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AN AS-AD VIEW

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New-Keynesian Economics: An AS-AD View

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ABSTRACT

A simple New-Keynesian model is set out with AS-AD graphical analysis. The model is consistent with modern central banking, which targets short- term nominal interest rates instead of money supply aggregates. This simple framework enables us to analyze the economic impact of productivity or mark-up disturbances and to study alternative monetary and fiscal policies. The impact of the fiscal multipliers on output and the output gap can be quantified showing that a short-run increase in public spending has a multiplier less than one on output and a much smaller multiplier on the output gap, while a decrease in short-run taxes has a positive multiplier on output, but negative on the output gap. In the AS-AD graphical view, optimal policy simplifies to nothing more than an additional line, IT, along which the trade-off between the objective of price stability and that of stabilizing the output gap can be optimally exploited. The framework is also suitable for studying a liquidity-trap environment and possible solutions.

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