9.3: Putting It Together- Keynesian and Neoclassical Economics

Keynesian economics argues that the macro economy is inherently unstable, because aggregate demand, especially autonomous consumption, investment and net exports, tends to fluctuate. Thus, even if the economy starts at potential GDP and full employment, there's no reason to expect the economy will stay there.

If you believe the Keynesian approach, this implies that government has a strong motive to use activist policy to attempt to "stabilize" (or manage) the economy. In other words, if aggregate demand falls threatening a recession, government needs to act to stimulate aggregate demand, to return the economy to potential GDP. Similarly, if aggregate demand rises threatening inflation, the government should cut aggregate demand. We will explore these policy options in future modules on fiscal and monetary policy.

In the early 1970s, Keynesians believed that business cycles were caused primarily by shifts in the aggregate demand curve. Neoclassicals added to economists' understanding of the macro economy by observing that business cycles can also be caused by shifts in the short run aggregate supply curve.

While there are economists who consider themselves exclusively Keynesian or exclusively neoclassical, the majority believe that both perspectives have something to offer. Keynesian thinking makes sense over periods of time too short for wages and prices to adjust fully to demand or supply shocks. Neoclassical thinking makes sense over longer periods of time. Thus, Keynesian thinking is usually applied to understanding business cycles and neoclassical thinking to economic growth.