Chapter 16

MACROECONOMIC VIEWPOINTS: NEW KEYNESIAN, MONETARIST, AND NEW CLASSICAL

FUNDAMENTAL QUESTIONS

1. What do Keynesian economists believe about macroeconomic policy?

   Keynesians believe the following:
   Wages and prices are not flexible in the short run.
   The economy is not always in equilibrium.
   The government must take an active role in the economy to stabilize aggregate demand.
   The private sector, especially investment, is an important source of shifts in aggregate demand.
   The aggregate supply curve is not horizontal, but slopes upward as real GDP approaches its potential level.

2. What role do monetarists believe the government should play in the economy?

   Monetarists believe that the economy is inherently stable and that government intervention in the economy makes business cycles worse. They therefore favor minimal government intervention in the economy.

3. What is new classical economics?

   New classical economists emphasize rational expectations and believe that the economy tends toward equilibrium. They also believe that fiscal and monetary policies can change the equilibrium level of real GDP only if the changes are unexpected. Any predictable policy simply affects prices. Government policy should therefore target a low, stable rate of inflation.

4. How do theories of economics change over time?

   Economic theories develop in response to new economic situations or perceived failings in old theories. Thus Keynesian theory evolved to explain the Great Depression, and monetarist and new classical economics evolved to explain the problem of simultaneous unemployment and inflation.

Key Terms

Keynesian economics
monetarist economics
classical economics
new classical economics

Quick-Check Quiz

Section 1: Keynesian Economics

1. Which of the following is *not* common to Keynesian and new Keynesian economists?
   a. the belief that wages and prices are not flexible in the short run
   b. the belief that the aggregate supply curve is a horizontal line
   c. the belief that monetary policy should be used to manage aggregate demand
   d. the belief that fiscal policy should be used to stabilize aggregate demand
   e. the belief that disequilibrium occurs in the labor market

2. Keynesians
   a. believe that the price system efficiently allocates resources.
   b. believe that monetary policy operates with long and variable lags.
   c. emphasize rational expectations.
   d. believe that the government needs to take an active role in managing aggregate demand.
   e. believe that only unexpected changes in the money supply affect real national income

3. According to the traditional Keynesian school of thought, contractionary fiscal and monetary policies will
   a. decrease interest rates, thereby shifting the investment function to the left.
   b. increase both consumption and investment spending, thereby increasing inflationary pressures.
   c. increase investment spending, thereby stabilizing any aggregate supply shocks.
   d. decrease both consumption and investment spending, thereby further decreasing aggregate demand.
   e. shift the aggregate demand curve to the right, thereby increasing the unemployment rate.

Section 2: Monetarist Economics

1. Monetarists believe that
   a. fiscal policy is an effective way to manage aggregate demand.
   b. the government should use only monetary policy to achieve its goals of low inflation and economic growth.
   c. government intervention should be kept to a minimum.
   d. the government should change monetary and fiscal policies to suit current conditions.
   e. government policies have an effect on real GDP only if the changes are unanticipated.

2. Monetarists
   a. have great faith that the market system allocates resources efficiently.
   b. believe that government intervention accentuates business cycles.
   c. believe that the government should follow a fixed rule for monetary growth.
   d. believe that government intervention in the economy is ineffective because of long and variable lags.
   e. All of these statements are true.

3. The effect lag is the time
   a. it takes for the effects of a policy to work their way through the economy once the policy is implemented.
   b. it takes for policymakers to realize there is a problem.
   c. it takes for policymakers to formulate a policy once they recognize there is a problem.
   d. from when policymakers realize there is a problem until the effects of the policy work their way through the economy.
   e. from when policymakers formulate a policy until the effects of the policy work their way through the economy.

4. Regarding the government's role in the economy, monetarists believe that
   a. monetary policy, as opposed to fiscal policy, should be used to stabilize the economy.
   b. government policy heightens the effects of the business cycle.
   c. fiscal policy can change equilibrium GDP only if it unexpectedly changes the level of prices or one of the determinants of aggregate supply.
   d. the economy is subject to disequilibria that must be offset by fiscal policy.
   e. wages and prices are flexible in the long run, so the government should stabilize the economy by managing aggregate demand.

