

Economics of Business cycles

Paper Notes

Will the new Keynesian Macroeconomics Resurrect the IS-LM Model?

Key Problem: Why prices are sticky in certain historical episodes and rapidly adjusting in others? Why do economies grow and fluctuate at different rates? Is the IS-LM Model a viable tool to analyze macroeconomics?

Main Results:

- The IS-LM Model is not a viable tool to analyze macroeconomics
- To simplify economics to use the IS-LM Model as an analytical tool essentially ignores expectations that we know eliminates key determinates in aggregate demand
- The influence of expectations is underestimated with regards to aggregate demand

Analysis of Keynesian Model

- 1) Keynes represented the private sector by simple behavioral rules. i.e. consumption linked to income via. Propensity to consume.
- 2) Viewed key economic activities as dependent on expectations, as in the idea that investment demand was determined by future yield to capital assets.
- 3) Desirable public policy could be found by asking how the monetary and fiscal authorities should respond on a case-by-case basis, treating the simple behavior rules and expectations as fixed while authorities responded to particular economic disturbances.

“Keynes’ view was that business fluctuations resulted mostly from shocks to aggregate demand; he suggested that expectations-induced shifts in investment demand were the principal business cycle impulse.” He adopted a short-run focus

Overall this modeling procedure was a short-cut.

Refinement in the LM specifications

According to the theory, changes in expected inflation should influence the holdings of cash balances only via their influence on the nominal interest rate. On the other side of the money market, an interest sensitivity of money supply was typically derived by considering aspects of how banks managed their reserves. This incorporated a static view of money supply and demand behavior was incorporated into the IS-LM Model.

Rational Expectations

Keynes 2 distinctions: Between a long run that was very far away and a short run that was very important; and 2) between shifts in the saving-investment area and shifts in the monetary sector.

Expectations about the future require that the long run and the short run are treated jointly and expectations linked together the conditions in the saving and monetary sectors. Rational expectations have proved to be a powerful tool for understanding economic phenomena.

Expectations, Consumption and the IS curve

Real business cycle models give a remarkably uniform finding: the permanent income theory of consumption is a central mechanism in generating relative volatility of consumption and output which resembles actual macroeconomic time series.

When the permanent income theory governs savings, expectations play a major role in the IS sector.

Expectations, Investment and the IS curve

Recent dynamic models have shown the power of rational expectations on investment demand. I.e. Government purchases.

IS-LM Model Practical Macroeconomics

Leading economists generally downplay the role of expectations and focus on direct effects of policy and other disturbances, i.e. Education, policy analysis and econometrics.

Gali and the 4 basic sources of shock: aggregate supply, money supply, money demand, and IS shocks. Aggregate supply shocks account for 70% of fluctuations in gross national product, and money supply and IS shock account for the rest. Positive supply shock raises output permanently, raises real interest rates temporarily, lowers the price level and produces a temporary decline in the inflation rate. A positive IS shock has the effect of raising output and the nominal interest rate in the short run. Higher expected inflation at every horizon lowers the real cost of investing at the initial nominal interest rate: macroeconomic equilibrium thus requires higher nominal interest rates.

Concluding Comments

This essay has challenged the view of traditional IS-LM analysis. Economists should be constructing new small scale dynamic theoretical models to take the place of the IS-LM Model. Also they should be constructing medium sized dynamic models that can serve as laboratories for thinking about the details of policy. The attempt to resurrect the IS-LM model is unlikely to have much effect on the first activity as it is too major a component of ongoing research.