Chapter 7: Classical-Keynesian Controversy
John Petroff

The purpose of this topic is show two alternative views of the business cycle and the major problems of unemployment and inflation. The classical theory is first presented. The Keynesian view is offered as a critique of the classical theory.

CLASSICAL THEORY

The classical theory is essentially the laissez faire belief of pure capitalism. In this view, business cycles are natural processes of adjustment which do not require any action on the part of government.

> In Adam Smith's explanation of the invisible hand, the process which leads firms to produce what people want, no government is necessary: the economy works out its problems.

SAY'S LAW

Say's law proposes that supply creates its own demand. This means that the income derived from producing certain goods by some, allows them to purchase goods produced by others. Since all people have a need to purchase goods, they will seek to produce some goods to derive income and buy whatever they want. Thus the product markets will always necessarily be in equilibrium.

> Workers who earn income, earn that income in order to be able to buy a variety of products they want. Thus, by working and producing goods, these workers generate the income with which these goods can be purchased.

CLASSICAL MONEY MARKET

If some income happens not to be consumed immediately it will enter the money market as a saving. This saving will be put back into the economy as investment (i.e increase in capital) when it is borrowed. The interest paid by borrowers to savers assures that no saving will be idle. The money market equilibrates through an adjustment in the interest rate.

> The interest paid to those who save is an inducement to lend money. When the interest rate is high, people will want to save or lend more. On the other side of the market, the borrowers are discouraged to borrow too much by a high interest rate. Thus, the market does tend to reequilibrate under the influence of the interest rate.

PRICE AND WAGE FLEXIBILITY

The classical theory proposes that all markets reequilibrate because of adjustments in prices and wages which are flexible. For instance, if an excess in the labor force or products exist, the wage or price of these will adjust to absorb the excess.

> If prices and wages are flexible, markets reequilibrate. If, for instance, many people are unemployed, firms can hire workers at lower wages; but, hiring more workers precisely reduces unemployment.

INVOLUNTARY UNEMPLOYMENT

The classical theory proposes that no involuntary unemployment will exist because an adjustment in the wage rate will assure that the unemployed will be hired again. In addition, the need of workers to buy goods will encourage them to accept work at even the lower wage rates.

> If wages are flexible as the classical economists argue, then a decrease in wages does allow firms to hire more workers. Only those who are reluctant to work for lower wages would then remain unemployed.

CLASSICAL-KEYNESIAN CONTROVERSY

Keynesian employment theory is built on a critique of the classical theory. In this critique, Keynes argued that savers and investors have incompatible plans which may not assure that an equilibrium exists in the money market, that prices and wages tend to be rigid and equilibrium may not exist in the product and labor markets, and that periods of severe unemployment have occurred (which the classical theory denied).

> The Keynesian theory was developed in the wake of the great depression. It was very hard to argue then that only voluntary

> unemployment can exist as millions of workers were out of work.

KEYNESIAN SAVING-INVESTMENT PLANS

Keynes showed that savers and investors are separate groups which do not necessarily interact: financial intermediaries (banks) are in between. When a recession is present, investment may not be equal to saving because, although the interest rate is very low, 1) borrowers have poor sales prospect, 2) banks are afraid of lending because of potential bankruptcy, and 3) savers want to wait for higher returns. This causes a liquidity trap: some saving is idle.

> Banks do tend to be very prudent when making loans to businesses when economic conditions do not seem promising. But, their reluctance to make loans is itself contributing to the economic slow down.

KEYNESIAN PRICE-WAGE RIGIDITY

Keynes argued that prices and wages are not flexible as the classical theory asserts. Wages tend to be rigid on the down side because workers will not accept wages which do not permit them to live adequately; this is reinforced by the actions of unions. If wages are too low, unemployment will exist. In the case of prices, firms producing large tag items prefer to cut production and lay off workers than cut price. Their monopoly power often permits them to act that way.

> Since the mid l980's, there have been several instances where employees have accepted wage give-backs: for instance, in the airline and steel industries. Aside from these exceptions, wage decreases are extremely rare. The general pattern is one of continuous increases, at least, to match cost of living increases.

AGGREGATE DEMAND

Aggregate demand shown graphically represents the sum total of what household are willing and able to buy at different level of the price level.

> Aggregate demand can be thought of as a combination of all the different products people may want to buy.

