Macroeconomics *under* Financial Crisis

Week 1 Day 3: Keynesian Revolution

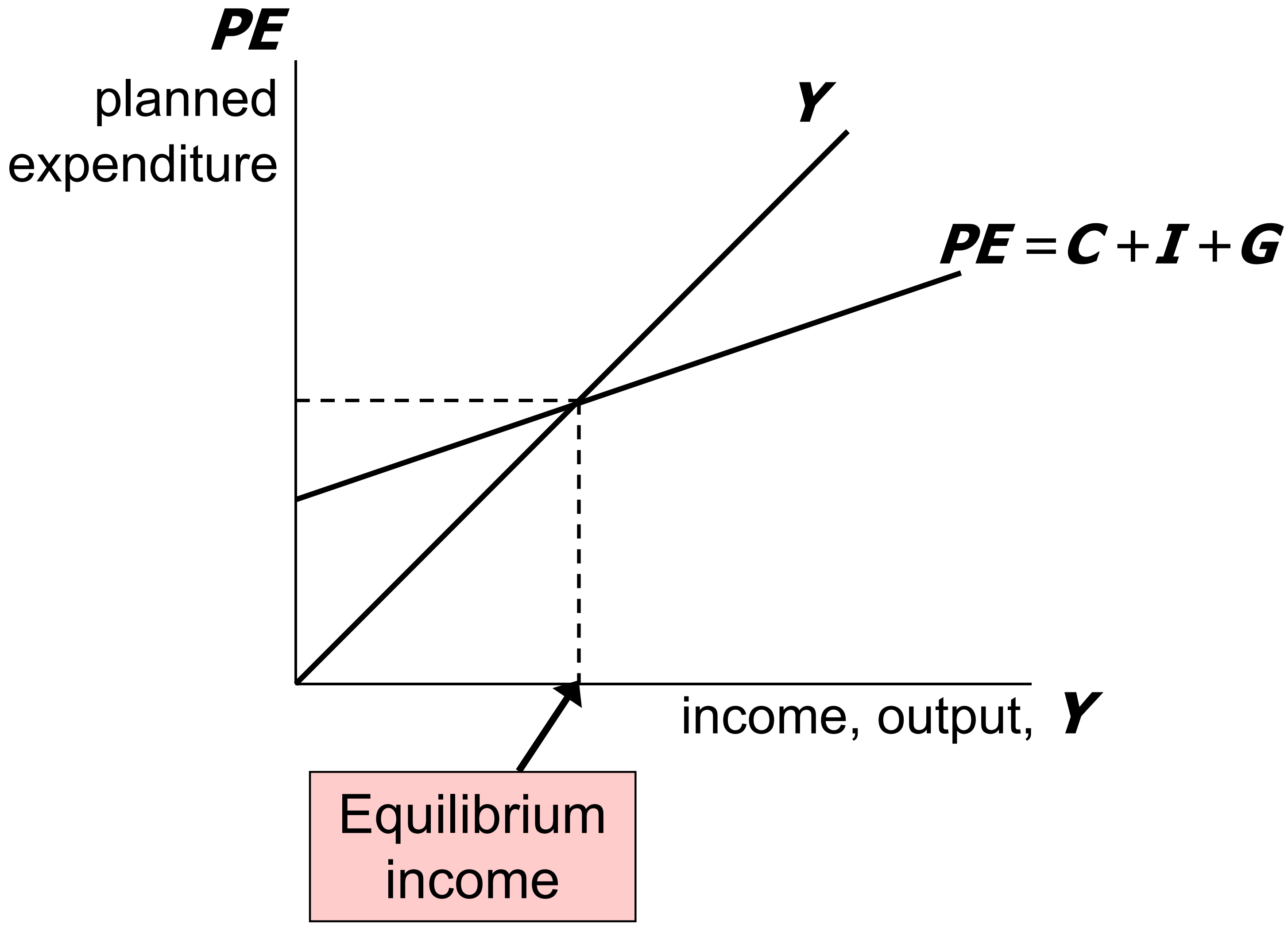
Keynes' General Theory

- John Maynard Keynes, *The General Theory of Employment, Interest, and Money (1936)*
- Theory of effective demand
  - critique of Say's law
  - Significance of effective demand
  - Countercyclical policies: fiscal and monetary
    - Both shift aggregate demand, and thus output, income, employment.

