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:

\[ Y = \bar{Y} + b(P - P^e) \]

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 counter-cyclical 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?