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NEW-KEYNESIAN ECONOMICS:
AN AS-AD VIEW

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Working Paper 14824
<http://www.nber.org/papers/w14824>

NATIONAL BUREAU OF ECONOMIC RESEARCH
1050 Massachusetts Avenue
Cambridge, MA 02138
March 2009

I am grateful to Mike Woodford for helpful discussions and comments and to Roger Meservey for professional editing. The views expressed herein are those of the author(s) and do not necessarily reflect the views of the National Bureau of Economic Research.

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NBER Working Paper No. 14824
March 2009, Revised April 2010
JEL No. E0

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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