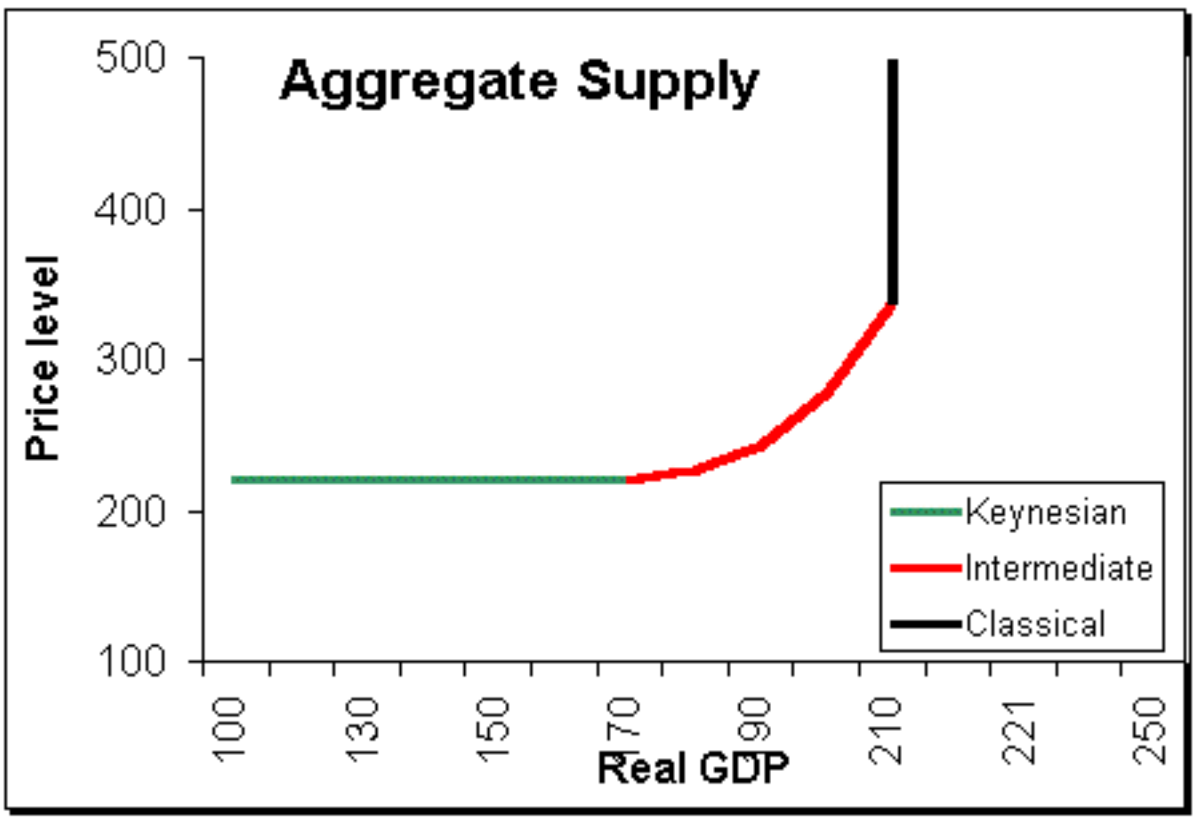
REAL BALANCE EFFECT

Aggregate demand curve is downsloping because of the real balance effect. If prices are higher than averages, then the purchasing power of monetary assets decreases and individuals tend to feel poorer and buy less. If prices are lower than historical price averages, the purchasing power of monetary assets increases, individuals tend to feel wealthier and buy more.

> There is an inverse mathematical relationship between interest rates and financial assets. Securities markets, such as the New York Stock Exchange, are very sensitive to inflation which is the major cause for increasing interest rates. This sensitivity was observed in October 19, 1987 stock market crash. It was also observed in securities markets reactions to
> to lowering of interest rates by the US federal reserve bank in 2001.

AGGREGATE SUPPLY

Aggregate supply is made of three sections: the classical range is vertical, the Keynesian range is horizontal and the intermediate range is upsloping.
Graph G-MAC7.1



The aggregate supply can be thought of as the combination of all the goods that firms produce: it is GNP if the government is ignored.

CLASSICAL RANGE

The classical range of aggregate supply is vertical because of the proposition of the classical theory that prices will adjust so that output is always at full employment. In this range, expanding aggregate demand will cause inflation, while contracting aggregate demand will reduce inflation.

There are many sectors of the economy where all adjustments take place through price changes. One can think of all goods related to fashion: if a dress is in high demand, it will be priced very high; but if the dress is out of fashion, the price will be very low and, eventually, it will not be produced at all.

KEYNESIAN RANGE

The Keynesian range of aggregate supply corresponds to the proposition that when price are very low, firms will prefer to cut production rather than sell at a loss. In this range, any change in aggregate demand will produce a change in output. Thus, in the case of a recession the correct government policy is to expand aggregate demand.

Numerous sectors of the economy have very few changes in price but sizable changes in the volume of production and the number of employees. For example, car manufacturers offer rebates which do not amount to even 10% of the value of a car. Compared to changes in price of 50% or more in clothing for instance, the car rebates are very small. The reason is the large fixed costs. Closings of entire car manufacturing plants are not uncommon during recessions.