Section 3: New Classical Economics

1. New classical economists agree with Keynesians that
   a. wages and prices are flexible.
   b. the aggregate supply curve is vertical.
   c. markets are always in equilibrium.
   d. any predictable macroeconomic policy has an effect only on prices.
   e. monetary and fiscal policies can achieve a low, stable rate of inflation.

2. New classical economics and classical economics both
   a. emphasize rational expectations.
   b. assume perfect information.
   c. assume a horizontal aggregate supply curve.
   d. believe that wages and prices are flexible.
   e. believe that formal rules should govern economic policymaking.

3. Monetarists and new classical economists agree that
   a. only unexpected changes in prices have effects on real GDP.
   b. wages and prices are not flexible in the short run.
   c. any predictable macroeconomic policy has an effect only on prices.
   d. attempts by the government to manage aggregate demand make business cycles worse.
   e. the government should not try to affect the equilibrium level of real output.

Section 4: Comparison and Influence

1. Which of the following favor an active role for government in promoting low inflation and economic growth?
   a. only Keynesians
   b. only monetarists
   c. only new classical economists
   d. monetarists and new classical economists
   e. monetarists and Keynesians

2. Which of the following believe that wages and prices are flexible in the short run?
   a. only Keynesians
   b. only monetarists
   c. only new classical economists
   d. monetarists and new classical economists
   e. monetarists and Keynesians

3. Which of the following emphasize rational expectations?
   a. only Keynesians
   b. only monetarists
   c. only new classical economists
   d. monetarists and new classical economists
   e. monetarists and Keynesians

4. Whose theory(ies) developed as a response to the problem of unemployment and inflation at the same time?
   a. only Keynesian
   b. only monetarist
   c. only new classical economist
   d. monetarist and new classical economist
   e. monetarist and Keynesian

5. Which of the following believe that the economy tends toward equilibrium at potential real GDP?
   a. only Keynesians
   b. only monetarists
   c. only new classical economists
   d. monetarists and new classical economists
   e. monetarists and Keynesians

6. Which of the following favor fixed rules for money growth?
   a. only Keynesians
   b. only monetarists
   c. only new classical economists
   d. monetarists and new classical economists
   e. monetarists and Keynesians

7. Which of the following believe that monetary and fiscal policies are effective only if people cannot anticipate the changes?
   a. only Keynesians
   b. only monetarists
   c. only new classical economists
   d. monetarists and new classical economists
   e. monetarists and Keynesians

Practice Questions and Problems

Section 1: Keynesian Economics

1. ___________ economics focuses on the role government plays in stabilizing the economy by managing aggregate demand.
2. New Keynesians ___________ (do, do not) believe that wages and prices are flexible in the short run.
3. New Keynesians believe that the economy ___________ (is, is not) always in equilibrium.
4. New Keynesian economists ___________ (do, do not) believe that the government must play an active role in stabilizing the economy.

Section 2: Monetarist Economics

1. ___________ is the leading monetarist economist.
2. Monetarists believe that changes in the money supply directly affect ___________ and ___________.
3. Monetarists believe that fiscal and monetary policies have only ___________ effects on real GDP.
4. Monetarists believe that, in the long run, a change in the money supply will affect only the ___________.
5. Monetarists believe that the economy ___________ (does, does not) tend toward equilibrium at a level consistent with the natural rate of unemployment.
6. Monetarists ___________ (do, do not) believe that the government needs to play an active role in stabilizing the economy.
7. In recent years, the inflation rate seemed to follow changes in the growth rate of the money supply with a lag of ___________ or ___________ years.
8. ___________ lag is the time it takes policymakers to realize that a problem exists.

9. __________ lag is the time it takes policymakers to formulate an appropriate policy once they realize that a problem exists.
10. The __________ lag is the time it takes for the effects of the policy to work through the economy.
11. Monetarists believe that government attempts at achieving full employment and low inflation make the business cycle __________ .
12. Instead of discretionary fiscal and monetary policies, monetarists advocate fiscal and monetary __________ .
13. Monetarists emphasize the role of the __________ in determining equilibrium income and prices.
14. Monetarists believe that government intervention makes the economy worse because of the existence of long and variable __________ .

