CIE Economics A-level

Topic 4: The Macroeconomy

g) Keynesian and Monetarist schools

Notes

Different theoretical approaches to how the macro economy functions

Keynesian economics is a view that believes AD (spending) influences economic output in the short run. Keynesians also believe that the private sector sometimes leads to inefficiency, so the public sector has to intervene in order to stabilise the business cycle. This refers to monetary policy and fiscal policy in particular.

Keynesians prefer mixed economies, where the private sector is dominant, but the government intervenes during recessions.

The Great Depression initiated in 1929, and by 1933 real GDP had fallen by 30% and the unemployment rate increased to 25%. In the 75 years prior to this, economic declines lasted about 2 years; the Great Depression lasted for over a decade.

Keynes shifted macroeconomic thought from a focus on AS to AD. Keynesian economists emphasise the use of demand-side policies, fiscal and monetary, to close gaps between actual and potential output. The 2008 financial crisis caused an increase in popularity of Keynesian beliefs.

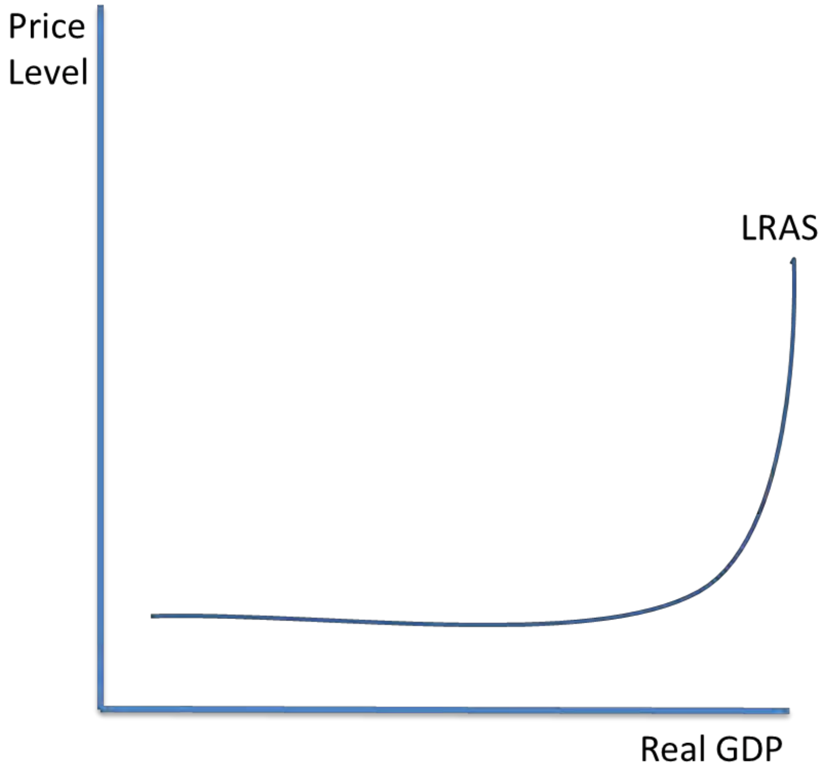
Keynesians believe that as long as firms have confidence about the future, they will invest. Investment is independent of the price level or interest rates.

Monetarism emphasises government control over the money supply. This view believes that changes in the money supply influences national output in the short run, and influences the price level in the long run.

Rather than how confident firms feel, monetarists believe that interest rates have a greater influence over investment decisions.

Monetarists believe that inflation is caused by excessive quantities of money flowing in the system. If production increases at a slower rate to the money supply, monetarists argue that there will be inflation. The money supply increases when more money is printed or there are several loans and credit.

- **Keynesian view of long run aggregate supply**



- The Keynesian view suggests that the price level in the economy is fixed until resources are fully employed. The horizontal section shows the output and price level when resources are not fully employed; there is spare capacity in the economy. The vertical section is when resources are fully employed.
- Over the spare capacity section, output can be increased (AD1 to AD2) without affecting the price level (stays at P1). In other words, output changes are not inflationary.
- Once resources are fully employed, an increase in output (AD3 to AD4) will be inflationary (price level increases from P2 to P3).