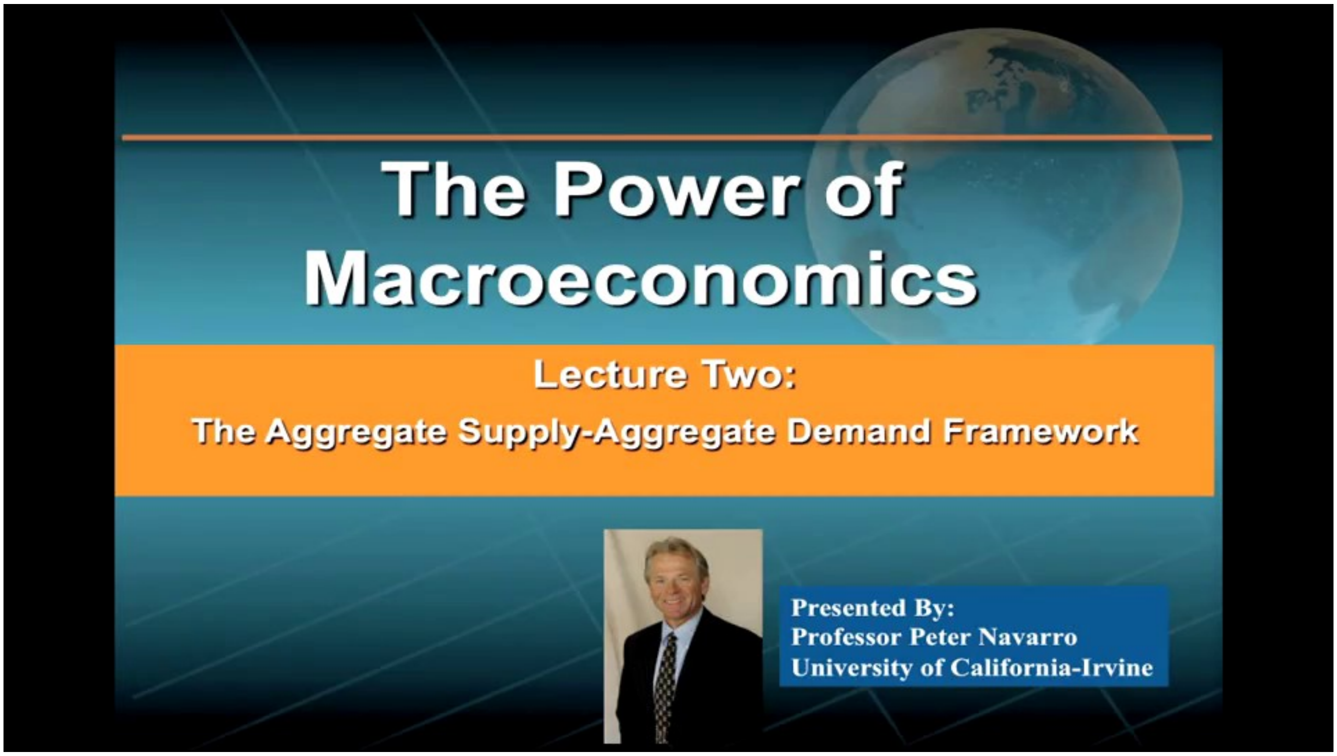