Section 3: New Classical Economics

1. Classical economists believed that the aggregate supply curve was __________ and that changes in aggregate demand affected only the __________ level, not the level of __________ .
2. Classical economists believed that prices and wages __________ (were, were not) perfectly flexible.
3. New classical economists believe that wages and prices __________ (are, are not) flexible.
4. New classical economists emphasize __________ expectations. Classical economists assumed __________ information.
5. It is much easier for policymakers to make unexpected changes in policy if expectations are formed __________ rather than __________ .
6. New classical economists believe that the economy __________ (does, does not) tend toward equilibrium at a level consistent with the natural rate of unemployment.
7. New classical economists believe that during recessions low real wages cause workers to substitute __________ activities for work.
8. New classical economists believe that changes in fiscal and monetary policies can affect the equilibrium level of real GDP only if those changes are __________ .
9. New classical economists believe that any predictable policy simply affects __________ .
10. New classical economists believe that the goal of monetary and fiscal policies should be a low, stable rate of __________ .

Section 4: Comparison and Influence

1. Macroeconomic theories develop in response to ___________ in existing theories.
2. Only ___________ economics supports an active role for government; the other two theories suggest that government should not intervene.
3. ___________ and ___________ economists believe that the economy tends toward equilibrium at the natural rate of unemployment.

Thinking About and Applying Macroeconomic Viewpoints: New Keynesian, Monetarist, and New Classical

I. The Roots of "Freshwater" Economists

"Freshwater" economists are named for the origins of this group at universities along the shores of the Great Lakes. Like other economic theories, the theory of this group incorporates parts of economic theories that came before it. For each tenet of "freshwater" economic thought, place a *K* if the tenet has Keynesian roots, an *M* if it has monetarist roots, and an *N* if it has new classical roots. A tenet may have more than one letter next to it.

1. The government should not tinker with (or fine-tune) the economy. ___________
2. Consumers, workers, business executives, and investors anticipate changes in the economy faster than the government and can adjust to them better on their own. ___________
3. People anticipate the effects of changes in government policy and sometimes blunt the government's objectives in devising ways to accommodate the changes. ___________
4. Recessions are not a problem, and the government can't do anything about them anyway. ___________
5. Tax cuts have no effect on consumption. ___________
6. "Freshwater" economists are rational expectationalists. ___________
7. There is a lag before Congress recognizes that there is a problem and acts, and another lag before the acts have effects. ___________
8. Government intervention could accentuate the business cycle. ___________
9. Free markets work. ___________

II. Comparing and Contrasting New Keynesians, Monetarists, and New Classical Economists

Place a K next to statements associated with new Keynesians, an M next to statements associated with monetarists, and an N next to statements associated with new classical economists.

________ Fiscal and monetary policies can change the equilibrium level of real GDP only if those changes are unexpected.

________ Monetary and fiscal policies should be set according to formal rules.

________ Wages and prices are inflexible.

________ When real wages are lower, people voluntarily substitute nonlabor activities for employment.

________ The private sector is an important source of shifts for aggregate demand.

________ Money affects income and consumption directly.

________ The economy tends toward equilibrium at the level of potential real GDP.

________ Since economic policy acts with a long and variable lag, government should not attempt discretionary monetary and fiscal policies.

________ The economy is subject to disequilibrium in labor and goods markets.

________ Wages are flexible.

________ Expectations are formed using all available information, not just past experience.

________ Any predictable expansionary fiscal or monetary policy affects only prices.

________ Fiscal and monetary policies should aim for a low, stable rate of inflation.

________ In the long run, real GDP will be at a level consistent with the natural level of unemployment.

________ Government intervention is necessary to achieve high employment and low, stable inflation.

Chapter 16 Homework Problems

Name ________________________________

1. For each group of economists listed below, decide whether they would agree (A) or disagree (D) with the following statement:

   "The economy tends toward equilibrium without government interference."

   __________ new Keynesian economists

   __________ monetarist economists

   __________ new classical economists

2. For each group of economists listed below, decide whether they would agree (A) or disagree (D) with the following statement:

   "Wages and prices are not very flexible in the short run."

