**Keynesian-Aligned Theories**

These share core assumptions about imperfect markets and active policy effects:

- ***Keynesian Theory***: Consumption depends on current income. ***Fiscal policy*** (e.g. government spending) boosts consumption.

- ***New Keynesian DSGE Models***: Extend Keynesian logic with microfoundations and sticky prices; recognize both Ricardian and non-Ricardian households.

- ***Empirical models (e.g., Galí et al., Coenen & Straub)***: Include both types of households and validate Keynesian mechanisms using data.

**Summary**

- Households are not always forward-looking or unconstrained.

- Government spending can increase private consumption (especially via non-Ricardian behavior).

- Markets are imperfect, allowing for demand-side policies to be effective.

**Model**

- Regressing log – log model helps stabilize variance and reduce heteroscedasticity, making the OLS estimates more reliable. It also improves the normality of residuals and allows for interpretation of coefficients as approximate percentage changes, which is common in economic modelling.

|  |  |  |
| --- | --- | --- |
| **Variable** | **Description** | **Theoretical Basis** |
|  | Real consumption per capital (household or per capita, time t) | Keynesian |
|  | Government spending exclude military per capital | New Keynesian (Fiscal multiplier effect) |
|  | Government spending on military per capital | New Keynesian (Fiscal multiplier effect) |
|  | Real disposable income per capital | Keynesian & DSGE |
|  | Real interest rate (or lending rate) | Intertemporal substitution (DSGE) |
|  | Other factors |  |

**Data**

|  |  |
| --- | --- |
| **Variable** | **Data** |
|  | World Bank |
|  | IMF/ World Bank |
|  | World Bank |
|  | World Bank |
|  | World Bank |
|  |  |

### ****1. Keynesian Theory****

**- Core Idea**: Consumption depends primarily on **current disposable income**.

**- Implication**: Households spend a fraction of their current income; higher income leads to higher consumption.

**- Policy Insight**: **Fiscal policy** (like increasing government spending or cutting taxes) is effective in stimulating consumption and aggregate demand.

### ****\*Fiscal Policy and Consumption****

**- Key Insight**: Government interventions (e.g., **transfers**, **spending**, or **tax cuts**) **directly affect disposable income**, thus influencing consumption.

**- Multiplier Effect**: A government spending increase boosts income → more consumption → further income and output growth.

### ****3. New Keynesian DSGE Models****

**- Core Features**:

+ Microfoundations: Rational agents optimize utility.

+ Intertemporal behavior: Consumption depends on **expected future income** and **interest rates**.

**+ Sticky prices** and **nominal rigidities**: Prevent instant market adjustments.

**- Household Types**:

**+ Ricardian**: Forward-looking, smooth consumption over time.

**+ Non-Ricardian (Rule-of-Thumb)**: Consume their current income.

**- Implication**: Fiscal policy can affect consumption **even in models with rational agents**, especially when non-Ricardian households are present.

**- Policy**: Supports Keynesian logic but with a foundation in modern macro theory.

### ****4. Empirical Models (Galí et al., Coenen & Straub, etc.)****

**- Approach**: Estimate structural or reduced-form models using macro and micro data.

**- Key Findings**:

+ A **large fraction of households** behave in a non-Ricardian way — they **consume most or all of their income**.

+ Fiscal stimulus (transfers or government spending) **raises consumption**, especially for credit-constrained households.

**- Models Often Include**:

+ Lagged consumption (habit formation).

+ Real interest rates (intertemporal substitution).

+ Share of non-Ricardian households (ωt\omega\_tωt​) as a key parameter.

**- Policy Relevance**: Strong empirical support for **fiscal stimulus effectiveness**, especially in economies with more liquidity-constrained households.