**Macroeconomic Economist Models of Conflict**

**Classical .v. Keynesian Schools of Economics**

**TASK 1: Using the internet, research briefly the following two people and the 1930’s Great Depression**

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| **Frederick Hayek**  Classical Economist | **John Maynard Keynes**  Keynesian Economist | **Period in History**  The 1930’s Great Depression |
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**TASK 2: In 2008, there was a global financial crisis. This led to what was termed the ‘Great Recession’. Using the internet, complete some brief research using the internet and answer the following questions:**

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| What might have caused the financial crash of 2008? |  |
| What were the effects on the UK economy? |  |

**TASK 3: READ THE FOLLOWING ARTICLE AND ANSWER THE QUESTIONS AT THE BOTTOM**

Up until the 1930s, economics had been dominated by “classical economists” who argued that markets were self-regulating, markets would clear and markets were the most efficient method of distributing resources. They claimed that if the economy suffered from a recession in the short run there might be some unemployment (real wage and structural). However in the “long run”, eventually workers would be willing to lower their wages so as not to lose their jobs and so in the long run unemployment would not exist as firms could afford to keep these workers. In other words, in the long run there would always be ‘Full Employment’.

By the 1930’s, Macroeconomics was not really invented and economists did not really have a toolkit to help explain the workings of the larger economy. This changed in the 1930’s in light of the ‘Great depression’ which seemed to show a persistent level of unemployment that was not reducing as the Classical economists had argued. Workers were losing their jobs and real wages were not falling; it seemed workers would rather lose their jobs than expect a pay cut.

John Maynard Keynes, therefore challenged the traditional Classical theory put forward by economists like Frederik Hayek. Keynesian theory, suggested markets weren’t self-regulating, and could be below full employment for a considerable time.

Keynes was critical of the UK 1931 budget, which cut wages for hospital workers, and cut back spending on roads and new houses. He argued this would depress demand further and make the recession worse. Instead he advocated higher government spending financed by higher borrowing.

Keynes’ policy recommendations went against classical orthodoxy. Classical orthodoxy argued higher government spending would crowd out private sector investment. Higher government borrowing would push in interest rates on bonds and reduce the quantity of private sector investment. The Treasury view was to try and balance the budget, but Keynes’ criticism was this only reduced overall aggregate demand.

The Great Depression only ended in the UK and US, when government spending on military caused sufficient demand. Though, there is evidence partial stimulus (e.g. in 1936, helped stimulate demand) The problem with Keynesianism is that governments are often too timid – unless there is a war.

Keynes defended his policy of expansionary fiscal policy and criticised the classical idea that Government spending would ‘crowd out’ or prevent the private sector from investing.

* Accelerator effect. This stated that investment was highly volatile. If the rate of GDP growth fell, private sector investment fell. However, if government spending increased the growth rate – this would encourage the private sector to also invest. Thus government investment could complement private sector investment – not crowd it out.
* Multiplier effect. Government spending could have a bigger final impact on real GDP. the Multiplier is likely to be higher in a recession because there are unused resources.
* Ending the glut. Keynes’ strongest argument is that in a recession, private sector saving rises sharply leading to unused saving. Therefore, the government spending is merely making use of unemployed resources. Bond yields on government borrowing won’t rise because the private sector want to buy government bonds.

The two schools of economics continued to fight each other until the 1980’s when a grudging consensus was reached.

Using the information above, how would Keynes have responded to the 2008 financial crisis and looming recession and unemployment and how would Hayek have responded?

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**TASK 4:** Read the following table and answer the questions on the other side?

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| **VIEWS** | **Keynesians** | **Classicals** |
| View on the power of markets and flexibility of wages in the labour market | Keynesians argue that in the real world, wages are often inflexible. In particular, wages are ‘sticky downwards’. Workers resist nominal wage cuts. For example, if there was a fall in demand for labour, trade unions would reject wage cuts.  Keynesian economists argued against ‘Says Law’ stating the demand creates supply. | In the classical model, there is an assumption that prices and wages are flexible, and in the long-term markets will be efficient and clear. For example, suppose there was a fall in aggregate demand, in the classical model, this fall in demand for labour would cause a fall in wages. This decline in wages would ensure that full employment was maintained and markets ‘clear’.  Classical economists believed in ‘Says Law’ that supply creates demand. |
| What caused recessions and how long will recessions last? | Recessions were caused by a lack of aggregate demand in the economy (AD curve to the left of the LRAS). Recessions could last a very long time without Government intervention. This is because of  CONSUMERS: Paradox of thrift - In a recession, people take a rational approach to be risk averse – fearing possible recession, their MPS rises and MPC falls. In other words, they increase savings and spend less because of poor consumer confidence. When this lower spending is aggregated, it leads to lower overall demand in the economy.  FIRMS: ‘Animal spirits’ which essentially is business confidence which can mean that recovery’s are delayed (the de-accelerator effect).  OVERALL: Keynes also emphasized the negative multiplier affect. So a fall in output/growth could lead to larger falls than the initial amount. | Recessions were caused by a lack of short run aggregate supply. Recessions were mostly the result of wages being too high and above the equilibrium meaning costs of production for the firm were too high and they had to cut output (shift to the left in the SRAS). Recessions will not last long therefore because workers will lower their wages to keep their jobs and therefore costs of production for firms will fall and the economy will return to long term equilibrium. Another explanation is that any fall in investment (from a recession) would lead to less borrowing from banks. Therefore banks would lower interest rates to attract more business. This in turn would lower savings and kick start the economy resolving any losses of output. |
| The types of policy Government’s should be adopting in a recession? | Demand side policies (policies which shift the AD curve). A Keynesian would argue in this situation, the best solution is to increase aggregate demand. In a recession, if the government did force lower wages, this might be counter-productive because lower wages would lead to lower spending and a further fall in aggregate demand. | Supply side policies (policies which shift the LRAS curve). The classical view suggests that Real GDP is determined by supply side factors – the level of investment, the level of capital and the productivity of labour e.t.c. |
| Views on demand side policies   1. Fiscal Policy (Taxation and Government Spending) 2. Monetary Policy (Interest Rates) | A Keynesian plays greater emphasis on the role of aggregate demand in causing and overcoming a recession.  Keynesian economics suggests governments need to use fiscal policy, especially in a recession. (This is an argument to reject austerity policies of 2008-13 recession. The Keynesian view suggests that government borrowing may be necessary because it helps to increase overall aggregate demand.  Keynesians did not rate monetary policy claiming that if it was too low, it would cease to be an effective instrument. | Classical economists suggest that in the long-term an increase in aggregate demand (faster than growth in LRAS) will just cause inflation. Therefore, the economy will sort itself out and return to full employment in long term equilibrium.  Classical economics places little emphasis on the use of fiscal policy to manage aggregate demand. A classical view will stress the importance of reducing government borrowing and balancing the budget, because there is no benefit from higher government spending. Lower taxes will increase economic efficiency. (e.g. at the start of the 1930s, the ‘Treasury View‘ argued the UK needed to balance its budget by cutting unemployment benefits.  Classical theory is the basis for Monetarism, which only concentrates on managing money supply, through monetary policy. |
| Views on supply side policies | Keynesian don’t reject supply side policies. They just say they may not always be enough. e.g. in a deep recession, supply side policies can’t deal with the fundamental problem of a lack of demand.  The Keynesian model makes a case for greater levels of government intervention in the supply side, especially in a recession when there is a need for government spending to offset the fall in private sector investment. (Keynesian economics is a justification for the ‘New Deal’ programmes of the 1930s.) | The classical model is often termed ‘laissez faire’ because there is little need for the government to intervene in managing the economy.  Classical ‘interventions’ in the supply side tend to involve removing Government influence. The classical view suggests the most important thing is enabling the free market to operate. This may involve reducing the power of trade unions to prevent wage inflexibility. Classical economics is the parent of ‘supply side economics‘ – which emphasises the role of supply side policies in promoting long term economic growth. |
| Macroeconomic equilibrium | The Keynesian view of long run aggregate supply is that the economy can be below full capacity in the long term (so behind the LRAS). The essential element of Keynesian economics is the idea the macro economy can be in disequilibrium (recession) for a considerable time. Keynesian economics therefore advocates government intervention to help overcome the lack of aggregate demand to reduce unemployment and increase growth and close the negative output gap. | The classical view is that in the long run, equilibrium will be on the LRAS (where there is also ‘full employment’). |
| Demand deficient (or cyclical unemployment) | Keynesians place a greater emphasis on demand deficient unemployment. For example the current situation in Europe (2014), a Keynesian would say that this unemployment is partly due to insufficient economic growth and low growth of aggregate demand (AD) | Classical economists argue that unemployment is caused by supply side factors – real wage unemployment, frictional unemployment and structural factors. They downplay the role of demand deficient unemployment and feel there is no unemployment in the long run. |

**Keynesian .v. Classical Schools of Thought: Questions you should be able to answer**

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| Q’s | Write your answers here (do not worry if you are unsure; have a go!) | |
| 1. List the four main causes of unemployment (need to think back to RWS2 Macro). 2. Quickly define each one (sentence max) | 1.  2.  3.  4. | |
| 1. Would a Keynesian or a Classical Economist agree with that definition? Why? | 1.  2.  3.  4. | |
| 1. Therefore, what is the best way to escape a recession and therefore reduce unemployment according to a Keynesian or Classical Economist? | **Keynesian Economist** | **Classical Economist** |