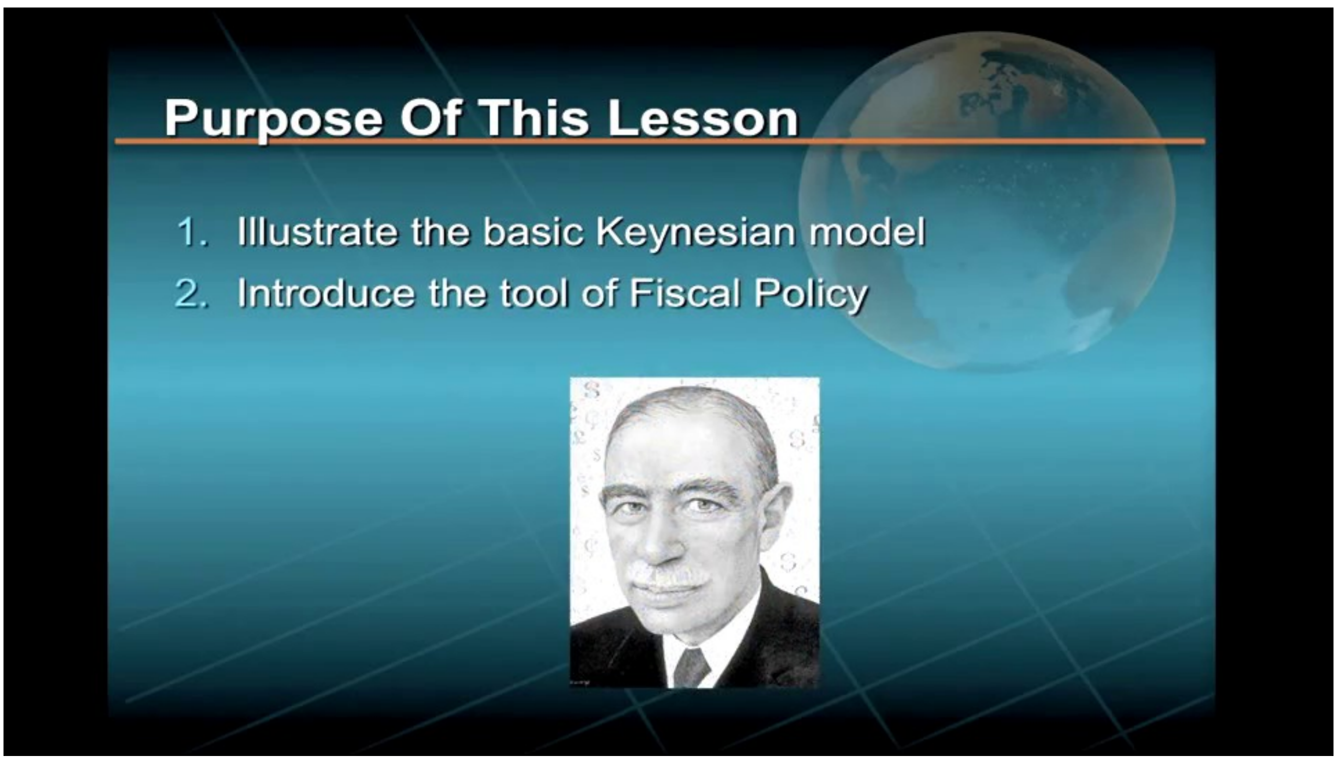
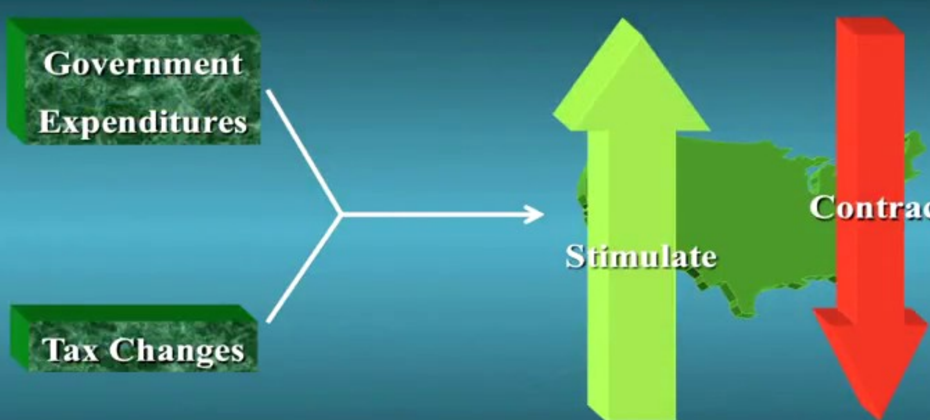

