Keynesian Economics with Flexible Prices*

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Abstract

I propose a Keynesian growth model where prices are flexible, and yet aggregate demand shocks have permanent effects. A key assumption in the model is that production runs fast into diminishing returns to capital, so that "Saving equals Investment" is not achieved through the interest rate, but through the use of different technologies implying different levels of aggregate saving. In such a model, increasing public debt or redistributing from high income to low income leads to permanently higher GDP, and aggregate demand shocks lead to apparent shifts in the Solow residual from a compositional effect. Old Keynesian intuitions, such as paradox-of-thrift type intuitions, the Keynesian cross, are valid albeit with a small twist, even if resources are currently fully employed. In an open-economy, provided that the non-traded sector is less productive than the traded sector, public debt or redistributive policies are underprovided. The adjustment should fall on creditor countries with external surpluses, not on borrowing countries with external deficits.

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Introduction

New-Keynesian economics is fundamentally based on sticky-prices. This paper considers another potential candidate: too much saving, too plentiful to be absorbed into productive investment. The Cobb-Douglas production function implies infinite absorption capacity of saving. With such a production function, investment possibilities are never exhausted. In contrast, I show that

I consider instead a model where production functions exhibit satiation. To the extent that saving propensities are fixed and large, there might be too much aggregate demand.

1 Model

Increases in investment, crowding in of investment.

Two technologies: $\underline{A}$, $\bar{A}$.

There is a distribution of skills of workers, and productivity is given by the product of efficiency units and productivity.

1.1 Market clearing through wages

1.2 Market clearing through inequality

The key is investment = saving.

Imagine that there are limited investment opportunities in the following sense:

more investment: (from some value of capital)

$$Y = \min(\underline{A}l, k)$$

New ones:

$$Y = \min(\bar{A}l, k)$$

Redistribution: giving money to "low income" people

Limits to growth are due to the saving propensity of very rich people.

2 New ones

Conclusion

References

A Proofs

B Comparing with OLG models of Dynamic Inefficiency

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