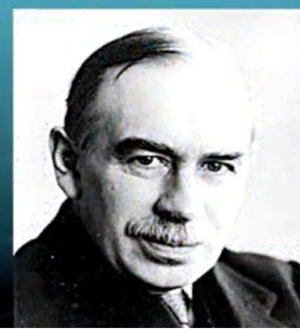
LECTURE TWO - PART THREE

Classical Economics Gives Way to Keynesian Economics

- The failure of Classical Economics during the Great Depression resulted in a search for an alternative solution.
- That solution was Keynesian economics.

Why Classical Economics Failed

- The problem with Classical economics was not the price adjustment mechanism it relied on.
- Keynes believed that before the price mechanism could work, it would be dwarfed by a much more powerful *"income adjustment mechanism."*



The Income Adjustment Mechanism

- When an economy sinks into recession, peoples' incomes fall.
- A fall in income causes people to spend and save less.
- Businesses respond by investing and producing less.
- This reduction in consumption, savings, investment, and output drives the economy deeper into recession rather than back to full employment.

An Economy Stuck in a Classical Rut

- Eventually income falls far enough so that savings and investment return to equilibrium
- However, the economy will be at a level well below full employment.
- In other words, the economy is stuck in a rut with a glut of goods.
- This is just as Thomas Malthus predicted in his original critique of the Classical model.

A Key Difference in Price Assumptions

- The AS-AD framework has its roots in Classical economics. It allows for price adjustments.
- The Keynesian model assumes prices are fixed.

In The Remainder Of This Lecture

- We develop the aggregate supply-aggregate demand model and then turn to the Keynesian model in the next lecture.
- *Both* models are helpful in understanding how modern economies function.