The Power of Macroeconomics
Lecture Three:
The Keynesian Model & Fiscal Policy
Presented By:
Professor Peter Navarro
University of California-Irvine


Purpose Of This Lesson
1. Illustrate the basic Keynesian model
2. Introduce the tool of Fiscal Policy

A Model With Many Names

- Some economists refer to the Keynesian model as the "multiplier model"
- Others call it the aggregate production-aggregate expenditures model.
- We will use these names interchangeably as we illustrate how the Keynesian model gave birth to fiscal policy.

Fiscal Policy



The Basic Keynesian Model

- A straightforward approach to using fiscal policy to close a recessionary gap.
- The <u>theoretical</u> model may be used to <u>exactly</u> calculate how much government spending must be increased, or how much taxes must be cut, to stimulate an economy back to full employment.

A Warning

- Macroeconomics is not this simple.
- The harsh reality:
  - Economists learned in the 1970s within the context of stagflation that Keynesian solutions don't always work!

This was President Gerald Ford's slogan.

His Keynesian efforts to "whip inflation" only drove the economy deeper into recession!

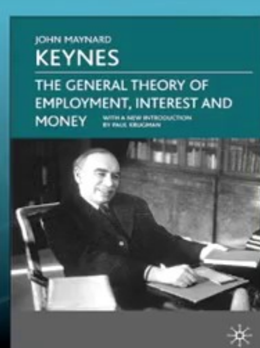
In Future Lessons

- We'll talk more about stagflation and the complexities of macroeconomics later.
- For now, let's master the simple Keynesian model and fiscal policy.

Keynes' General Theory

- Keynes' book contains little resembling today's basic textbook Keynesian model.
- Professors Alvin Hansen and Paul Samuelson would transform Keynes' arcane prose into an easily understood model.

Alvin Hansen



Paul Samuelson

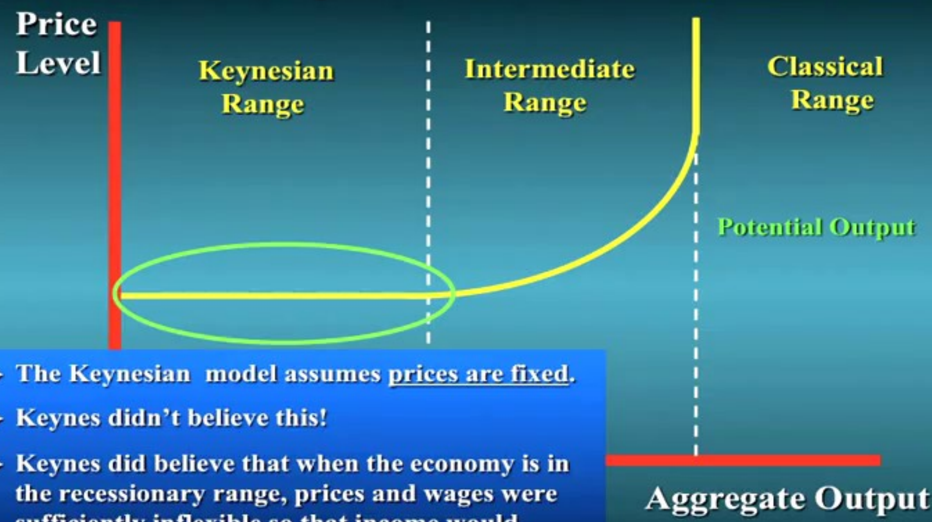
Hansen’s Role in the Keynesian Model

- Alvin Hansen was a Classical economist.
  - Left the University of Wisconsin for Harvard.
  - Converted to Keynesianism.
  - Led a Harvard seminar about the Keynesian doctrine.
- Hansen took regular trips to Washington, D.C. to spread the Keynesian gospel to policymakers.

