Keynesian Model

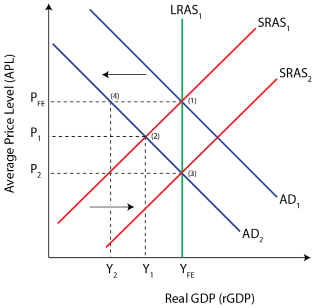
RIDLEY COLLEGE
SINCE 1889

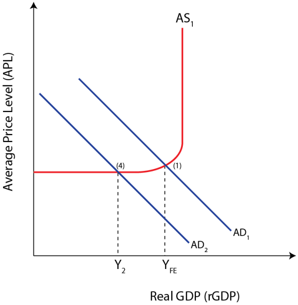
Assessment Objectives

Specific Expectations	
2.E	Explain the Keynesian perspective of the aggregate supply (AS) curve
2.F	Explain equilibrium in the Keynesian model
2.G	Draw a diagram showing equilibrium in the Keynesian model
2.H	Explain that in the Keynesian model deflationary/recessionary gaps may persist so that the equilibrium level of output may differ from the full employment level of output

Keynesian Model

- In the Keynesian model, inflexible wages and prices in the downward direction mean that the economy cannot move into the long run when experiencing a deflationary gap.
  - Inflexible wages and prices are shown graphically by a horizontal section of the Keynesian aggregate supply (AS) curve.





Keynesian Model: Aggregate Supply Curve

- **Keynesian aggregate supply curve** is an aggregate supply curve that has a flat (horizontal) section, an upward sloping section and a vertical section.
  - It shows the relationship between real GDP and the price level on the assumption that prices and wages are inflexible downward.
  - Changes in the price level and/or real GDP depend on the level of aggregate demand and where the economy is producing relative to full capacity output.

1. **Section I (Keynesian Zone/Elastic):** real GDP is low, and the price level remains constant as real GDP increases.
   - In this range of real GDP, there is a lot of unemployment of resources and spare capacity.
   - Firms can easily increase their output by employing the unemployed capital and other unemployed resources, without having to bid up wages and other resource prices.

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2. **Section II (Intermediate Zone):** real GDP increases are accompanied by increases in the price level.
   - As output increases, so does employment of resources, and eventually bottlenecks in resource supplies begin to appear as there is no longer spare capacity in the economy.
   - Wages and other resource prices begin to rise, which means that costs of production increase.
   - The only way firms will be induced to increase their output is if they can sell at higher prices.
   - Therefore, growing output leads to an increase price level.
3. **Section III (Neoclassical Zone: Inelastic):** the aggregate supply (AS) curve becomes vertical at Y_{max}.
   - This indicates that real GDP reaches a level beyond which it cannot increase anymore; at this pint, the price level rises rapidly.
   - Real GDP can no longer increase because firms are using the maximum amount of labour and all other resources in the economy.

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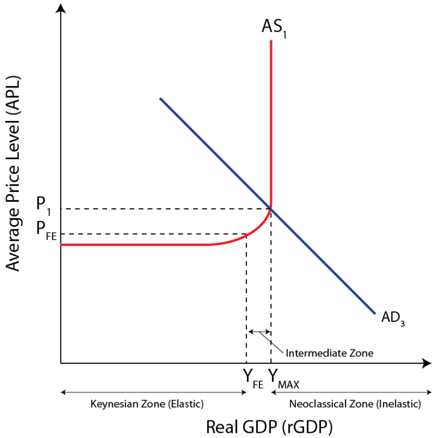
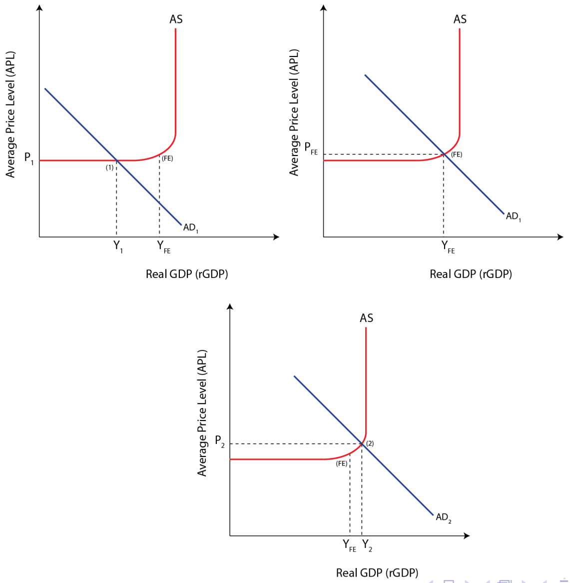
- Any efforts on the part of firms to increase their output only result in greater increases in the price level.



Keynesian Model: Aggregate Supply Curve

- The Keynesian model arrives at some conclusions that differ significantly from the conclusions of the monetarist (new classical) model.
    - The economy in the Keynesian model can remain indefinitely stuck in a deflationary gap, unlike in the monetariest (new classical) model where the economy automatically returns to full employment equilibrium.
    - Increase in aggregate demand in the Keynesian model need not necessarily result in increases in the price level, unlike in the monetarist (new classcial) model where increase in aggregate demand always results in a higher price level.

Keynesian Model: Aggregate Supply Curve



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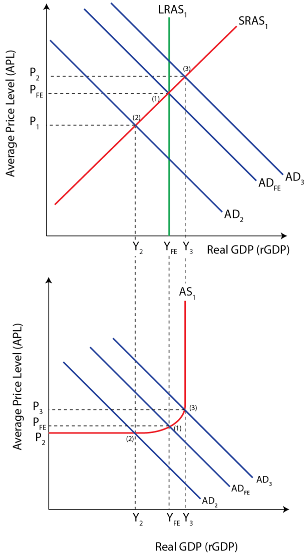

Implications of the Keynesian Model

- In contrast to the monetarist/new classical model, which automatically corrects for deflationary/recessionary gaps by returning to full employment, the Keynesian model shows that an economy can remain for long periods of time in an equilibrium where there is less than full employment, caused by insufficient aggregate demand.
- In the Keynesian view increases in aggregate demand need not result in a higher price level.
  - This is in contrast to the monetarist/new classical view where increases in aggregate demand always result in a higher price level.
  - Policies focusing on increasing aggregate demand are not only harmless, but in fact they are essential in order to both prevent and reduce the size of both deflationary and inflationary gaps.

Implications of the Keynesian Model