LECTURE THREE - PART FIVE

Explaining the Great Depression

- In 1929, the economy was booming and at full employment.
- The stock market crash sent the business community into a panic.
- "Animal spirits" went from bullish to bearish.
- Businesses cut back sharply on investment and production.
- Frightened consumers cut back dramatically on consumption and MPS rose!

Keynes' Income Adjustment Mechanism in Action

- The reactions of business and consumers led to a sharp and sudden downward shift of the aggregate expenditures curve.
- Business people responded by decreasing output further.
- This depressed income and consumption.
- The economy continued its downward spiral, and eventually unemployment reached a staggering 25 percent of the workforce .

The Paradox Of Thrift

- In attempting to save more, many individual households saved less because their incomes fell as aggregate expenditures fell.
- This "paradox of thrift" can be an important contributor to recessionary events.

Fiscal Policy (and War) to the Rescue

- With consumers saving more and spending less, businesses were also unwilling to invest no matter how low interest rates fell.
- The government stepped in with a massive dose of expansionary fiscal policy.
- FDR's New Deal followed by the dramatic spurt of WWII expenditures triggered increased consumption and investment and the economy roared back to full employment.

Mechanistic Keynesianism

- The Keynesian model provides a very mechanistic approach to curing a recession.
- If you know what the actual GDP and full employment GDP are, you know the size of the recessionary or inflationary gap.
- If you know the MPC and therefore the multiplier, you know how much to increase or decrease G or T to close the gap.

It's Not This Simple

- If mechanistic Keynesianism worked like the simple model, none of us would have to worry about being unemployed.
- Any of us, after mastering the simple lesson of this lecture, would be qualified to serve as the President's top economic advisor!
- But it's just not this simple – even if many economists at the height of the 1960s Keynesian era thought it was!!!

A Key Concept: "Crowding Out"

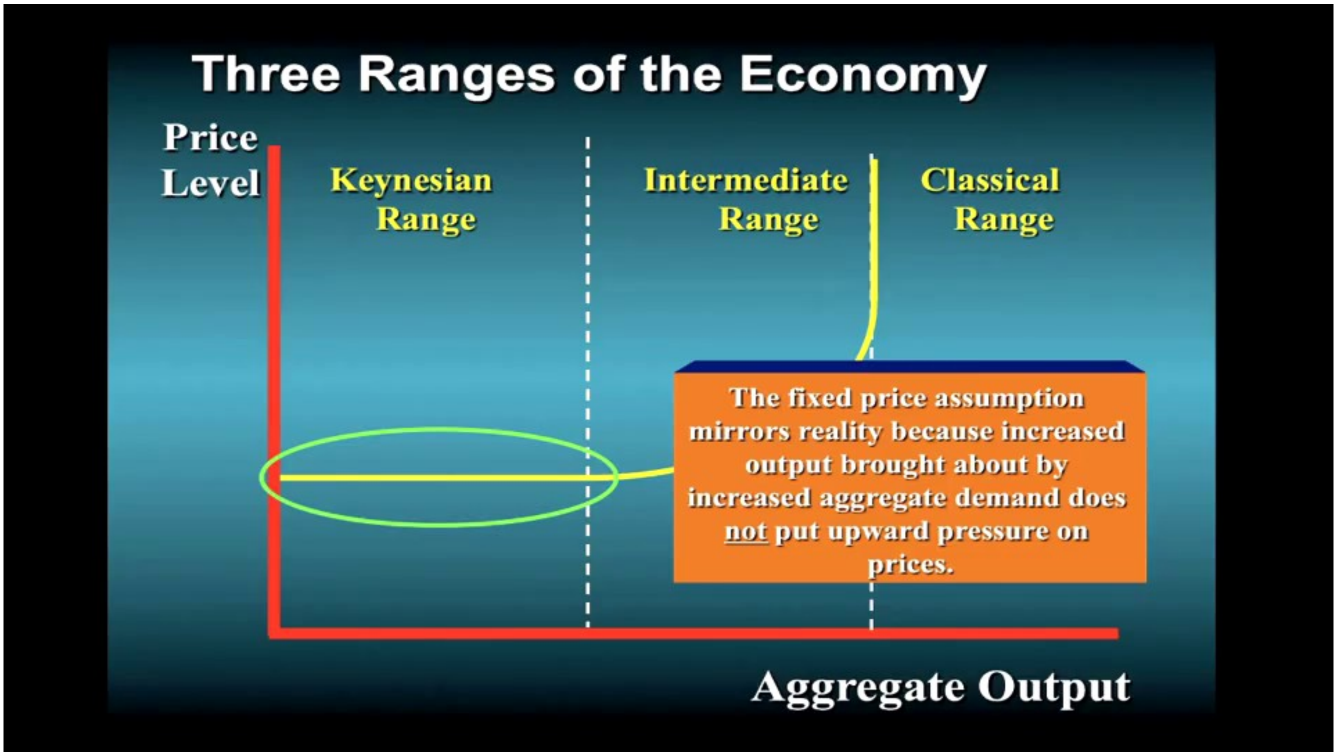
- Crowding out: A reduction in private sector investment that can be caused by increased government spending.
- Crowding out can happen when the government borrows money to finance these expenditures.
- Such borrowing or "deficit spending" can drive up interest rates.
- Higher interest rates can, in turn, reduce private sector investment.

