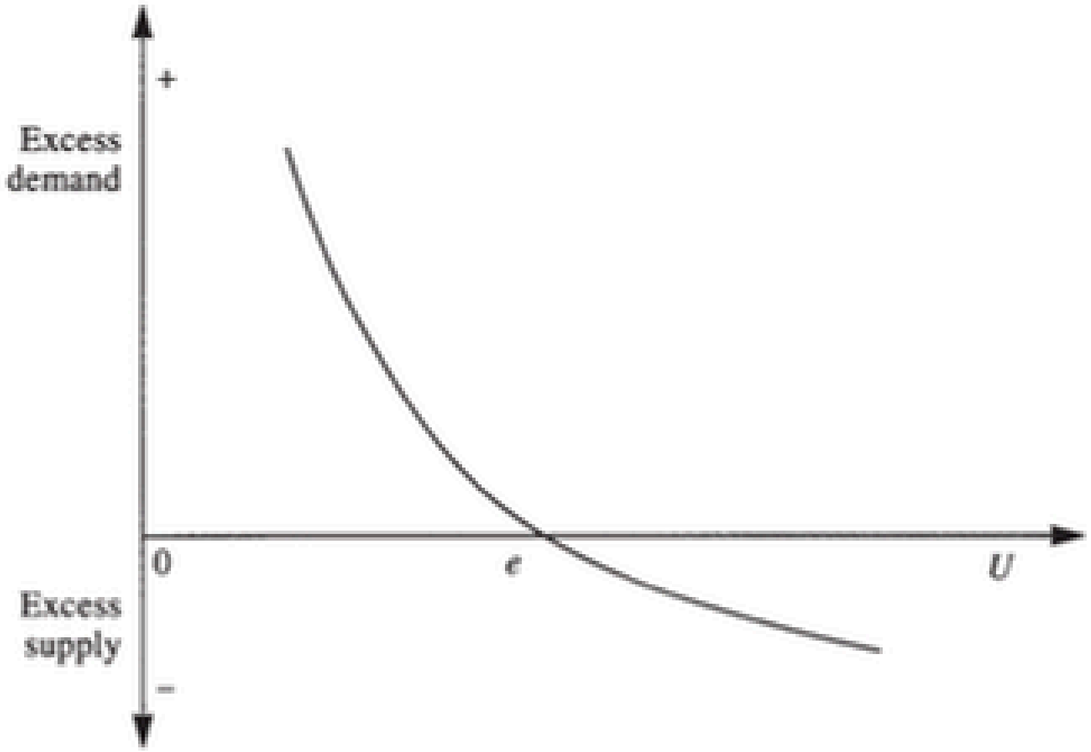


Figure 3.16 The relationship between excess demand for labour and unemployment

even when the labour market is in equilibrium — no excess demand, no excess supply — unemployment is not zero.