Alvin Hansen’s “A Guide to Keynes”

- The bible for economic students in the 1950s.
- Hansen’ s star pupil Paul Samuelson wrote the definitive macroeconomic textbook.
- Out of these writings has emerged the basic Keynesian model.

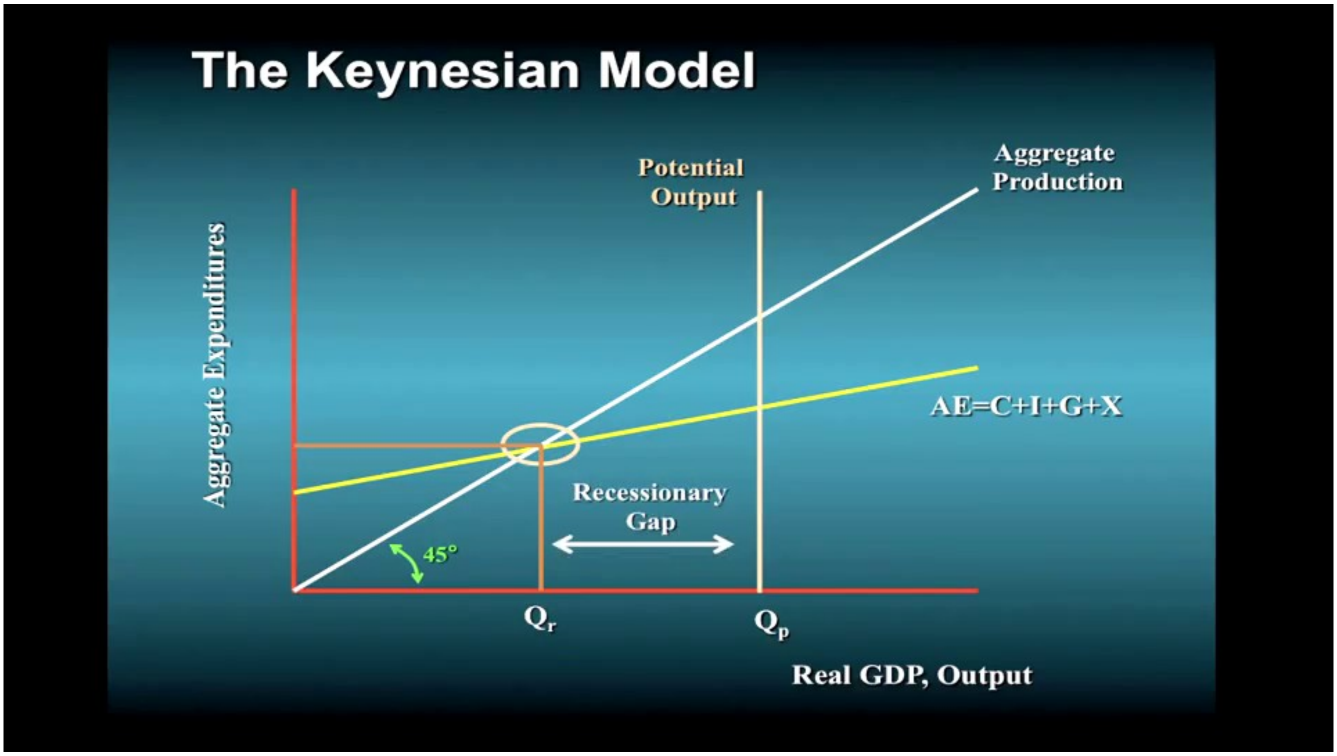
The Assumption Of Fixed Prices

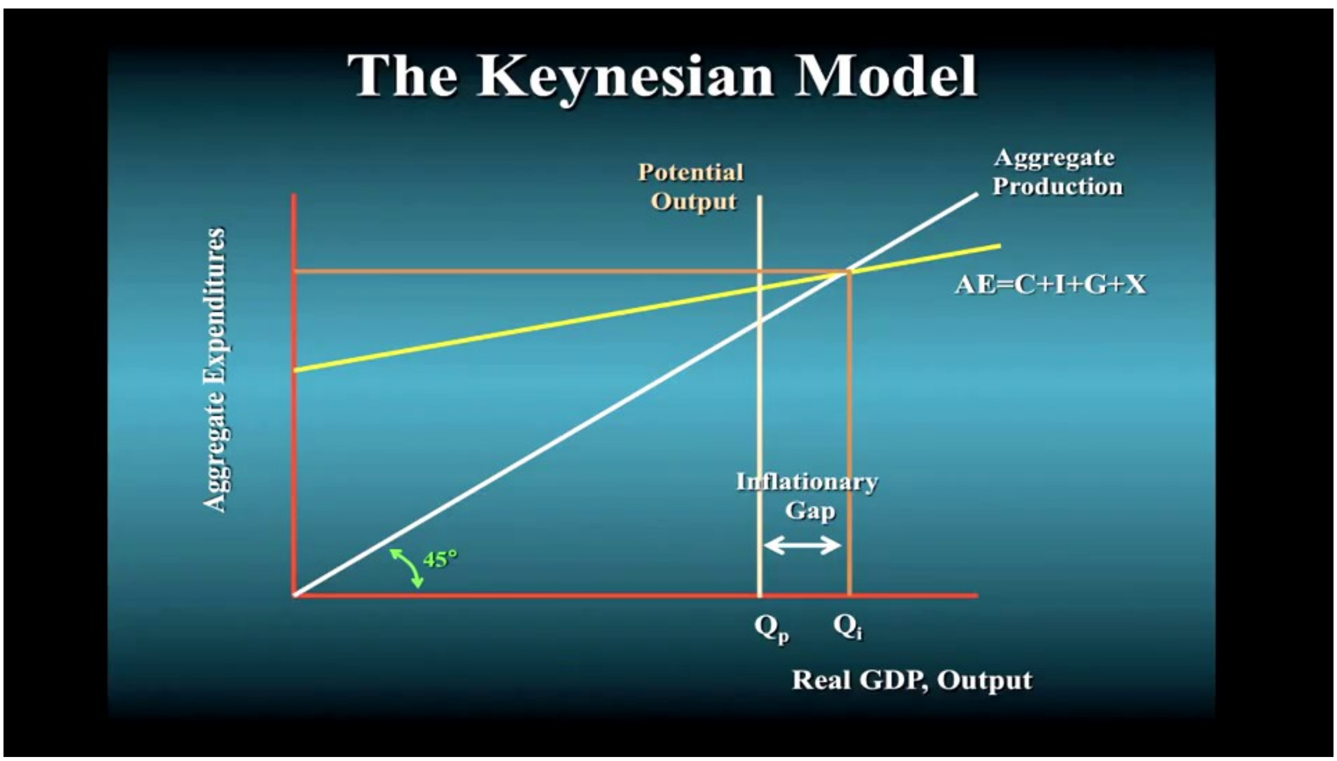


- The Keynesian model assumes prices are fixed.
- Keynes didn't believe this!
- Keynes did believe that when the economy is in the recessionary range, prices and wages