Topics for Today

1.) Review of the Keynesian vs. Lucas AS curves

2.) Interpreting the Evidence

3.) Summary of Business Cycle Theories

4.) Intro to Macroeconomic Policy
- The "Phillips Curve"
- Shifts in the Phillips Curve
- The "Natural Rate Hypothesis"
- Testing the Natural Rate Hypothesis

Keynesian vs. Lucas (classical) AS Curves

- Macroeconomists agree about the properties of the AD curve (e.g., why it slopes down, and why it shifts).

- Macroeconomists disagree about the AS curve. The data suggests it slopes up (because inflation + output tend to be positively correlated), and that it is unstable (because the correlation between output + inflation is unstable). The disagreement is about why it slopes up.

- Keynesians attribute it to slowly adjusting wages + prices (due to procyclical real wages, most Keynesians models feature slow price adjustment rather than slow wage adjustment.

- Classical economists attribute it to informational imperfections. (People tend to have better info about local market conditions, and sometimes get confused between inflation + relative price changes.

- In **both** theories the AS curve takes the form:

$$\boxed{Y = \bar{Y} + b(P - P^e)}$$

where b is a positive parameter (Note: the economic interpretation of b is different in the 2 theories!)

- In both theories, firms + households try to forecast inflation, and will not alter their output + employment decisions in response to **anticipated** changes in AD.

- Given this, why do we care which is true?!

- The answer is that they have very different **policy implications**.

- In Keynesian theories, firms forecast inflation in order to set appropriate prices + wages.

- If a forecast turns out to be wrong, they may "have to" endure (because it is too costly to re-set prices) a period of suboptimal prices + wages.

- In classical models, firms + workers can re-set prices + wages at any time. They will not be fooled for long, and they will not be fooled systematically (according to the "Rational Expectations Hypothesis")

- The key difference then, is that the output effects of unanticipated AD shifts may be long lasting in Keynesian models. What's more, they may respond to countercyclical monetary + fiscal policies. In contrast, classical models predict that output responses are short-lived + unresponsive to policy.

- Hence, it is important to be able to distinguish between these theories. But how?