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Week #2

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Week Two: The Aggregate Supply-Aggregate Demand Model and the Classical-Keynesian Debate

The debate between Classical economists and Keynesians is one of the most important in macroeconomics. This debate goes back to the 1930s and the Great Depression. However, it remains important even today. This is because many of the macroeconomic policies now favored by conservatives have their roots in Classical economics while those on the other side of the ideological spectrum are generally much more supportive of the Keynesian approach.

The purpose of this week is first to illustrate why Classical economics gave way to Keynesianism in the 1930s. This discussion sets the stage for the development of one of the most important tools used in macroeconomics, the aggregate supply-aggregate demand framework.

During this week, the most important point we'll make is that the Classical versus Keynesian controversy is primarily a dispute over how an economy adjusts back to full employment during a recession. On the one hand, the Classical economists believed that 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 full employment.

In contrast, the Keynesian school argued that before the price adjustment mechanism had time to work, it would be overpowered by a more deadly "income adjustment mechanism": When an economy sinks into a recession, peoples' incomes fall. This causes them to both spend less and save less while businesses respond by investing and producing less. This drives the economy deeper into recession rather than back to full employment.

This debate is important because the Keynesian approach calls for large scale government intervention while the Classical approach believes that the best cure for a recession is to leave the free market alone.

Key Questions for Week Two: The Aggregate Supply-Aggregate Demand Model and the Classical-Keynesian Debate

1. The Classical versus Keynesian controversy is primarily a dispute over what?
2. State Say's Law.
3. What was Thomas Malthus' critique of Say's Law?
4. Use the circular flow diagram to illustrate Say's Law.
5. Describe the quantity theory of money.
6. Explain the two major assumptions of the quantity theory of money.

7. Describe the Keynesian income adjustment mechanism.
8. Illustrate equilibrium in the aggregate supply-aggregate demand model.
9. Explain the three reasons why the aggregate demand curve slopes downward.
10. List at least five major reasons why the aggregate demand curve shifts.
11. Why does the aggregate supply curve slope upward?
12. List at least five reasons why the aggregate supply curve shifts.
13. Draw and explain the three ranges of the economy.
14. Draw and describe the Classical price adjustment mechanism.

Week #2 Quiz

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