The key assumption in Keynesian economics

The Keynesian model is an analysis of the economy over the short run. This is the period of time in which firms match their production to the level of demand, rather than responding to price. In fact, in the basic Keynesian model, the price level is held constant. This is another way of thinking about the short run; it is the period of time in which prices do not adjust in response to changes in demand.

REVIEW

REVIEW

Review sections summarise key points of the material just covered and are an excellent revision aid. See Chapter 7, page 193.

What is the difference, if any, between the following:

a. An upward shift in the Reserve Bank's policy reaction function.

b. A response by the Reserve Bank to higher inflation, for a given policy reaction function.

How does each scenario affect the *AD* curve?

EXERCISE 10.3

EXERCISES

Quick questions are posed throughout the chapters in Exercises. These are another way for you to test your understanding. Make sure you can answer them before moving on. Check Appendix A, at the end of the book, for the solution. See Chapter 10, page 299.

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Summary

- The basic Keynesian model shows how fluctuations in planned aggregate expenditure, or total planned spending, can cause actual output to differ from potential output. Too little spending leads to a recessionary output gap; too much spending creates an expansionary output gap. This model relies on the crucial assumption that firms do not respond to every change in demand by changing prices. Instead, they typically set a price for some period, then meet the demand forthcoming at that on the horizontal axis. The Keynesian cross contains two lines: an expenditure line, which relates planned aggregate expenditure to output, and a 45-degree line, which represents the condition that short-run equilibrium output equals planned aggregate expenditure. Short-run equilibrium output is determined at the point at which these two lines intersect. Alternatively, equilibrium is the point at which the planned injections schedule intersects the positively sloped withdrawals schedule.

SUMMARY

Each chapter concludes with a summary of the topics covered. This helps to reinforce the key principles and is a valuable learning aid. See page 224.

REVIEW QUESTIONS

1. What is the key assumption of the basic Keynesian model? Explain why this assumption is needed if one is to accept the view that aggregate spending is a driving force behind short-term economic fluctuations.
2. Give an example of a good or service whose price changes very frequently and one whose price changes relatively infrequently. What accounts for the difference?
3. Define *planned aggregate expenditure* and list its components. Why does planned spending change when output changes?

PROBLEMS

1. Acme Manufacturing is producing $4 000 000 worth of goods this year and expects to sell its entire production. It is also planning to purchase $1 500 000 in new equipment during the year. At the beginning of the year the company has $500 000 in inventory in its warehouse. Find actual investment and planned investment if
   a. Acme actually sells $3 850 000 worth of goods.
   b. Acme actually sells $4 000 000 worth of goods.

REVIEW QUESTIONS AND PROBLEMS

Thought-provoking questions and problems are provided at the end of each chapter and are another excellent learning aid, reinforcing the key principles and topics covered. See page 226.