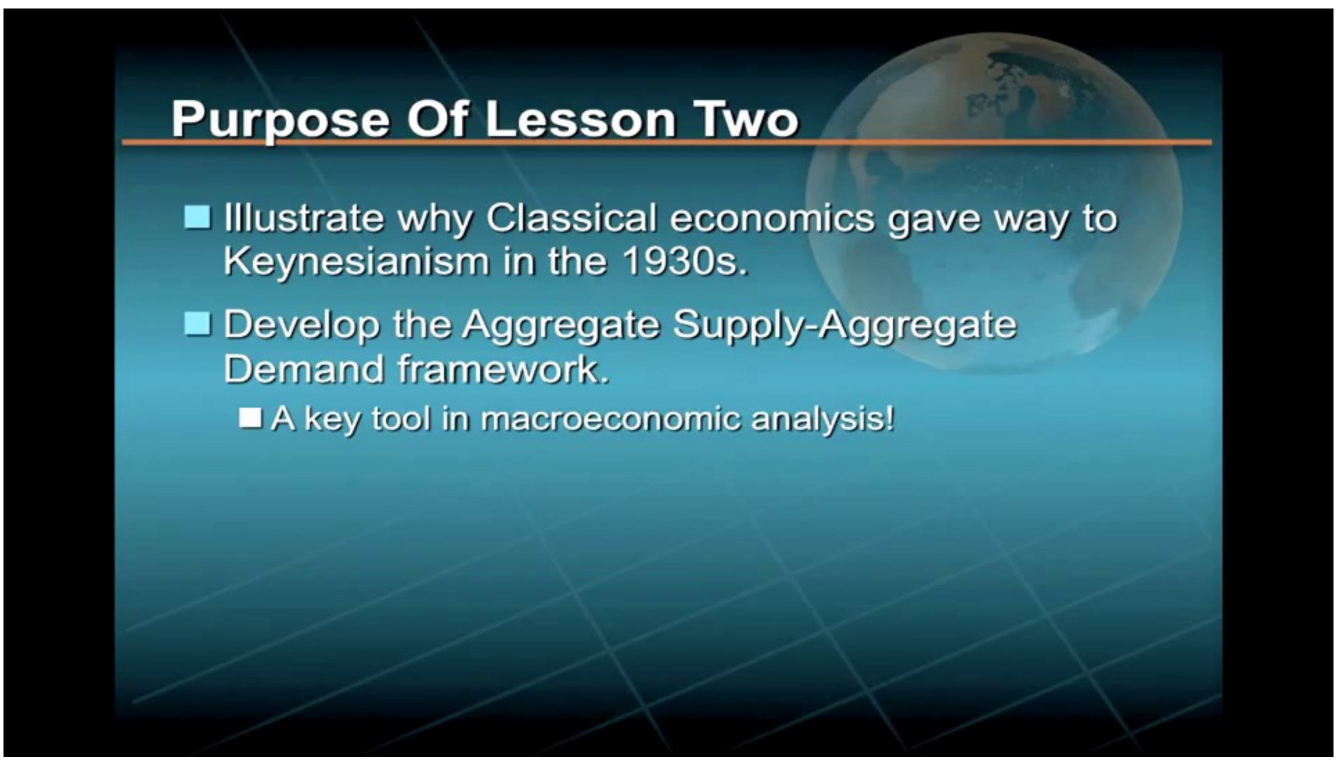


