EC201 Intermediate Macroeconomics

Lecture 21: New Keynesian Macroeconomics

<u>Lecture Outline:</u>

- Introduction to New Keynesian macroeconomics:

<u>Essential reading:</u>

This Lecture Note

<u>Introduction:</u>

In the early 1980s, the Keynesian view of business cycles was in trouble. The problem was in the weakness in the theory. According to the Keynesian view, fluctuations in output arise largely from fluctuations in nominal aggregate demand. These changes in demand have real effects because nominal wages and prices are rigid. But those nominal rigidities were assumed rather than explained. The problem is: why should we assume that prices and wages are fixed in the short run when it is clearly in the interests of agents to eliminate the rigidities they were assumed to create? If wages, for example, were set above the market-clearing level, firms could increase profits by reducing wages. Thus the 1970s and early 1980s saw many economists turn away from Keynesian theories and toward new classical models with flexible wages and prices. In the lecture notes on new classical macroeconomics (lecture 17-18) we showed that with Rational Expectations and with price flexibility systematic policies should not have any real effects. This result was also a result of RBC theory that assumes rational expectations and price flexibility.

Obviously the result depends heavily on the assumption of price flexibility. New Keynesian macroeconomists try to use the same methodology of new classical macroeconomists and RBC theorists, meaning using microfoundations and incorporating the idea of Rational Expectations in models, but including some nominal rigidities in order to show that policies can have real effects in the short-run. Moreover since New Keynesian economists wants to explain why prices and wages may be sticky, in their model an important feature is represented by imperfect competition. For example firms in the economy are normally in monopolistic competition (meaning they can set prices).

There are two main ways in which nominal rigidities are modelled: