Economic Recovery From A Recession: Classical Theory Versus Keynesian Theory

A. Learning Objectives:

(i) Long Run Equilibrium
(ii) A Recessionary Gap
(iii) Economic Recovery:
   * The Classical View
   * The Keynesian View
(iv) Policy Implications

B. Introduction:

Why do some economists believe that the best policy action is no action, while other economists advocate an active, forceful use of government’s power to tax and spend? The simple answer is that an economist’s view of the economy and his/her policy prescriptions are often linked.

Before we go on to compare and contrast the Classical economists’ view with the Keynesian economists’ view of the macroeconomy, let us first clarify some economic concepts.

C. Some Clarifications:

* Actual Real GDP---total output of final goods & services produced within an economy during a given time period, say, a year.

* Potential (Full employment) Real GDP---total output of final goods & services an economy would produce if all resources were fully & efficiently employed.

* Long Run Equilibrium---When the actual Real GDP produced is equal to the potential Real GDP, the economy is said to be in long run equilibrium.

* Recessionary Gap---When the actual Real GDP is less than the potential Real GDP (characterized by surplus labor), the economy is said to be experiencing a recessionary gap.

* Aggregate Demand---the sum total of Real GDP purchased at various price levels.
* Aggregate Supply---the sum total of Real GDP produced at various price levels.

* Fiscal Policy---the use of government spending and/or taxation, in order to influence the level of unemployment rate and/or inflation rate in the economy. Typically associated with the economic theories of traditional Keynesian analysis.
* Expansionary Fiscal Policy---an increase in government spending, a decrease in taxes, or both in order to raise aggregate demand.
D. Classical Macroeconomic Theory: The Self-Regulating Economy

Classical economists are a group of 18th- and 19th-century economists who believed that recessions were short-run phenomena that corrected themselves through natural market forces such as changes in wage rates, prices and interest rates. They therefore believed the economy was self-correcting. This means that if the economy is in a recessionary gap, the economy can, based on its own internal mechanism, move itself smoothly and quickly into equilibrium where it is once again producing at the potential Real GDP level.

The assumption of freely flexible wages, prices and interest rates plays a critical role in the story of the self-regulating economy. Simply put, classical economists argued that if the economy's price level was too high to sell all that was produced, prices would fall until the quantity of Real GDP produced equals quantity demanded; if wages were too high to employ all who wanted to work, wage rates would fall until the quantity of labor supplied equals quantity demanded; and if interest rates were too high to channel the amount saved into the amount invested, interest rates would fall until the amount saved equals the amount invested. So the classical approach implied that natural market forces, by way of flexible wages, prices and interest rates, would move the economy toward its potential Real GDP.

Hence, if the economy finds itself in a recessionary gap [point 1, in Fig. 1 below], there will be an excess supply of labor. This will cause wage rates to fall, raising aggregate supply and therefore shifting the short-run aggregate supply (SRAS) to the right. As a result of the rise in aggregate supply, the price level will fall. As the price level falls, quantity demanded of Real GDP will rise, moving from point 1 along the aggregate demand curve (AD), towards point 2. As long as actual Real GDP is less than the potential Real GDP, the price level will continue to fall until point 2 is reached, where Q1 = QN, once again achieving long run equilibrium.

**Policy Implications:**
Since classical economists consider the economy inherently stable and therefore, self-correcting, for them, full employment is the norm: the economy always moves back to full employment Real GDP. If it becomes “ill”, it certainly is capable of healing itself through changes in wages and prices. This position has led classical economists to prescribe a macroeconomic policy of "**Hands-off**". In their view, government has minimal role to play in the macroeconomy.

![Fig. 1](image-url)
E. Keynesian Economic Theory: The Inherently Unstable Economy

However, a theory is judged not by the realism of its assumptions but by the accuracy of its predictions. Hence, the years of high unemployment during the Great Depression of the 1930s could not be explained by the classical theory and therefore strained belief in the economy’s ability to correct itself quickly.

In 1936 therefore, John Maynard Keynes, by addressing this problem of unemployment, developed the Keynesian model that challenged the classical view of the economy and offered an explanation of the Great Depression.

While classical economists believed that wage rates will fall whenever there is surplus labor, Keynes didn’t agree that the adjustment was that simple. Instead, Keynesians suggested that wages and prices may be inflexible in the downward direction. This is not only because employees will naturally resist wage cuts, but mainly due to the powerful labor unions and the existence of long-term contracts.

If wages won’t fall, then an economy in a recessionary gap can’t get itself out because the SRAS curve will not shift to the right. If the SRAS curve doesn’t shift to the right, the price level won’t come down either. If the price level doesn’t come down, buyers will not buy more goods and services (that is, aggregate demand won’t rise) and remove the economy from a recessionary gap back to long-run equilibrium. So unemployment continues.

In terms of Fig. 2, the economy is stuck at point 1. It cannot get to point 2 for a long time! Hence, Keynesians believed that the economy was inherently unstable—it may not automatically cure itself of a recessionary gap.

Fig. 2
Policy Implications:

Traditional Keynesians believe that the economy is inherently unstable and can therefore get stuck for a long time, at a level of Real GDP well below potential. They therefore suggest active government intervention by way of expansionary fiscal policy to raise aggregate demand, stimulate output and employment and move the economy back to equilibrium.

Ridding the Economy of a Recessionary Gap:

Suppose the economy is experiencing excessive unemployment that causes actual Real GDP to be less than potential. How can full employment be restored?

In terms of Fig 3 below, the economy is at point 1 and therefore in a recessionary gap. Aggregate demand is too low to create full employment and move the economy to long-run equilibrium at the potential Real GDP level. The Keynesian prescription is to enact expansionary fiscal policy (an increase in government spending, a decrease in taxes, or both) in order to shift the aggregate demand curve rightward from AD1 to AD2 and move the economy to the potential Real GDP level at point 2.

Summary:

While the classical economists would say: simply wait for the SRAS curve to shift rightward and intersect the AD curve at point 2, the Keynesians usually respond that (1) the economy is stuck at point 1 and won’t move naturally to point 2—perhaps because wage rates won’t fall; or (2), the SRAS curve takes too long to shift rightward, and in the interim we must deal with the high cost of unemployment.