The Power of Macroeconomics
Lecture Two:
The Aggregate Supply-Aggregate Demand Framework
Presented By:
Professor Peter Navarro
University of California-Irvine

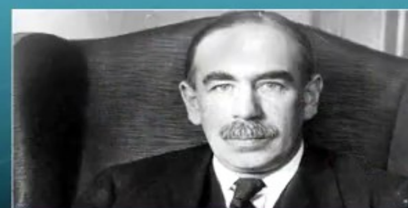


Purpose Of Lesson Two
Illustrate why Classical economics gave way to Keynesianism in the 1930s.
Develop the Aggregate Supply-Aggregate Demand framework.
A key tool in macroeconomic analysis!

An Important Debate

- The debate between Classical economists and Keynesians ranks as one of the most important in macroeconomics.

Adam Smith



John Maynard Keynes

The Classical-Keynesian Debate

- Debate goes back to the 1930s and the Great Depression – but very important today!
- Many of the macroeconomic policies now favored by conservatives have their roots in Classical economics.
- Those on the other side of the ideological spectrum are generally more supportive of the Keynesian approach.

The Most Important Point

- The Classical versus Keynesian controversy:
  - Primarily a dispute over how an economy adjusts during a recession and finds its way back to full employment.

The Classical View

- A "*price adjustment mechanism*" would cure the economy.
- In the event of unemployment, prices, wages, and interest rates would all fall.
- This would increase consumption, production, and investment and quickly return the economy back to its full employment equilibrium.

The Keynesian View

- Before price adjustment mechanism can work, it is overpowered by an *"income adjustment mechanism."*
  - When an economy sinks into a recession, peoples' incomes fall.
  - They spend and save less while businesses invest and produce less.
- This income adjustment mechanism drives the economy further into recession rather than back to full employment.

Laissez-Fair Economics

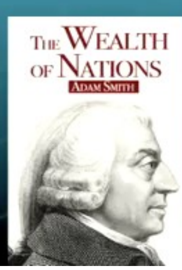
- The Classical approach believes that the best cure for a recession is to leave the free market alone.
- Laissez faire economists believe most government policies will probably make things worse--not better--so the best policy is relatively little government.

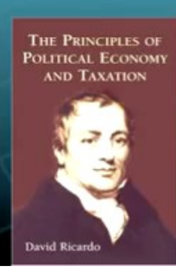
“Activist” Economics

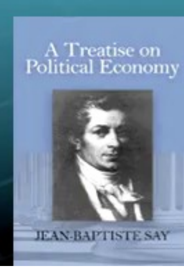
- Keynesians prescribe large-scale government expenditures to prime the economic pump.
- Keynesians are “activist” economists who believe that the government can create and implement policies that will positively affect the economy.

Classical Economics

- Roots are in the free market writings of Adam Smith, David Ricardo, and Jean Baptiste Say.
- Unemployment is a natural part of the business cycle and is self-correcting.
  - There is no need for government intervention into the free market!!







Classical Unemployment

- Unemployment results when wages are too high.
- In the event of a recession, unemployed workers would be willing to work for less.
- Wages would then fall back down to levels where it once again made it profitable for firms to hire the workers and the recession would end.

There Is No Cyclical Unemployment

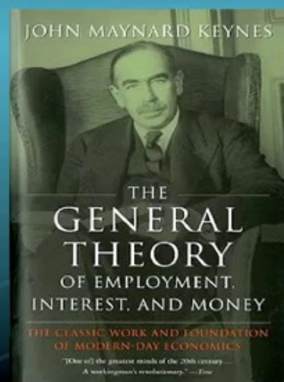
- Classical economists agreed that *frictional* and *structural* unemployment could exist.
- They did not agree that *cyclical* unemployment could be caused by a shortage of aggregate demand.


The Classical Economists
Meet Their Match in the Great Depression
WANTED
JOB
WANTED
JOB
JOBLESS MEN
KEEP GOING
WE CAN'T TAKE CARE OF OUR OWN


A Deepening Crisis
31.
Herbert Hoover 1929-1933
A “Hooverville during the
Great Depression
TIME
JOHN
MAYNARD
KEYNES

Keynes' General Theory

- Keynes flatly rejected the Classical notion of a self-correcting economy that would solve unemployment through adjustments in wages and prices.

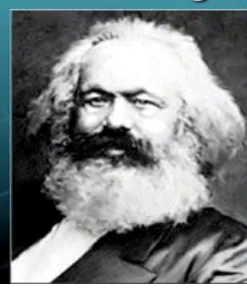


The Keynesian Bottom Line

- Waiting for eventual recovery was fruitless because "in the long run, we' re all dead."
- Under certain circumstances, a recessionary economy would not rebound but fall into a deep spiral.
- The only way to get the economy moving again was to prime the economic pump with massive government expenditures!!!!!

Keynes' An Economic Heretic

- Keynes' approach was economic heresy.
- Keynesian policies were initially rejected by virtually the entire economics profession.
- Keynes and his followers were branded as socialists or communists for advocating an activist role for the central government.



Karl Marx

Keynesian Economics is Born

- Keynes stuck to his guns.
- As the Depression wore on, his teachings gained adherents and disciples.