INTRODUCTION TO ECONOMICS

LEARNING JOURNAL UNIT 5

ECON 1580-01 INTRODUCTION TO ECONOMICS - AY2024-T3

MARCH 2, 2024

INSTRUCTOR: CHRISTOPHER STUTTS

INTRODUCTION

New Keynesian economics evolved in the 1990s as a response to certain shortcomings associated with classic Keynesian theory. It aims to explain Keynes' ideas on demand-driven output and employment in the short run using microeconomic foundations grounded in rational expectations and price rigidities. “New Keynesian economics is a modern macroeconomic school of thought that evolved from classical Keynesian economics. This revised theory differs from classical Keynesian thinking in terms of how quickly prices and wages adjust” (Liberto, 2023).

INCORPORATING RATIONAL EXPECTATIONS

A major point of departure lies in New Keynesians utilizing the concept of rational expectations, which was missing in old Keynesian models. As per this idea, economic agents make consumption and output decisions based on realistic forecasts instead of merely past data. It provides more credible micro-level decision rules.

ROLE OF STICKY PRICES AND WAGES

“New Keynesian advocates maintain that prices and wages are "sticky," meaning they adjust more slowly to short-term economic fluctuations” (Liberto, 2023). While Keynes focused on demand deficiencies causing underutilization, his failure to explain why prices don’t naturally adjust downwards to restore equilibrium was a limitation. New Keynesians fill this void through nominal rigidities like sticky prices and wages due to contractual obligations. As per versed incentives inhibit quick price corrections, demand drives real output.

NON-CONTINUOUS MARKET CLEARING

The assumption in classical theories that markets instantly clear to maintain equilibrium does not convince New Keynesians. They highlight that transaction costs and informational inadequacies can obstruct continuous market clearing. Involuntary unemployment may persist in the short term despite competitive labor markets.

MONETARY POLICY EFFECTIVENESS

New Keynesian theory demonstrates why monetary stimulus can positively impact real output and employment, unlike classical notions. Since sticky prices delay adjustment to money supply changes, policy induced swings in interest rates and money growth can stimulate consumption and investment to motivate employment.

CONCLUSION

By accounting for rational expectations and nominal rigidities, New Keynesian economics solidifies demand-driven macroeconomic analysis with sound micro foundations. It bridges old Keynesian intuition with modern price and employment theory advancements in a more realistic and applicable framework for monetary policy. These fundamental refinements cement Keynes' legacy.

Wordcount: 350

REFERENCE:

Liberto, D. (2023, October 20). New Keynesian Economics: Definition and Vs. Keynesian. Investopedia. https://www.investopedia.com/terms/n/new-keynesian-economics.asp