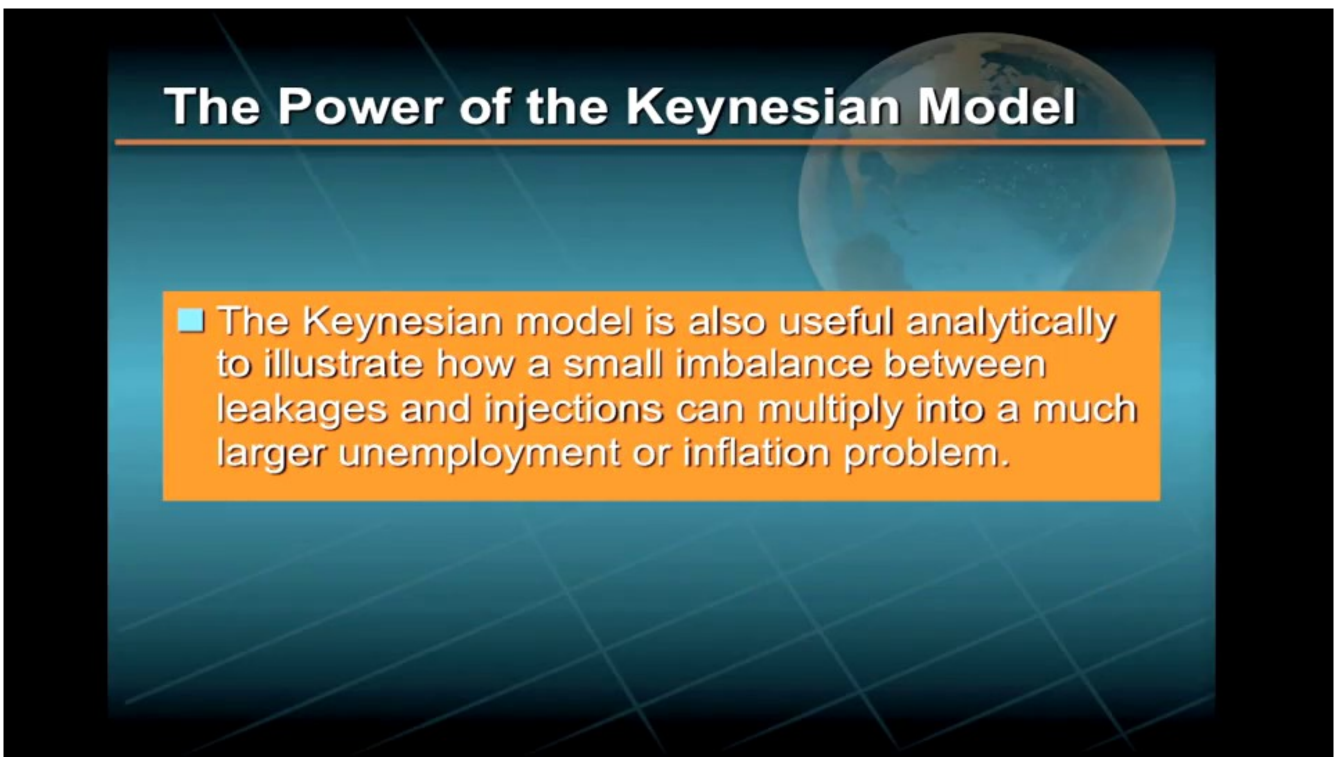
Crowding Out Reduces the Effect of Fiscal Policy

- Any fiscal policy stimulus may be partly or fully offset by a reduction in private sector demand because of crowding out.
- Therefore, the net expansionary effect of fiscal policy might be smaller than intended!!

