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Reconstructing Keynesian Macroeconomics Volume 1

Partial perspectives

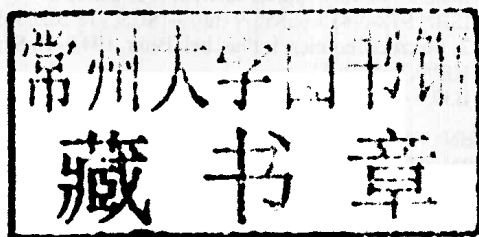
Carl Chiarella, Peter Flaschel and
Willi Semmler



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Partial perspectives

**Carl Chiarella, Peter Flaschel
and Willi Semmler**



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Reconstructing Keynesian Macroeconomics Volume 1

Reconstructing Keynesian Macroeconomics lives up to its title. The authors present an up-to-date, technically sophisticated version of truly Keynesian macrodynamics along with a trenchant critique of mainstream modeling. The book represents the state of the art in an exciting area of macroeconomics.

This book represents the first of three volumes offering a complete reinterpretation and restructuring of Keynesian macroeconomics and a detailed investigation of the disequilibrium adjustment processes characterizing the financial, the goods and the labor markets and their interaction. It questions in a radical way the evolution of Keynesian macroeconomics after World War II and focuses on the limitations of the traditional Keynesian approach until it fell apart in the early 1970s, as well as the inadequacy of the new consensus in macroeconomics that emerged from the Monetarist critique of Keynesianism.

Professors Chiarella, Flaschel and Semmler investigate basic methodological issues, the pitfalls of the Rational Expectations School, important feedback channels in the tradition of Tobin's work, and theories of the wage-price spiral and the evidences for them. The book uses primarily partial approaches, the integration of which will be the subject of subsequent volumes. With its focus on Keynesian propagation mechanisms, the research in this book provides a unique alternative to the black-box shock-absorber approaches that dominate modern macroeconomics.

Reconstructing Keynesian Macroeconomics should be of interest to students and researchers who want to look at alternatives to the mainstream macrodynamics that emerged from the Monetarist critique of Keynesianism.

Carl Chiarella is currently Professor of Quantitative Finance in the Business Faculty at the University of Technology, Sydney, Australia.

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Partial perspectives

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Notation

Steady state or trend values are indicated by a sub- or superscript “o” (sometimes also by an “*”). When no confusion arises, letters F , G , H may also define certain functional expressions in a specific context. A dot over a variable $x = x(t)$ denotes the time derivative, a caret its growth rate; $\dot{x} = dx/dt$, $\hat{x} = \dot{x}/x$. In the numerical simulations, flow variables are measured at annual rates.

As far as possible, the notation tries to follow the logic of using capital letters for level variables and lower case letters for variables in intensive form, or for constant (steady state) ratios. Greek letters are most often constant coefficients in behavioral equations (with, however, the notable exceptions being π^e , ω). We use the abbreviation “NAIRU” for the Non-Accelerating-Inflation Rate of Unemployment, but use this acronym also in the case of “Utilization” (of labor or capital) in the place of “Unemployment”. And the acronym “RE (S)” stands for the “Rational Expectations (School)”. Further acronyms are of a local nature only and will be explained in the sections where they are used. There will also be some chapter-specific (local) notation in some of the chapters.

B	outstanding government fixed-price bonds (priced at $p_b = 1$)
C	real private consumption (demand is generally realized)
E	number of equities
F	neoclassical production function
G	real government expenditure (demand is always realized)
I	net investment in fixed capital
I	desired real inventory investment
J	Jacobian matrix in the mathematical analysis
K	stock of fixed capital
L^d	total working hours (labor demand is always realized)
L^w	Employed workforce, i.e., number of employed people
L or N	labor supply, i.e., supply of total working hours per year
M	stock of money supply
N	inventories of finished goods
N^d	desired stock of inventories
S_f	real saving of firms
S_g	real government saving

S_p	real saving of private households
S	total real saving
T	total real tax collections
$T_w(t_w)$	real taxes of workers (per unit of capital)
$T_c(t_c)$	real taxes of asset holders (per unit of capital)
W	real wealth of private households
Y	real output
Y^p	potential real output
Y^f	full employment real output
Y^d	real aggregate demand
Y^e	expected real aggregate demand
c	marginal propensity to consume
e	employment rate
$U = 1 - e$	unemployment rate
$f_x = f_1$, etc.	partial derivative
r, i	nominal rate of interest on government bonds;
k	capital intensity K/L (or parameter in money demand)
$\sigma = 1/y$	capital coefficient K/Y
l	labor intensity (in efficiency units)
m	real balances relative to the capital stock; $m = M/pK$
n	inventory–capital ratio; $n = N/K$
p	price level
p_e	price of equities
q	return differential; $q = r - (i - \pi)$ or Tobin's q
r, ρ	rate of return on fixed capital: $r = (pY - wL - \delta pK)/pK$
s_c	propensity to save out of capital income, asset owners
u, u^w, e^w	rate of capacity utilization $u = Y/Y^n = y/y^n$
v	wage share (in gross product); $v = wL/pY$
w	nominal wage rate per hour
y	output–capital ratio; $y = Y/K$;
y^d	ratio of aggregate demand to capital stock; $y^d = Y^d/K$
y^e	ratio of expected demand to capital stock; $y^e = Y^e/K$
z or x	labor productivity, i.e., output per worker; $z = Y/L^d$
α	symbol for policy parameters in Taylor rule
α_i	interest rate smoothing coefficient in the Taylor rule
α_p	coefficient on inflation gap in the Taylor rule
α_u	coefficient on output gap in the Taylor rule
β_x	reaction coefficient in an equation determining x , \dot{x} or \hat{x}
β_y	adjustment speed in adaptive sales expectations
β_π	general adjustment speed in revisions of the inflation climate
β_{xy}	reaction coefficient related to the determination of variable x , \dot{x} or \hat{x} with respect to changes in the variable y
α_q	responsiveness of investment to changes in q
α_u	responsiveness of investment to changes in u
β_n	stock adjustment speed

