

Notes on

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

By

Robert G. King

In

Journal of Economic Perspectives

7:1, Winter 1993, pp. 67-82

Noted by

Student 4, Student 5, Student 6

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

Research in the 1950's and 60's has stressed the importance of tying macro changes to microeconomic. Recent macroeconomic research has stressed the role of rational expectations and its influence on macroeconomic variables. Author Robert King seeks to answer several questions in this paper. 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 because it ignores rational expectations in the analysis of macroeconomic variables. Keynes and the IS-LM model treat rational expectations as an exogenous element.
- 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 and investment. Tinbergen (1939) and Klein (1950) found large residuals linked to cyclical movements in income and product that was consistent with the Keynesian model, which left economists uncomfortable with a feeling that key elements were lacking. Expectations were thought to be a significant missing variable.
- Friedman's permanent income theory that relies heavily on future expectations of income sources, discounted the strength of the Keynesian propensity to consume. Baumol (1952) and Tobin (1956) expanded to demand for money. 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.

- Three exceptions to the static view of money demand in the IS-LM model:
  - Freidman (1959) introduced the influence of wealth.
  - Many researchers showed the influence of inflation expectations.
  - An adjustment process along the lines of the investment influence, was introduced that stressed expectation (Feige, 1967)
- 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.
- Recent dynamic models have shown the power of rational expectations on investment demand. Ie. Government purchases.
- 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 pay a major role in the IS sector.
- Leading economists generally downplay the role of expectations and focus on direct effects of policy and other disturbances, ie. 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 ever horizon lower the real cost of investing at the initial nominal interest rate: macroeconomic equilibrium thus requires higher nominal interest rates.

## **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.

Keynes 2 distinctions: 1) 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.

Overall this modeling procedure was a short-cut.

## **Empirical Results**

- Gali (1992) decomposed economic fluctuations of the postwar era U.S. business cycle and found four sources of shocks:

- Aggregate supply- supply shocks accounted 70% of the fluctuations in GNP. Empirical investigations and real business cycle theory confirm the dominant role of supply shocks.
- Money supply
- Money demand
- IS shocks- Behavioral shocks
- The last three account for the remaining 30%

### **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.