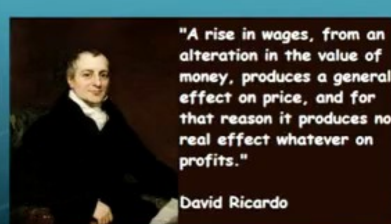
LECTURE ONE - PART FOUR

Classical Economics

- Dates back to the late 1700s.
- Rooted in the *laissez faire* writings of Adam Smith, David Ricardo, and Jean Baptiste Say.



Classical Economics Principles

- Unemployment a natural part of business cycle.
- Economy is self-correcting.
- No need for government intervention like fiscal or monetary policy!

The Classical Economists Get Run Over By the Great Depression

- Between Civil War and Roaring 20's, a series of booms and busts
  - Five depressions!
- The economy always self-corrected like Classical Economists predicted.
- Classical economists were no match, however, for the Great Depression!

The Great Depression Cometh

- Stock market crash in 1929.
- GDP falls by almost a third between 1929 and 1933.
- 25% of work force unemployed.
- Business investment fell from $16 billion in 1929 to $1 billion by 1933!

The Birth of Keynesian Economics

- President Herbert Hoover wrongly believed prosperity just around the corner
- Classical economists waited fruitlessly for the “inevitable recovery”
- Enter stage left:
  - Economist John Maynard Keynes
  - President Franklin Delano Roosevelt

The Keynesian View

- Keynes flatly rejected the Classical notion of a self-correcting economy.
- He warned that patiently waiting for the eventual recovery was fruitless because "in the long run, we're all dead."

Classical Economics' Death Spiral

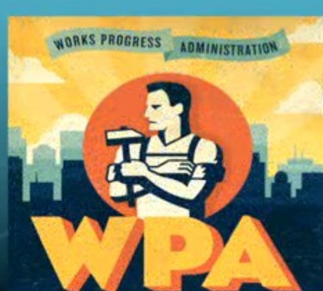
- Under certain circumstances, economy would not naturally rebound.
- Instead, it would stagnate or fall into a death spiral!

The Keynesian Spending Cure

- Only way to get the economy moving again?
  - Prime the economic pump with increased government expenditures!
- Thus, fiscal policy was born!
  - The Keynesian prescription became the underlying philosophy of Franklin Delano Roosevelt's New Deal.

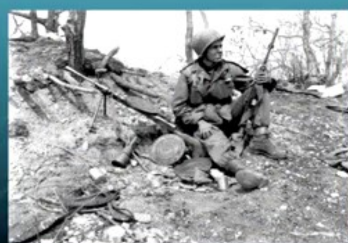
Roosevelt's New Deal and WWII Lifts The Economy

- The New Deal's public works projects PLUS a World War II manufacturing boom lift the American economy up to unprecedented heights!



The Keynesian Cure Redux

- Korean War expenditures stimulate the economy out of a 1950s recession.
- The famous Kennedy tax cut lifts the economy out of the doldrums in the 1960s.



The Promise of "Fine Tuning"

- President Kennedy's chief economic advisor popularized the term "fine tuning."
- The concept: By mechanically applying Keynesian principles, the U.S. economy could be held very close to full employment with minimal inflation.

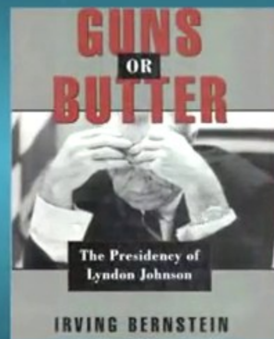
The Kennedy Tax Cut

- 1962: Heller recommend a large tax cut to stimulate the sluggish economy.
- This was revolutionary – usually fiscal stimulus meant more government spending and not tax cuts.
- The Kennedy tax cut made the 1960s one of the most prosperous decades in America.

The Foundation of Stagflation

- This fiscal stimulus laid the foundation for the emergence of stagflation.
- Stagflation is simultaneous high inflation and high unemployment.
- Stagflation would prove difficult to cure with traditional Keynesian tools.

The Roots of Stagflation



Guns Or Butter – You Can't Have Both

- President Johnson increased expenditures on the Vietnam War.
- He refused to cut spending on his Great Society social welfare programs.
- LBJ's refusal to cut "butter" while buying "guns" helped spawn a virulent "demand pull" inflation.