The Achilles Heel of the Keynesian Model

- Here's a much broader problem with the mechanistic Keynesian approach:
  - It relies on a model that is incomplete.
  - It ignores the monetary and financial sector.
  - It assumes a closed economy.


Three Ranges of the Economy
Price Level
Keynesian Range
Intermediate Range
Classical Range
The fixed price assumption mirrors reality because increased output brought about by increased aggregate demand does not put upward pressure on prices.
Aggregate Output


The Power of the Keynesian Model
The Keynesian model is also useful analytically to illustrate how a small imbalance between leakages and injections can multiply into a much larger unemployment or inflation problem.

A Key Weakness – The Fixed Price Assumption

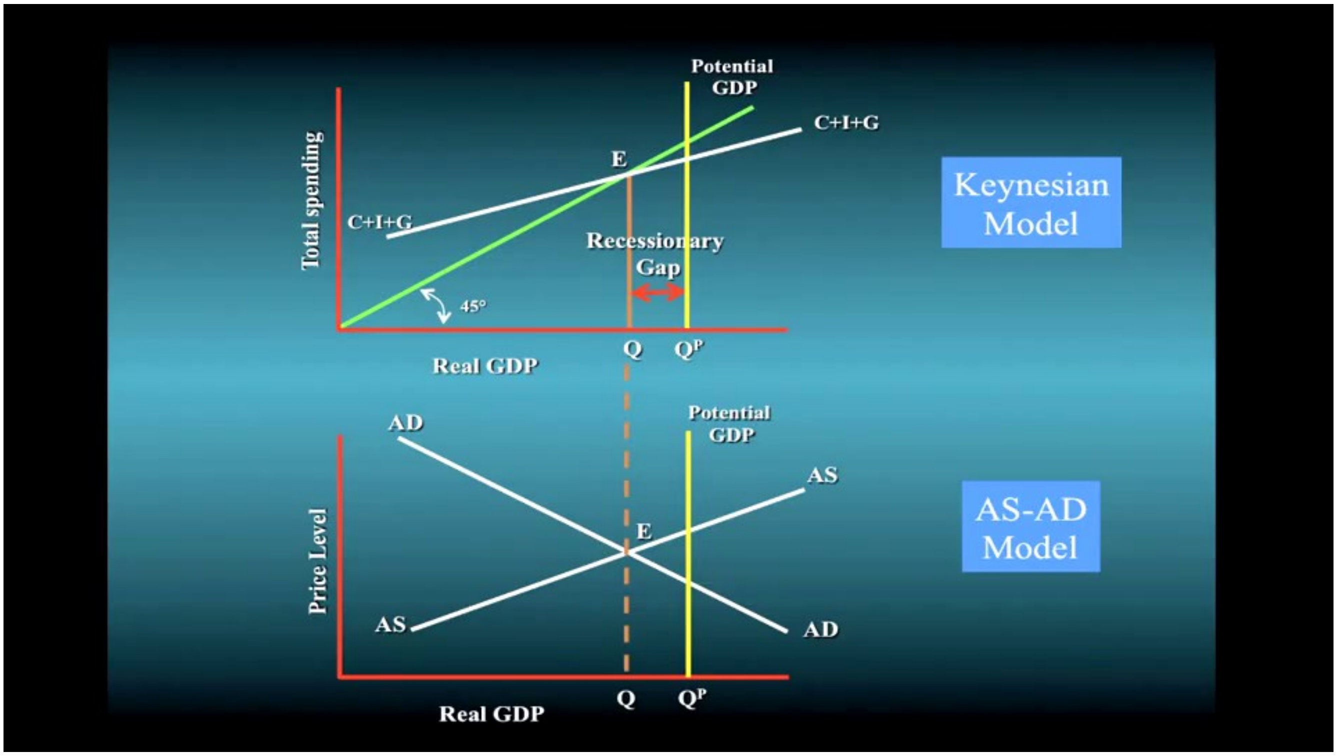
- The Keynesian model assumes away inflation.
- The Keynesian model thereby neglects the crucial influence of monetary factors on interest rates and interest-sensitive components of output such as investment.