Aggregate Demand

- Y = C + I + G + NX
- Consumption
  - disposable income (Yd), permanent vs. transitory
  - wealth (W)
- Investment
  - income (Y)
  - interest rate (long term rate)
- Government Spending
  - budget (deficit or surplus); fiscal policy
- Net export (Export – Import)
  - exchange rate

The Keynesian Cross

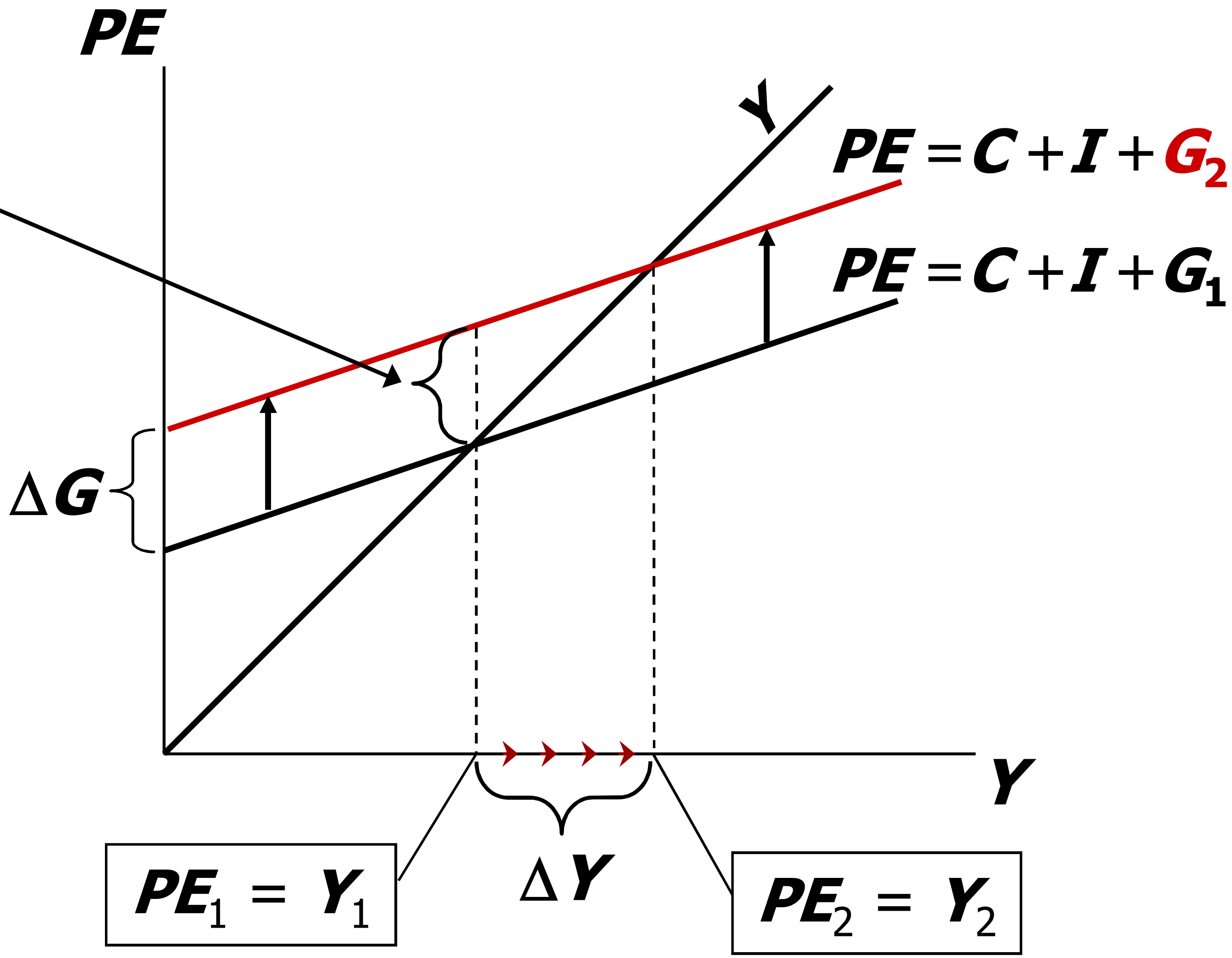


Fiscal policy tools

- direct effect on AD
- government spending (G)
  - multiplier effect
  - crowding out effect
- tax (T)
  - permanent change in Yd

An increase in government purchases

At Y_1,
there is now an unplanned drop in inventory…



…so firms increase output, and income rises toward a new equilibrium.

Theory of liquidity preference

- 3 motives for holding money
  - Transactions motive
  - Precautionary motive
  - Speculative
- Basis of monetary policy

Monetary policy

- money supply and interest rate
- indirect effect on AD through investment and net export
- 3 traditional tools of monetary policy
  - reserve requirement change
  - discount rate change
  - open market operations (OMO)
- direct control of interest rates in some countries