Keynesian economics is a theory of total spending in the economy (called aggregate demand) and of its effects on output and inflation. Although the term is used (and abused) to describe many things, six principal tenets seem central to Keynesianism. The first three describe how the economy works.

1. A Keynesian believes that aggregate demand is influenced by a host of economic decisions—both public and private—and sometimes behaves erratically. The public decisions include, most prominently, those on monetary and fiscal (i.e., spending and tax) policy. Some decades ago, economists heatedly debated the relative strengths of monetary and fiscal policy, with some Keynesians arguing that monetary policy is powerless, and some monetarists arguing that fiscal policy is powerless. Both of these are essentially dead issues today. Nearly all Keynesians and monetarists now believe that both fiscal and monetary policy affect aggregate demand. A few economists, however, believe in what is called debt neutrality—the doctrine that substitutions of government borrowing for taxes have no effects on total demand (more on this below).

2. According to Keynesian theory, changes in aggregate demand, whether anticipated or unanticipated, have their greatest short-run impact on real output and employment, not on prices. This idea is portrayed, for example, in Phillips curves that show inflation changing only slowly when unemployment changes. Keynesians believe the short run lasts long enough to matter. They often quote Keynes's famous statement "In the long run, we are all dead" to make the point.

Anticipated monetary policy (that is, policies that people expect in advance) can produce real effects on output and employment only if some prices are rigid—if nominal wages (wages in dollars, not in real purchasing power), for example, do not adjust instantly. Otherwise, an injection of new money would change all prices by the same percentage. So Keynesian models generally either assume or try to explain rigid prices or wages. Rationalizing rigid prices is hard to do because, according to standard microeconomic theory, real supplies and demands do not change if all nominal prices rise or fall proportionally.

But Keynesians believe that, because prices are somewhat rigid, fluctuations in any component of spending—consumption, investment,
or government expenditures—cause output to fluctuate. If government spending increases, for example, and all other components of spending remain constant, then output will increase. Keynesian models of economic activity also include a so-called multiplier effect. That is, output increases by a multiple of the original change in spending that caused it. Thus, a $10 billion increase in government spending could cause total output to rise by $15 billion (a multiplier of 1.5) or by $5 billion (a multiplier of 0.5). Contrary to what many people believe, Keynesian analysis does not require that the multiplier exceed 1.0. For Keynesian economics to work, however, the multiplier must be greater than zero.

3. Keynesians believe that prices and, especially, wages respond slowly to changes in supply and demand, resulting in shortages and surpluses, especially of labor. Even though monetarists are more confident than Keynesians in the ability of markets to adjust to changes in supply and demand, many monetarists accept the Keynesian position on this matter. Milton Friedman, for example, the most prominent monetarist, has written: "Under any conceivable institutional arrangements, and certainly under those that now prevail in the United States, there is only a limited amount of flexibility in prices and wages." In current parlance, that would certainly be called a Keynesian position.

No policy prescriptions follow from these three beliefs alone. And many economists who do not call themselves Keynesian—including most monetarists—would, nevertheless, accept the entire list. What distinguishes Keynesians from other economists is their belief in the following three tenets about economic policy.

4. Keynesians do not think that the typical level of unemployment is ideal—partly because unemployment is subject to the caprice of aggregate demand, and partly because they believe that prices adjust only gradually. In fact, Keynesians typically see unemployment as both too high on average and too variable, although they know that rigorous theoretical justification for these positions is hard to come by. Keynesians also feel certain that periods of recession or depression are economic maladies, not efficient market responses to unattractive opportunities. (Monetarists, as already noted, have a deeper belief in the invisible hand.)

5. Many, but not all, Keynesians advocate activist stabilization policy to reduce the amplitude of the business cycle, which they rank among the most important of all economic problems. Here Keynesians and monetarists (and even some conservative Keynesians) part company by doubting either the efficacy of stabilization policy or the wisdom of attempting it.

