**Webnote 223**
*grade weight 5*
*syllabus items 89 + 90*

# SYLLABUS REFERENCE 3.3 (1): Keynesianism vs Neo Classical / Monetarism

**Big Question:**
**Why do economists do not agree on the role for government in managing the macroeconomy?**

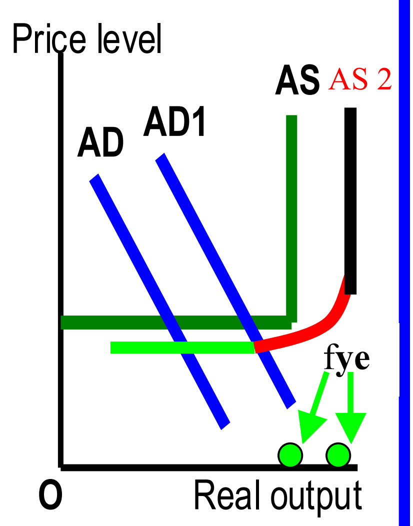
## The Keynesian vs Monetarist / Classical Debate of how to manage an economy

**Extreme Keynesian view is illustrated in diagram below. The 3 coloured /segment AS = best model for a long run analysis of the macroeconomy**

- The key issue is the shape of the AD and AS curves and how to bring about a situation of economic growth without damaging inflation and at the same time an acceptable level of unemployment
- Some agreement exists on both sides for example the government must use fiscal policy to manage the economy. The difference is how the government uses policies i.e. to stimulate Aggregate Demand or Aggregate Supply
- Extreme viewpoints are outlined here. In reality a combination is preferred of supply and demand side policies

- **Extreme monetarist or neo-classical viewpoint**

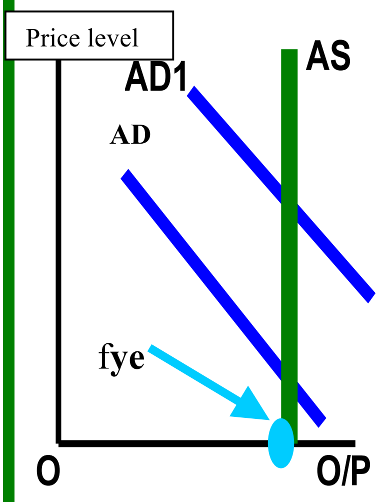
**Features:**
1. AS horizontal up to full employment
2. As AD shifts output and not prices increase
3. Only when full employment exists will inflation occur
4. Government should attempt to control AD so that equilibrium in the economy occurs at full employment




**Monetarists** / supply side theory suggests:
1. Inflation is caused by excess money in the economy, therefore excess demand. Therefore reducing rate of growth of money supply will result in less inflation without more unemployment in the long run
2. Inflation makes firms uncompetitive, discourages investment effective use of monetary policy is crucial.
3. Otherwise government intervention should be restricted as much as possible
4. Markets fast to adjust prices and wages so that the macreeconomy will return to long run equilibrium When a deflationary or inflationary gap occurs.

**Keynesians** suggest:
1. Government intervention to stabilize the economy is vital
2. Fiscal policy is more effective that monetary policy
3. Inflation is often caused by cost push factors
4. markets slow to adjust to price and therefore government intervention is required to avoid cyclical unemployment and AD management can inject spending into the macroeconomy

Features:
1. AS is vertical
2. Any increase in AD increases the price level but not output and employment.
3. To increase output and employment supply side policies are needed to shift aggregate supply to the right
4. See supply side policies



Mercantilism
'laissez faire'

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# League of Gentlemen 1963-1980's
# A story about how to manage an economy?

1930's to 1966 Keynesianism

1930's

- Keynesian economics: 1930's - present
  - Policy target = growth/jobs
  - Demand side management.
    - Inflation
      - Stagflation
        - Keynesianism 'dead' ? 1966
    - Markets not self adjusting
  - Markets unstable
    - Government intervention

**Big Question:**
**Why do economists do not agree on the role for government in managing the macroeconomy?**

1966 –1980's Monetarism emerges under Friedman

1940's

- Monetarism: Pre 1930's + 1946-present
  - Control money supply (quantity theory of money)
    - Policy target: Control inflation is key macroeonomic objetive
      - Control growth
  - Supply side management
    - Friedman couldn't control UK money supply and monetarism failed in 1980's economy
      - Inflation continued to rise. Theory has merits but is imperfect
        - Monetary policy remains a key policy to manage a macroeconomy
  - Money supply not easily controlled
  - Pro -Market solutions 'Markets stable' finding long run equilibrium

1980's present

1980's

- **How to manage an economy?**
  - Monetarist limitations Remains valid
  - Keynesianism limitations Remains valid
  - Economy not a 'scientific model'
    - Economy is a complex behavioural model and components of both schools apply.

**2008 crisis:**
**US response was fiscal stimulus and lower interest rates.**

Present

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# Key differences between Keynesian and monetarists

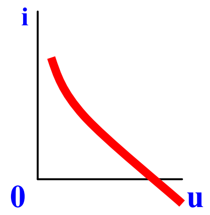
## Monetarist/neo-classical/supply side/ Friedman Economics

**Key points SL+HL**

1. **Control money supply ( HL students see quantity theory of money) is key to macromanagement. Friedman believed that he could control money supply.**
2. **Supply side management should form the basis for macromanagement**
3. **Supply side policies (6) are the most effective policies for micromanagement of an economy for inflation and unemployment**
4. **markets system is stable and government should let markets find equilibrium. Less intervention in terms of AD management. In(de)flationarys are solved by market. See Blink pp 193-194**

**HL Only**

5. **'crowding out' is a feature of demand side management + intervention causes inflationary pressure to increase.**
6. **natural rate of unemployment (approx. 6%) is a feature of equilibrium in any labour market. See web 316.**
7. **LRPC is vertical showing no relationship between inflation and unemployment. See webnote 311.**
8. **SRPC is viable in the short run (section 3.5). See webnote 311.**




**Note: LRPC= long run Phillips curve. SR is short run.**

## *Keynesian demand side Economics*

Key points: **SL+HL**

1. Demand side management should form the basis for macro management
2. Aggregate Supply side will react to the aggregate demand changes ( J or L) and growth /employment/ inflation will adjust to policy aim.
3. Markets are inherently weak (1930's Great Depression) and do not reach equilibrium e.g. labour market can have persistent disequilibrium. Government intervention on AD side essential.

**HL Only**

4. Multiplier theory:

$$\frac{1}{1\text{-mpc}} > 1$$

….therefore government spending (AD) justified

5. Multiplier has a ' crowding in' effect on national income. Demand side management can be used effectively to 'crowd in'. See webnote 314.
6. SRPC is viable in short run (section 2.3) and explains how the macroeconomy functions in terms of a 'trade off' between inflation and growth. Government plans for the best 'trade off'. **See webnotes 237 + 238.**