   __________ new Keynesian economists

   __________ monetarist economists

   __________ new classical economists

3. For each group of economists listed below, decide whether they would agree (A) or disagree (D) with the following statement:

   "Government policy can affect the price level."

   __________ new Keynesian economists

   __________ monetarist economists

   __________ new classical economists

4. For each group of economists listed below, decide whether they would agree (A) or disagree (D) with the following statement:

   "Government policy can effectively control real GDP by stabilizing aggregate demand."

   __________ new Keynesian economists

   __________ monetarist economists

   __________ new classical economists

5. John Maynard Keynes once wrote that "practical men . . . are the slaves of some defunct economist." Which group or groups of economists (defunct or not) discussed in Chapter 16 are each of the politicians below relying on for their comments?
   a. Politician #1: "The Fed always messes up the economy by playing around with the money supply. It should just pick a policy and stick to it."

   b. Politician #2: "We've got to do something new and different to get the economy growing again."

   c. Politician #3: "The economy is moving into a recession again. It's time to cut taxes and increase government spending."

   d. Politician #4: "Well, it looks like government policy caused another recession. We've got to decide how much taxes and spending will be, and live within those limits."

   e. Politician #5: "There's no point in having the government spend more money to create jobs—unemployment won't go any lower anyway."

If your instructor assigns these problems, write your answers above, then tear out this page and hand it in.

Answers

Quick-Check Quiz

Section 1: Keynesian Economics

1. b; 2. d; 3. d
If you missed any of these questions, you should go back and review Section 1 of Chapter 16.

Section 2: Monetarist Economics

1. c; 2. e; 3. a; 4. b
If you missed any of these questions, you should go back and review Section 2 of Chapter 16.

Section 3: New Classical Economics

1. e; 2. d; 3. e
If you missed any of these questions, you should go back and review Section 3 of Chapter 16.

Section 4: Comparison and Influence

1. a; 2. d; 3. c; 4. d; 5. d; 6. b; 7. c
If you missed any of these questions, you should go back and review Section 4 of Chapter 16.

Practice Questions and Problems

Section 1: Keynesian Economics

1. Keynesian
2. do not
3. is not
4. do

Section 2: Monetarist Economics

1. Milton Friedman
2. consumption; investment
3. short-term
4. price level
5. does
6. do not
7. one; two
8. Recognition
9. Reaction
10. effect
11. worse
12. rules
13. money supply
14. lags

Section 3: New Classical Economics

1. vertical; price; output
2. were
3. are
4. rational; perfect
5. adaptively; rationally
6. does
7. nonlabor
8. unexpected
9. prices
10. inflation

Section 4: Comparison and Influence

1. shortcomings
2. Keynesian
3. Monetarists; new classical

Thinking About and Applying Macroeconomic Viewpoints: New Keynesian, Monetarist, and New Classical

I. The Roots of "Freshwater" Economists

1. M, N
2. N
3. N
4. M, N
5. M, N
6. N
7. N, M
8. M
9. M, N

II. Comparing and Contrasting New Keynesians, Monetarists, and New Classical Economists

N — Fiscal and monetary policies can change the equilibrium level of real GDP only if those changes are unexpected.
M — Monetary and fiscal policies should be set according to formal rules.
K — Wages and prices are inflexible.
N — When real wages are lower, people voluntarily substitute nonlabor activities for employment.
K — The private sector is an important source of shifts for aggregate demand.
M — Money affects income and consumption directly.
M, N — The economy tends toward equilibrium at the level of potential real GDP.
M — Since economic policy acts with a long and variable lag, government should not attempt discretionary monetary and fiscal policies.

K	The economy is subject to disequilibrium in labor and goods markets.
M, N	Wages are flexible.
N	Expectations are formed using all available information, not just past experience.
M, N	Any predictable expansionary fiscal or monetary policy affects only prices.
K, N	Fiscal and monetary policies should aim for a low, stable rate of inflation.
M, N	In the long run, real GDP will be at a level consistent with the natural level of unemployment.
K	Government intervention is necessary to achieve high employment and low, stable inflation.