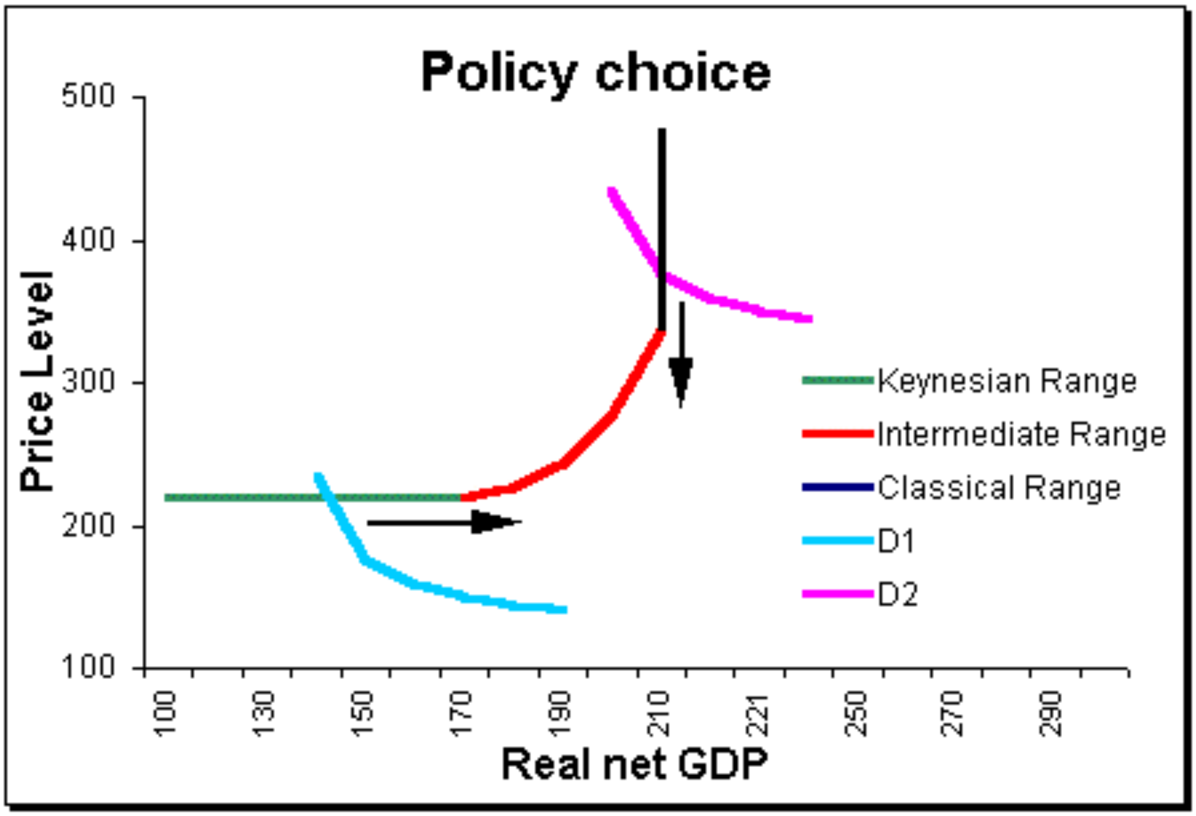
INTERMEDIATE RANGE

This intermediate range of aggregate supply represents the case of preliminary inflation (or sectoral inflation): when demand and output expand, some sectors of the economy may experience bottlenecks and require that prices increase because output cannot.

Some sectors of the economy tend to experience price and quantity changes at the same time. This would seem to be true of all the consumer goods sectors such as radios and televisions, or sport equipment.

AGGREGATE DEMAND POLICIES

When the intersection of aggregate demand and aggregate supply occurs in the Keynesian horizontal range a recession and excessive unemployment are present: the recommended policy would be to stimulate aggregate demand. When the intersection is in the classical vertical range, inflation is present: the recommended policy would be to contract aggregate demand.
Graph G-MAC7.2



Throughout the 1960's and the 1970's, the emphasis of the American administration has been to stimulate aggregate demand in order to control unemployment. Control of inflation was accomplished with the help of tax changes or controls over prices and wages.

SUPPLY SIDE POLICIES

Supply side policies can be shown by attributing periods of stagflation (high prices and low level of output) to upward shifts of aggregate supply. The recommended policy would then not be an increased aggregate demand which adds to inflation, but instead a shift in aggregate supply downward by cutting costs of production.

During the 1980's, the American administration has attempted to control the economy by paying more attention to the supply side of the economy. Specifically, costs of production are affected by regulations, restrictions and subsidies enacted by government bodies.