This does not mean that Keynesians advocate what used to be called fine-tuning—adjusting government spending, taxes, and the money supply every few months to keep the economy at full employment. Almost all economists, including most Keynesians, now believe that the
government simply cannot know enough soon enough to fine-tune successfully. Three lags make it unlikely that fine-tuning will work. First, there is a lag between the time that a change in policy is required and the time that the government recognizes this. Second, there is a lag between when the government recognizes that a change in policy is required and when it takes action. In the United States, this lag is often very long for fiscal policy because Congress and the administration must first agree on most changes in spending and taxes. The third lag comes between the time that policy is changed and when the changes affect the economy. This, too, can be many months. Yet many Keynesians still believe that more modest goals for stabilization policy—coarse-tuning, if you will—are not only defensible, but sensible. For example, an economist need not have detailed quantitative knowledge of lags to prescribe a dose of expansionary monetary policy when the unemployment rate is 10 percent or more—as it was in many leading industrial countries in the eighties.

6. Finally, and even less unanimously, many Keynesians are more concerned about combating unemployment than about conquering inflation. They have concluded from the evidence that the costs of low inflation are small. However, there are plenty of anti-inflation Keynesians. Most of the world's current and past central bankers, for example, merit this title whether they like it or not. Needless to say, views on the relative importance of unemployment and inflation heavily influence the policy advice that economists give and that policymakers accept. Keynesians typically advocate more aggressively expansionist policies than non-Keynesians.

Keynesians' belief in aggressive government action to stabilize the economy is based on value judgments and on the beliefs that (a) macroeconomic fluctuations significantly reduce economic well-being, (b) the government is knowledgeable and capable enough to improve upon the free market, and (c) unemployment is a more important problem than inflation.

The long, and to some extent, continuing battle between Keynesians and monetarists has been fought primarily over (b) and (c).

In contrast, the briefer and more recent debate between Keynesians and new classical economists has been fought primarily over (a) and over the first three tenets of Keynesianism—tenets that the monetarists had accepted. New classicals believe that anticipated changes in the money supply do not affect real output; that markets, even the labor market, adjust quickly to eliminate shortages and surpluses; and that business cycles may be efficient. For reasons that will be made clear below, I believe that the "objective" scientific evidence on these matters points strongly in the Keynesian direction.

Before leaving the realm of definition, however, I must underscore several glaring and intentional omissions.
First, I have said nothing about the rational expectations school of thought (see Rational Expectations). Like Keynes himself, many Keynesians doubt that school's view that people use all available information to form their expectations about economic policy. Other Keynesians accept the view. But when it comes to the large issues with which I have concerned myself, nothing much rides on whether or not expectations are rational. Rational expectations do not, for example, preclude rigid prices. Stanford's John Taylor and MIT's Stanley Fischer have constructed rational expectations models with sticky prices that are thoroughly Keynesian by my definition. I should note, though, that some new classicals see rational expectations as much more fundamental to the debate.

The second omission is the hypothesis that there is a "natural rate" of unemployment in the long run. Prior to 1970, Keynesians believed that the long-run level of unemployment depended on government policy, and that the government could achieve a low unemployment rate by accepting a high but steady rate of inflation. In the late sixties Milton Friedman, a monetarist, and Columbia's Edmund Phelps, a Keynesian, rejected the idea of such a long-run trade-off on theoretical grounds. They argued that the only way the government could keep unemployment below what they called the "natural rate" was with macroeconomic policies that would continuously drive inflation higher and higher. In the long run, they argued, the unemployment rate could not be below the natural rate. Shortly thereafter, Keynesians like Northwestern's Robert Gordon presented empirical evidence for Friedman's and Phelps's view. Since about 1972 Keynesians have integrated the "natural rate" of unemployment into their thinking. So the natural rate hypothesis played essentially no role in the intellectual ferment of the 1975-85 period.

Third, I have ignored the choice between monetary and fiscal policy as the preferred instrument of stabilization policy. Economists differ about this and occasionally change sides. By my definition, however, it is perfectly possible to be a Keynesian and still believe either that responsibility for stabilization policy should, in principle, be ceded to the monetary authority or that it is, in practice, so ceded.

