Learning Journal Unit 5

Department of Computer Science, UoPeople

ECON 1580-01 Introduction to Economics - AY2025-T1

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**New Keynesian Economics: Addressing Limitations of Classic Keynesian Theory**

New Keynesian Economics emerged in the late 20th century as a response to the perceived inadequacies of the classic Keynesian theory in explaining economic fluctuations and market behaviors. While classic Keynesian theory emphasized the importance of government intervention in stabilizing the economy during periods of recession, it was criticized for its inability to fully account for stagflation, a situation characterized by high inflation and stagnant economic growth. The New Keynesian framework addresses these shortcomings by incorporating microeconomic foundations into macroeconomic models, particularly focusing on the concepts of price stickiness and imperfect competition (Mankiw & Romer, 1991). Through this approach, New Keynesians argue that wages and prices do not always adjust instantaneously to shifts in supply and demand, which can lead to prolonged periods of unemployment and output gaps.

One of the key principles of New Keynesian Economics is the notion of price and wage rigidity, which explains why economies may not reach full employment even in the long run. According to this principle, firms often face "menu costs" associated with changing prices, such as the cost of reprinting menus or updating price lists (Ball & Mankiw, 1994). As a result, firms are reluctant to adjust prices frequently in response to changes in aggregate demand, leading to short-term non-neutrality of money and a slower adjustment process towards equilibrium. This price rigidity contributes to the persistence of economic fluctuations, supporting the view that active monetary and fiscal policies are necessary to smooth out business cycles and maintain economic stability.

Another critical contribution of New Keynesian Economics is its incorporation of rational expectations and how agents form their expectations of future economic variables. While classic Keynesian theory relied on adaptive expectations, New Keynesian models assume that individuals and firms form expectations rationally, based on all available information (Taylor, 1980). This addition resolves the inconsistency observed in classic Keynesian theory during the stagflation of the 1970s, when high inflation persisted despite high unemployment. By incorporating forward-looking behavior, New Keynesian Economics provides a more robust framework for understanding the impact of monetary policy on inflation and output. Ultimately, the New Keynesian framework strengthens the original Keynesian insights while addressing its limitations by integrating microeconomic factors and expectations into the analysis of macroeconomic phenomena.

**References**

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