were sufficiently inflexible so that income would adjust much faster than prices.
- So the fixed price assumption is justified.

Fixed Prices A Key Keynesian Assumption

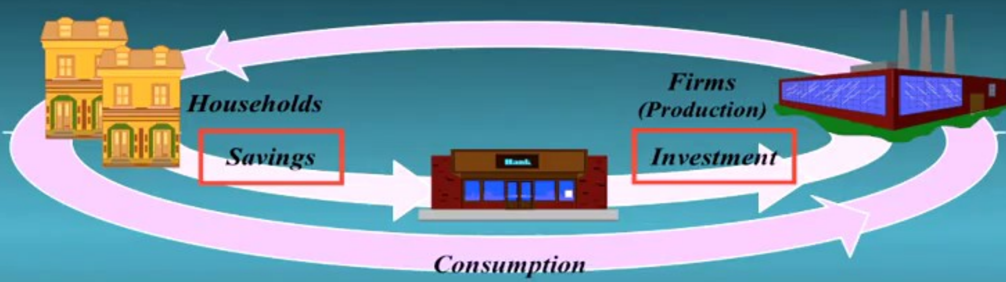
- The fixed price assumption allowed Hansen and Samuelson to develop the Keynesian Aggregate Production-Aggregate Expenditures model.
- This Keynesian model is readily distinguishable from the Classical Aggregate Supply-Aggregate Demand model we developed in the last lecture, which allows prices to vary.