Keynesian theory was much denigrated in academic circles from the midseventies until the mideighties. It has staged a strong comeback since then, however. The main reason appears to be that Keynesian economics was better able to explain the economic events of the seventies and eighties than its principal intellectual competitor, new classical economics.

True to its classical roots, new classical theory emphasizes the ability of a market economy to cure recessions by downward adjustments in wages and prices. The new classical economists of the midseventies attributed economic downturns to people's misperceptions about what was happening to relative prices (such as real wages). Misperceptions would arise, they argued, if people did not know the current price level or inflation rate. But such misperceptions should be fleeting and surely cannot be large in societies in which price indexes are published monthly and the typical monthly inflation rate is under 1 percent. Therefore, economic downturns, by the new classical view, should be mild and brief. Yet during the eighties most of the world's industrial economies
endured deep and long recessions. Keynesian economics may be theoretically untidy, but it certainly is a theory that predicts periods of persistent, involuntary unemployment.

According to new classical theory, a correctly perceived decrease in the growth of the money supply should have only small effects, if any, on real output. Yet when the Federal Reserve and the Bank of England announced that monetary policy would be tightened to fight inflation, and then made good on their promises, severe recessions followed in each country. New classicals might claim that the tightening was unanticipated (because people did not believe what the monetary authorities said). Perhaps it was in part. But surely the broad contours of the restrictive policies were anticipated, or at least correctly perceived as they unfolded. Old-fashioned Keynesian theory, which says that any monetary restriction is contractionary because firms and individuals are locked into fixed-price contracts, not inflation-adjusted ones, seems more consistent with actual events.

An offshoot of new classical theory formulated by Harvard's Robert Barro is the idea of debt neutrality. Barro argues that inflation, unemployment, real GNP, and real national saving should not be affected by whether the government finances its spending with high taxes and low deficits or with low taxes and high deficits. Because people are rational, he argues, they will correctly perceive that low taxes and high deficits today must mean higher future taxes for them and their heirs. They will, Barro argues, cut consumption and increase their saving by one dollar for each dollar increase in future tax liabilities. Thus, a rise in private saving should offset any increase in the government's deficit. Naïve Keynesian analysis, by contrast, sees an increased deficit, with government spending held constant, as an increase in aggregate demand. If, as happened in the United States, the stimulus to demand is nullified by contractionary monetary policy, real interest rates should rise strongly. There is no reason, in the Keynesian view, to expect the private saving rate to rise.

The massive U.S. tax cuts between 1981 and 1984 provided something approximating a laboratory test of these alternative views. What happened? The private saving rate did not rise. Real interest rates soared, even though a surprisingly large part of the shock was absorbed by exchange rates rather than by interest rates. With fiscal stimulus offset by monetary contraction, real GNP growth was approximately unaffected; it grew at about the same rate as it had in the recent past. Again, this all seems more consistent with Keynesian than with new classical theory.

Finally, there was the European depression of the eighties, which was the worst since the depression of the thirties. The Keynesian explanation is straightforward. Governments, led by the British and German central banks, decided to fight inflation with highly restrictive monetary and fiscal policies. The anti-inflation crusade was strengthened by the European Monetary System, which, in effect, spread the stern German monetary policy all over Europe. The new classical school has no comparable explanation. New classicals, and conservative economists in general, argue that European governments interfere more heavily in labor markets (with high
unemployment benefits, for example, and restrictions on firing workers). But most of these interferences were in place in the early seventies, when unemployment was extremely low.