α_{n^d}	desired ratio of inventories over expected sales
β_{pu}	reaction coefficient of u in price Phillips curve
β_{pv}	reaction coefficient of $(1 + \mu)v - 1$ in price Phillips curve
β_{we}	reaction coefficient of e in wage Phillips curve
β_{wv}	reaction coefficient of $(v - v^o)/v^o$ in wage Phillips curve
γ	government expenditures per unit of fixed capital; $\gamma = G/K$ (a constant)
τ	lump sum taxes per unit of fixed capital; $\tau = T/K$ (a constant)
δ	rate of depreciation of fixed capital (a constant)
$\eta_{m,i}$	interest elasticity of money demand (a positive number)
κ	coefficient in reduced-form wage-price equations $= \frac{1}{1 - \kappa_p \kappa_w}$
κ_p	parameter weighting \hat{w} vs. π in price Phillips curve
κ_w	parameter weighting \hat{p} vs. π in wage Phillips curve
κ_{wp}	same as κ_w
κ_{wz}	parameter weighting \hat{z} vs. \hat{z}^o in wage Phillips curve
κ_π	parameter weighting adaptive vs. regressive expectations
π^c	general inflation climate;
θ	log of real wages
$\tau_c = T_c/K$	tax parameter for T^c (net of interest per capital); $T^c = iB/p$
ω	real wage rate w/p

Contributors

Carl Chiarella is a Professor of Quantitative Finance and also an Emeritus Professor at the University of Technology, Sydney. Carl has held visiting appointments at a number of Universities around the world including the University of Kyoto, Nanyang Technological University, Hitotsubashi University, Tokyo Metropolitan University, the University of Bielefeld and the University of Urbino. He is currently an Editor of the *Journal of Economic Dynamics and Control* and an Associate Editor of *Studies in Nonlinear Dynamics and Econometrics*, and the *European Journal of Finance and Computational Economics*.

Peter Flaschel is Professor Emeritus at Bielefeld University, Germany. He was on numerous occasions Visiting Professor at the University of Technology, Sydney, and was invited as Theodor Heuss Professor to the New School for Social Research, New York, in 2006. He received an Opus Magnum Grant from the Fritz Thyssen/Volkswagen Stiftungen in 2007/08.

Willi Semmler is a Professor of Economics at the New School for Social Research, New York. He was Visiting Scholar at Columbia University and Stanford University, has taught at the Universities of Bielefeld, Marseilles/Aix-en-Provence, Mexico City and the European Doctoral Program in Quantitative Economics. He worked as a consultant for the ILO, World Bank and the European Unions and has been appointed Fulbright Visiting Professor to the University of Economics and Business, Vienna, for Fall 2011.

Introduction

Keynesian macroeconomics

The disarray in Keynesian macroeconomics

So here's what I think economists have to do. First, they have to face up to the inconvenient reality that financial markets fall far short of perfection, that they are subject to extraordinary delusions and the madness of crowds. Second, they have to admit – and this will be very hard for the people who giggled and whispered over Keynes – that Keynesian economics remains the best framework we have for making sense of recessions and depressions. Third, they'll have to do their best to incorporate the realities of finance into macroeconomics. Many economists will find these changes deeply disturbing.

(Paul Krugman, *New York Times*, September 6, 2009)

As the Nobel laureate Paul Krugman states in the above quotation the financial market meltdown of the years 2007–2009, and the subsequent world-wide great recession, has posed a great challenge for macroeconomics. This concerns not only the now dominant modern macroeconomic modeling framework, such as the Dynamic Stochastic General Equilibrium (DSGE) Model, but also traditional macroeconomics based on the Keynesian paradigm. This book takes the above statement as point of departure by critically evaluating not only the DSGE models but also the evolution of Keynesian macroeconomics after World War II.

Macroeconomics in the 1960s and 1970s was viewed as part of the old Neoclassical synthesis of Patinkin and others, with the Classical version of this synthesis on the one hand and the Keynesian variant of it on the other hand. From this traditional consensus the Neoclassical Synthesis was however transformed towards a new and extremely different one, the so-called New Neoclassical Synthesis, with Real Business Cycle theory now representing the Classical variant and New Keynesian theory now as the Keynesian variant.

This New Consensus in macroeconomics and its two basic variants could be summarized under the general heading of DSGE model building. There is from a general perspective much to be said for the first three letters in this acronym. Yet, the fulfillment of them is heavily biased towards a stochastic explanation of the business cycle, in particular in the Real Business Cycle (RBC) tradition. The DSGE