The Simple Keynesian Model

Introduction

The Simple Keynesian Model is simple. There is no intent to put forward a realistic depiction of a complete macroeconomy. The idea is to illustrate a select set of important points.

Most important among those points is that the economy can be in equilibrium without being at full employment. The Classical Model, which is the major predecessor to the Keynesian models, is anchored around an equilibrium in the labor market where the wage rate adjusts to clear the market, leaving no unemployment. In the Simple Keynesian Model, there is no wage rate and the level of aggregate output adjusts to reach an equilibrium. Simple equations not necessarily involving interest rates, wage rates, or prices determine consumption, investment, and government spending.

The Model

The accounting identity

$$Y = C + I + G$$

establishes one relation between consumption C, investment I, government spending G, and total income Y. G is treated as exogenous, but economic behavior determines C and I:

$$C = 125 + 0.75\ Y - 10\ R$$

$$I = 120 - 10\ R + \text{Animal Spirits}$$

Consumption depends on the interest rate R because C = Y - S and savings S depends on the interest rate. R is held constant through most of these exercises.

Exercises Holding R Constant

1. Suppose Animal Spirits equal the baseline value of zero and I = 60. Determine the equilibrium value for income Y. If full employment is Y = 500, is this equilibrium full employment?

2. Suppose animal spirits are unfavorable (negative). What happens to Y?

3. If government spending increases, show that Y increases by a multiple of the

change in government spending.

Changing R to Construct an IS Curve

4. Set R to several different values. Graph Y vs. R to produce an IS Curve.