**About the Author**

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**Further Reading**


[http://www.econlib.org/LIBRARY/Enc/KeynesianEconomics.html](http://www.econlib.org/LIBRARY/Enc/KeynesianEconomics.html)
"New classical macroeconomics" (NCM) uses the standard principles of economic analysis to understand how a nation's total output (gross domestic product, or GDP) is determined. In the NCM view supply and demand result from the actions of economically rational households and firms. Macroeconomic quantities like GDP are the result of the general equilibrium of the markets in an economy. It is surprising that this perspective is considered revolutionary in macroeconomics when we see the current nature of economic analysis in other fields, such as public finance, international trade, and labor economics. All use standard economic principles to analyze a wide range of issues. Macroeconomics has lagged behind because Keynesian macroeconomics was dominant when these principles were systematically applied in these other fields in the forties through the sixties.

From its inception with John Maynard Keynes's *General Theory of Employment, Interest, and Money* in 1936, Keynesian macroeconomics held a leading position for three main reasons. First, its basic analytical models were simple, flexible, and easy to use and seemed broadly consistent with observed patterns of economic activity. Second, Keynes and his disciples made a strong and effective critique of the alternative school, which they called classical macroeconomics, portraying it as complicated, inflexible, and empirically irrelevant. Third, these analytical Keynesian models provided a base for detailed statistical models of macroeconomic activity, which could be used for economic forecasting and for evaluating alternative policies.

In contrast to classical macroeconomics, new and old, Keynesian macroeconomics did not begin with the assumption that an economy is made up of individually rational economic suppliers and demanders. Instead of deriving demand from individual choices that are made within specified constraints, for example, the Keynesian procedure was to directly specify a behavioral rule. Keynes claimed that aggregate spending on consumption was governed by a "consumption function" in which consumption depended solely on current income. More generally, Keynesian macroeconomics posited that people followed fixed rules of thumb, with no presumption that firms and households made rational choices. Partly, this grew out of a suspicion on the part of Keynesian modelers that people did not typically act rationally. Partly, it was a pragmatic modeling decision: if people's economic behavior is purposeful, the task of specifying how they will act in various situations is more complicated and, therefore, more difficult to model.

The Keynesians were right that the classical macroeconomics of the thirties
could not answer important public policy questions. Classical macroeconomics at that time, like most other fields of economics, was just beginning to build formal mathematical and statistical models of economic behavior. Over the last decade an intense amount of research has largely overcome these challenges, and this body of research is now called the new classical macroeconomics. The NCM approach has become increasingly important in discussions of macroeconomic policy in the United States and other countries around the world in recent years.

The superiority of new classical or Keynesian macroeconomics will depend on which appears to provide a better understanding of macroeconomic activity. It is important to decide between these contending views because they typically imply very different consequences for public policies.

The General Differences in Perspective

Some central, repeated differences of opinion in macroeconomic policy are traceable to basic differences in Keynesian and new classical macroeconomics.

Three ideas are central to the Keynesian view. The first is that there is little presumption that market outcomes are desirable. This leaves a great deal of scope for government intervention. The second is that changes in the supply side of markets are important mainly in the long run, which is taken to be very far away in most policy situations. The third Keynesian view is that the fiscal and monetary authorities can control demand conditions for specific products and for the economy as a whole.

By contrast, three diametrically opposed ideas are central to new classical macroeconomics. First, because market supply and demand decisions are assumed to be made by economically rational agents, these decisions are presumed to be efficient for those who make them. That individual rationality in markets will generally lead to socially desirable outcomes is, of course, the message that is at the core of economic analysis from Adam Smith's *Wealth of Nations* to modern welfare economics. Thus, the case for government intervention, in the NCM view, requires two key steps: (1) identifying a "market failure" and (2) demonstrating that the government can actually follow policies that will lead to social improvements.

Second, the NCM view systematically stresses the importance of supply behavior to market outcomes even in the very short run. Third, the NCM view questions whether typical policy instruments can be manipulated to accomplish specific policy objectives.

Current Policy Discussions

Keynesian and new classical macroeconomics lead to very different conclusions about three economic policies that were often suggested, for example, during the election campaign of 1992:

1. a temporary tax cut for the middle class
Investigating the first two topics requires an understanding of how consumer spending and investment spending are determined, so we begin by discussing how Keynesian and new classical macroeconomics view each of these.