The Keynesian Model
Potential Output
Aggregate Production
Aggregate Expenditures
AE=C+I+G+X
Recessionary Gap
45°
Q r
Q p
Real GDP, Output


The Keynesian Model
Potential Output
Aggregate Production
Aggregate Expenditures
AE=C+I+G+X
Inflationary Gap
45°
Q p
Q i
Real GDP, Output

Say's Law and the Circular Flow Diagram

Aggregate Supply(AS)= Employee compensation, rents, interest, and profits

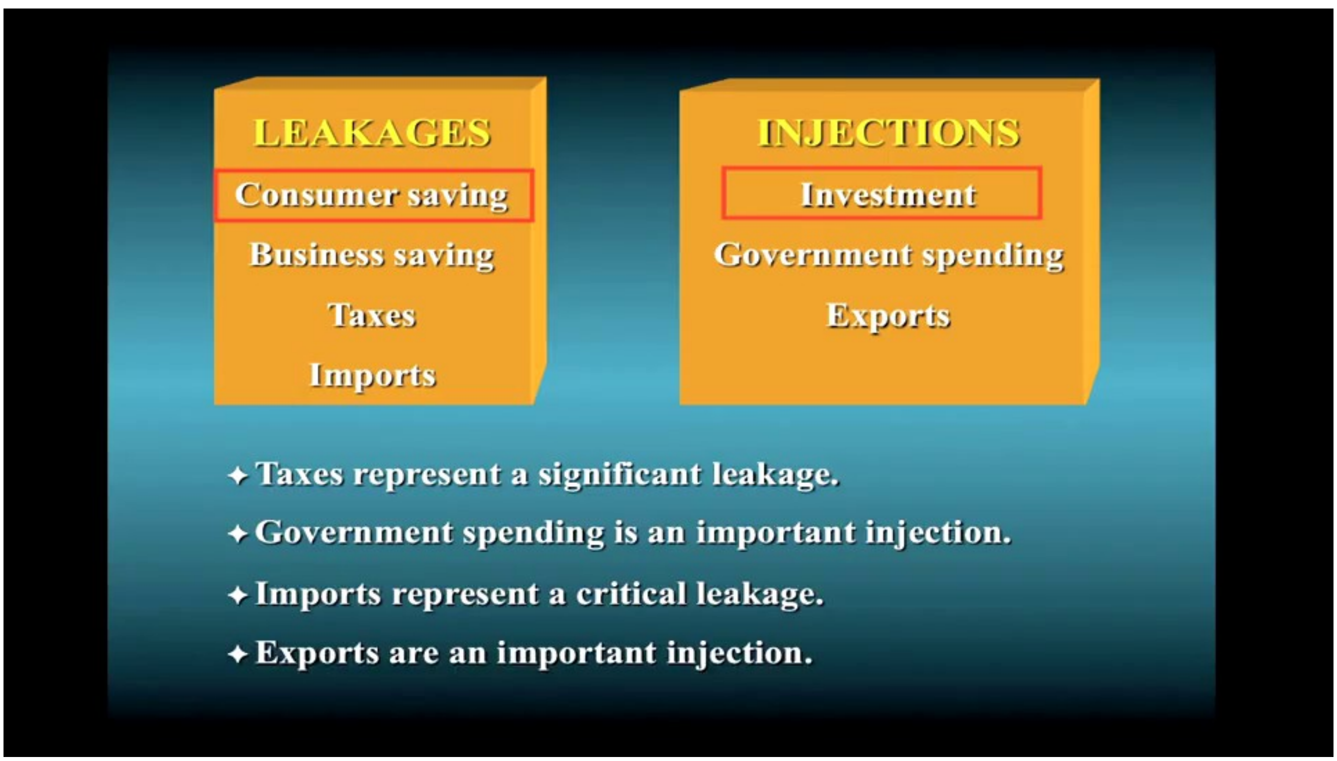


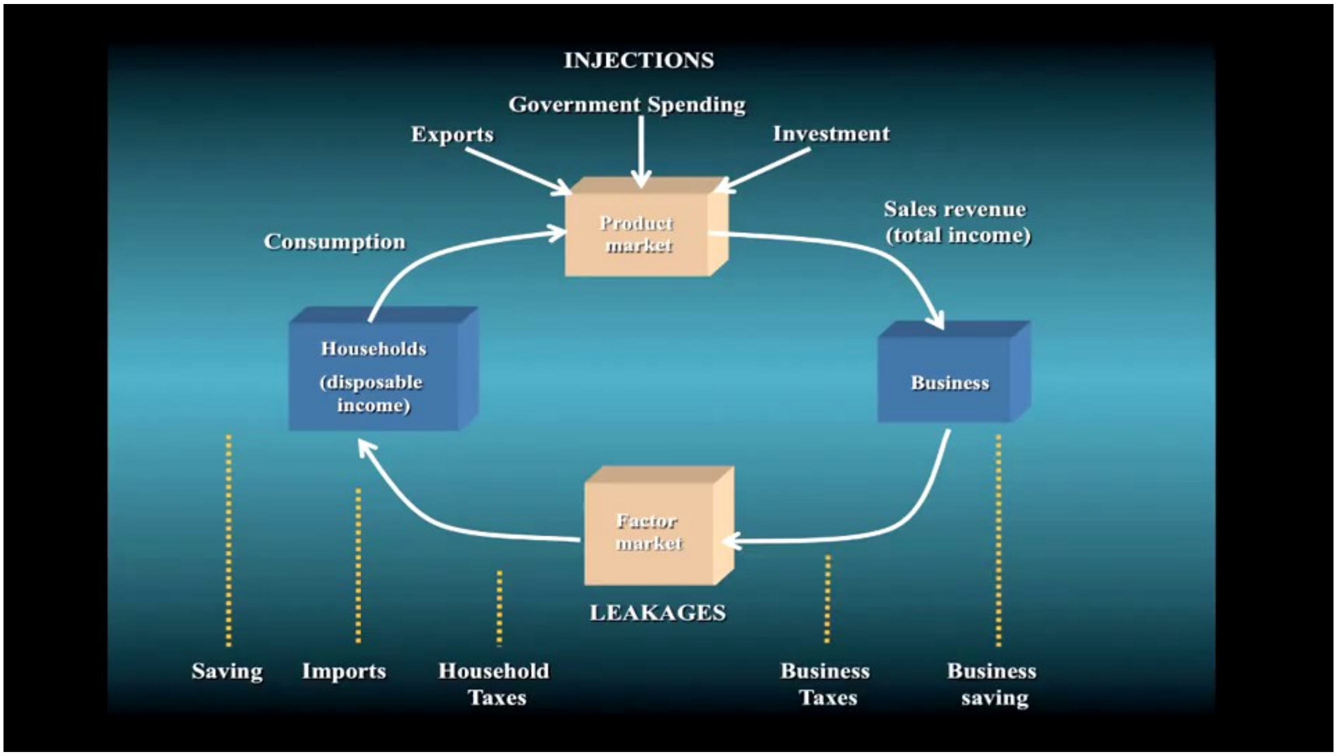
Aggregate Demand (AD) = Consumption+ Investment

- A leakage is income not directly spent on domestic output but is diverted from the circular flow.
- An injection is an addition of income to the circular flow.
- Savings is a leakage while investment is an injection.

LEAKAGES	INJECTIONS
Consumer saving	Investment
Business saving	Government spending
Taxes	Exports
Imports	


LEAKAGES
Consumer saving
Business saving
Taxes
Imports
INJECTIONS
Investment
Government spending
Exports


LEAKAGES
Consumer saving
Business saving
Taxes
Imports
INJECTIONS
Investment
Government spending
Exports
✦ Taxes represent a significant leakage.
✦ Government spending is an important injection.
✦ Imports represent a critical leakage.
✦ Exports are an important injection.


INJECTIONS
Government Spending
Exports
Investment
Sales revenue
(total income)
Consumption
Product
market
Households
(disposable
income)
Business
Factor
market
LEAKAGES
Saving
Imports
Household
Taxes
Business
Taxes
Business
saving