Hansen's refinement & shifts

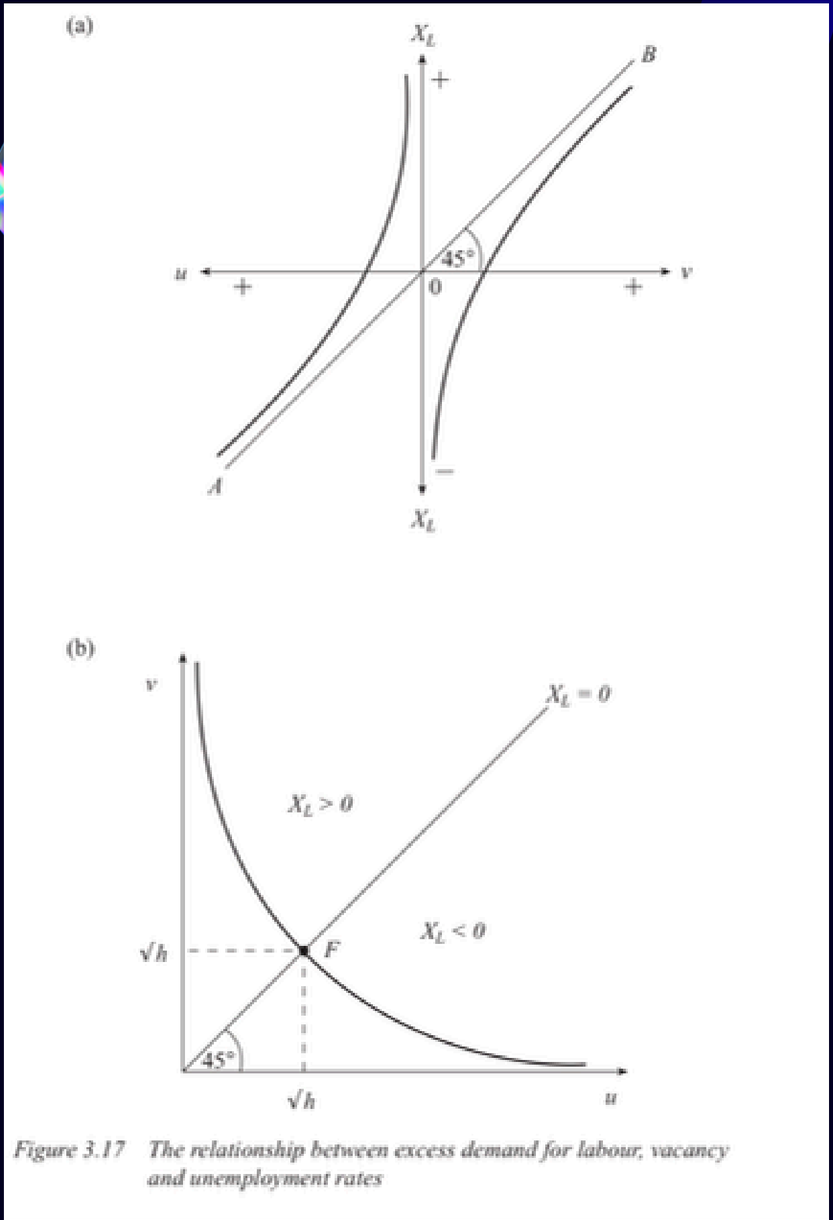


Figure 3.17 The relationship between excess demand for labour, vacancy and unemployment rates

If vacancies exceed unemployment (v > u), there is excess demand, and wages increase.

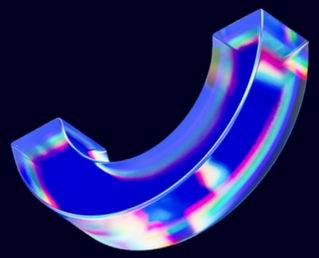
$h = vu$

$XL = v - u$

If unemployment exceeds vacancies (u > v), excess demand is negative, and wage growth slows down.

Given Hansen's refinements, the Phillips relationship can be expressed in the following form:

$$\dot{W} = \alpha(h/u - u) + w^* = \alpha h/u - \alpha u + w^*$$



Link to IS-LM

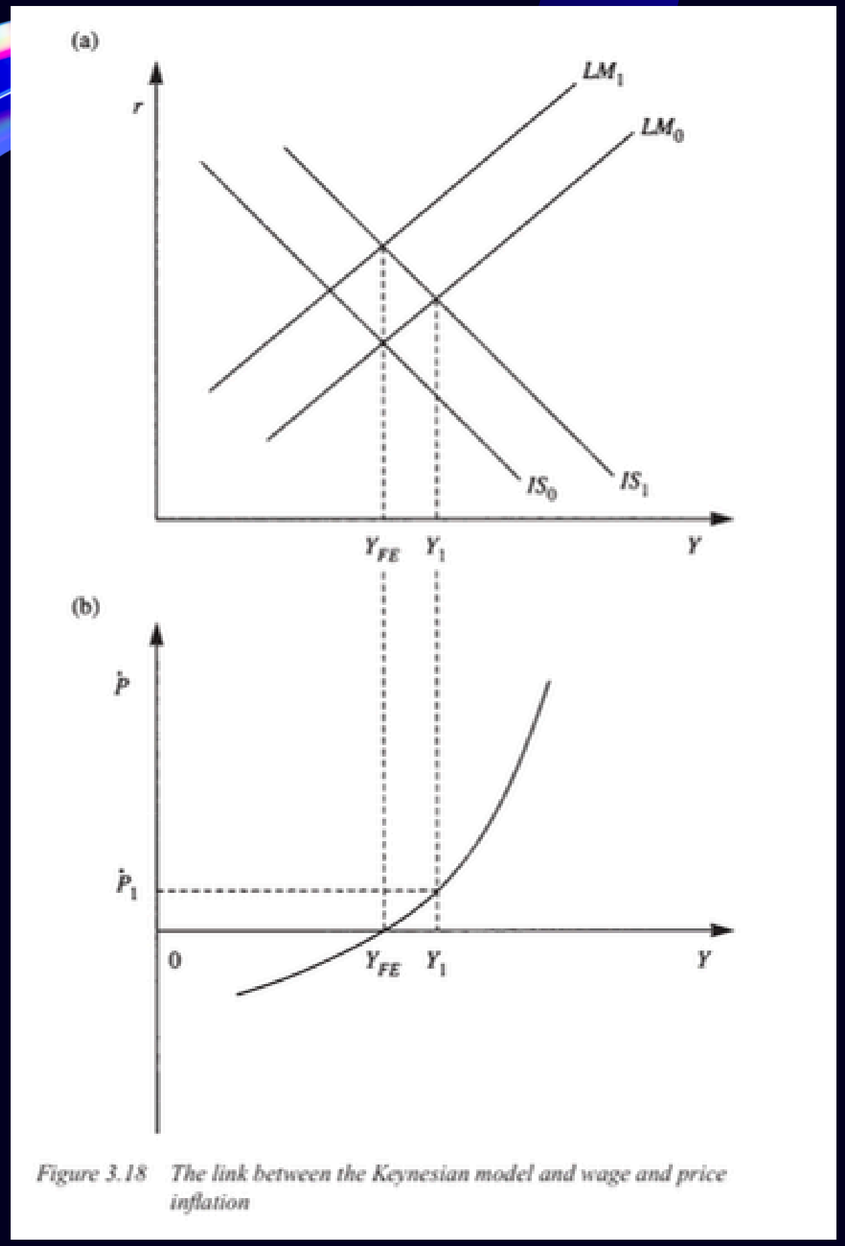


Figure 3.18 The link between the Keynesian model and wage and price inflation

Panel (a) — IS-LM: Shows equilibrium in the economy. Point Y_FE represents the full-employment level of output.

Panel (b) — Phillips Curve: Shows the relationship between the level of output (Y) and the rate of inflation (Ṗ).

Central Propositions

There is a short-run trade-off between inflation and unemployment (Phillips curve)

Business cycles are undesirable deviations from full employment trend

Incomes policies may sometimes be needed to achieve both full employment and price stability

Market economies are prone to recessions caused by demand deficiency

Prices and wages are not perfectly flexible — demand shocks hit output first, not prices

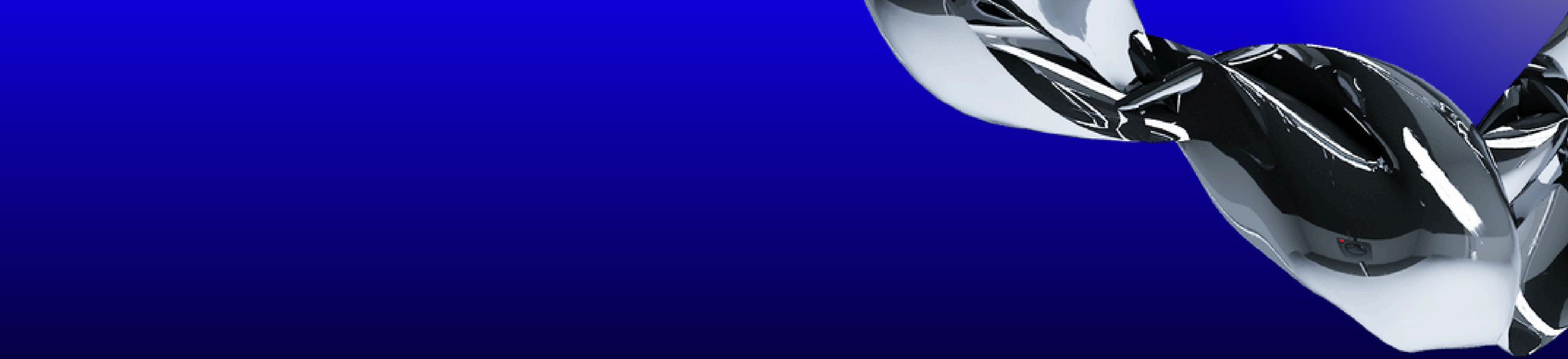
Keynesian economics focuses on short-run stabilization, not long-run growth"

The economy can be in either Keynesian (demand-constrained) or Classical (supply-constrained) regime

Both fiscal and monetary policy should stabilize the economy

Much unemployment is involuntary


43
KODAK PORTRA 400
is this?
Burkina Faso
Mali
mood
Kahoot
Choose game mode - Kahoot!



THANK YOU