Determinants of Consumption and Investment

In the Keynesian view, consumption (consumer spending) is determined primarily by changes in current disposable income (i.e., national income minus taxes). The new classical perspective is quite different. In the NCM view a household's consumption in a specific time period depends on its current income and on the income it expects in the future, as well as on the interest rates at which it can borrow or lend.

The Keynesian and new classical perspectives regarding investment also differ. Keynesian macroeconomists typically stress current cash flows to a firm and its current cost of capital as the main determinants of investment spending. NCM agrees that these matter, but stresses the role of expected future cash flows and expected future costs of capital as well.

For both consumption and investment, then, a key difference between the Keynesian and new classical views is the importance each puts on expectations about future economic conditions. While many Keynesian macroeconomists might accept some role for expectations, they do not think expectations are important. Further, many Keynesian macroeconomists view expectations about the future as having little systematic relationship to actual future outcomes. Therefore, in the Keynesian view, expectations change only gradually or are governed by what Keynes called "animal spirits." By contrast, NCM sees individuals as regularly trying to determine what will actually happen in the future and using new information efficiently in gauging the relative likelihood of different economic outcomes.

Temporary Tax Cuts for the Middle Class

The traditional Keynesian analysis of tax reductions is very simple and direct. Because tax cuts leave households with more funds, households increase their spending as a result. With higher demand for products, there is an increase in the output of domestic business. Thus tax cuts stimulate the economy, leading to more income and more jobs.

In this view there are only two problems. First, consumers may save their tax cut instead of spending it. Second, consumers may spend their tax cut on imported goods rather than domestic ones. Either way, demand would not rise by the full amount of the tax cut, and the tax cut would be less effective than otherwise at raising domestic production and creating jobs.
But Keynesian macroeconometric models suggest that these two problems are not very important. Following Keynes, economists describe the coefficient linking consumption changes to income changes as "the marginal propensity to consume [MPC] out of income." In a typical Keynesian econometric model the MPC is about .6, which means that 60 percent of a tax cut is spent. Further, standard Keynesian econometric models suggest that only a very small portion of changes in income is spent on imports. So the Keynesian policy of stimulating the economy looks pretty effective on these grounds.

NCM challenges this logic directly and concludes that a one-time tax cut would have a minimal effect on consumption. From the NCM perspective the key point is that the tax change is temporary and thus will add little to the household's ability to finance consumption expenditures on a sustained basis. Therefore, the NCM view is that about 95 percent of the tax reduction will be saved. In other words, the marginal propensity to consume out of this type of income is only .05.

But isn't this NCM view inconsistent with the estimates of Keynesian models, which have found that changes in income brought about sizable changes in consumption? The surprising answer is no. As Milton Friedman first explained and Robert Lucas subsequently emphasized, Keynesian macroeconomic models confuse the response of private consumption to permanent changes in income—such as those that often happen when someone changes jobs—with other, more transitory variations. Consumption responds a lot to permanent changes, which are the dominant influence, and little to temporary ones. By failing to distinguish between these different types of income changes, NCM followers believe, Keynesian modelers overestimate the effect of a temporary tax cut on consumption spending.

Moreover, when there is a tax cut now, the government must raise its borrowing and, ultimately, raise taxes in the future. The recognition that more taxes will come later can actually cause current overall demand to decrease. Thus, the NCM view questions the idea that a temporary tax cut will stimulate the total demand for products.

On-Again-Off-Again Investment Tax Credits

The investment tax credit (ITC), which was abolished in the 1986 tax reform, permitted a company to deduct a fraction of the purchase price of a new investment good from its corporate income tax payments. For this reason it provided a powerful incentive for investment. Most Keynesian macroeconomic models predict that a restoration of the tax credit would cause large, immediate increases in investment spending. The reasoning is that reducing a tax on any activity increases the amount of that activity.