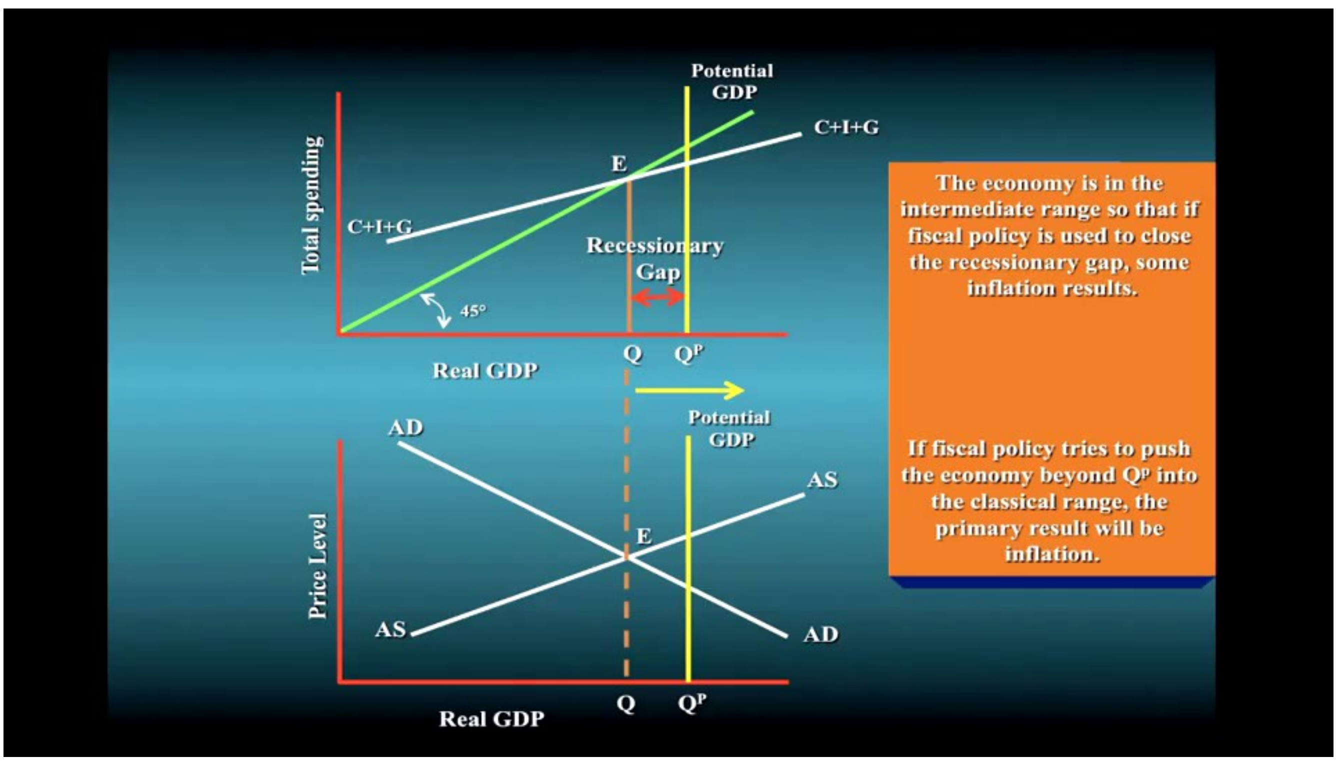
The Key Strength Of The AD/AS Model

- The AS-AD model illustrates both price levels *and* real output.

QUESTION

What is the relationship between the Keynesian aggregate expenditures-aggregate production model and the Classical aggregate supply-aggregate demand model?


Potential GDP
C+I+G
E
C+I+G
Total spending
Recessionary Gap
45°
Q
Q^P
Real GDP
Keynesian Model
AD
Potential GDP
AS
E
Price Level
AS
AD
Q
Q^P
Real GDP
AS-AD Model


Potential GDP
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Real GDP
AD
Potential GDP
AS
E
Price Level
AS
AD
Q
Q^P
Real GDP
The economy is in the intermediate range so that if fiscal policy is used to close the recessionary gap, some inflation results.
If fiscal policy tries to push the economy beyond Q^P into the classical range, the primary result will be inflation.

Coming Up Next!

Lesson Four:

The Federal Reserve & Monetary Policy

PLEASE REMEMBER

- Economics is not something to be memorized but rather conceptualized.
- As you study it, think about it too!!!!!

THE POWER OF MACROECONOMICS

Professor Peter Navarro
University of California-Irvine

END OF LESSON THREE