But Keynesian models typically miss a key feature of the investment tax credit—its on-again-off-again nature. An ITC that is temporarily high in one year makes it desirable for firms to delay investment they had scheduled for the prior year and move forward investment that would otherwise have been made in later years. Therefore, a temporary ITC, unlike a temporary income tax cut, can have very powerful effects on demand precisely because it is temporary. But the
effects are likely to be perverse.

Take the slowdown in the U.S. economy that started in the summer of 1990 and developed gradually through the subsequent year. By summer 1991 there was intense speculation in the financial press that the ITC would be restored. Such speculation was reasonable because the ITC was raised during many other post-World War II recessions. But subsequent to each recession, Congress typically reduced the ITC. Consider a company thinking of upgrading a photocopying machine during the summer of 1991. Suppose that the company would have to pay thirty thousand dollars for this machine. If there was a temporary ITC of 10 percent during 1992, then the company could save three thousand dollars just by delaying its purchase until the beginning of 1992. This is very likely a desirable strategy for the company. But for the economy it is perverse: lower investment occurs just when the economy needs high demand for investment goods.

Note the irony. In 1991 the administration considers an ITC for 1992 partly because of low investment in 1991. But part of the reason for low investment is that firms anticipate an ITC for 1992. Thus, the on-again—off-again ITC destabilizes the economy during 1991.

Investment and the Middle-Class Tax Cut

In considering the temporary income tax cut, we focused entirely on the implications for consumption and ignored investment. Did we miss something? It depends critically on how the government plans to pay for the tax cut. If it plans to increase taxes on business, then there could well be effects like those for the investment tax credit. A personal income tax cut for the middle class could signal higher future taxes on capital income and lower rewards to the current investments that are necessary to generate those incomes. The link is an indirect one, but one that could easily overwhelm the small positive effect on consumption.

Monetary Policy and Macroeconomic Activity

In the fifties and sixties the orthodox Keynesian view was that permanently high inflation—brought about by expansionary monetary and fiscal policy—would lead to permanent increases in GDP. Correspondingly, monetary policies that reduced the long-run rate of inflation would cause a long-run reduction in GDP. In the United Kingdom such a trade-off was suggested by the empirical work of A. W. Phillips, who was careful to avoid indicating whether the trade-off was short run or long run. But other economists in the United States and United Kingdom were less cautious. The importance of this trade-off in the United States was stressed by leading theoretical macroeconomists such as Paul Samuelson and Robert Solow of MIT and built into most major econometric models, such as the Data Resources model developed by Otto Eckstein and his colleagues.

But few economists now believe that higher inflation has any important long-run benefits. The shift in thinking has occurred because of two related events. First, work in the classical tradition by Milton Friedman, Edmund Phelps, and Robert
Lucas suggested that little or no long-run trade-off should exist, even if macroeconometric models predicted their existence. Second, the coexistence of high inflation and low growth in the United States during the seventies led to a questioning of this trade-off. Economists devoted increased attention to other episodes of high inflation, like those in Latin America in recent decades and in Europe between the wars. In those episodes very high inflation rates proved unambiguously bad for real GDP.

Thus, if a U.S. recession is due in part to real factors—such as a decline in U.S. competitiveness in world markets—monetary policy has limited ability to make things better. Although expansionary monetary policy may work to increase real activity over one or two years, it cannot deal with the systematic long-run challenges that the United States faces. And the expansionary monetary policy risks igniting higher inflation.

Conclusion

New classical macroeconomics applies standard principles of economics to the behavior of the economy as a whole. Thus, it means that macroeconomists and other economists—such as public finance economists—can use broadly similar models to discuss what public policies are best for the United States and for other countries. As a result NCM has begun to refocus the debate about the appropriate choice of macroeconomic policies. In particular, since NCM now enjoys an increasingly wide following among economists, there is less discussion of policies that seek to "fine-tune" the economy in the short run—like the temporary middle-class tax cut or the countercyclical manipulation of the ITC—which were stressed by Keynesian macroeconomics. More attention is being given to developing macroeconomic policies that promote the long-run health of the economy.

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Further Reading


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