

M.A. ECONOMICS : SEM-II

CC-8 MODULE-1

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TOPIC: CRISIS IN KEYNESIANISM :

In USA and UK , the oil crisis in early 1970s, lead the coexistence of high inflation and high unemployment raised a basic question whether or not the AD can determine output , employment and inflation i.e., how the total demand for output can be too high and too low at the same time---high rate of inflation suggest that the level of AD is too high and on the other hand, a high rate of unemployment suggests that the level of AD is too low.

This challenges to Keynesian economics came from supply side economists like Robert Lucas and Thomas Sargent . According to them, the crisis in Keynesian economics or its failure can be contributed to some deficiencies in the Keynesian theoretical structure.

1. Rule of Thumb:

New classical economists pointed out that in Keynesian economics, employed rules of thumb in respect of consumption function and demand for money i.e,

- a) relationship of proportionality was postulated between current consumption and the current income
- b) there was a fixed proportional relation between income and transaction demand for money.
- c) Faulty handling of expectation i.e, the expected current price was a function of past behaviour of price, termed as backward expectations.

According to new classical , such fixed relation do not actually exist among the variables and also it neglected the rational choice of individual households and business firms i.e. these economists made an alternative assumption that the expectation were rational consistent with optimal use of entire available information about the future behaviour of variables, termed—forward expectation

2. Sticky Wages and Prices:

According to new classical economists, Keynesian economists failed to provide proper explanation for co-existence of high inflation and high unemployment due to faulty assumptions of wage- price rigidity. Keynesian believed that wage rates are fixed by contract between labour union and managements for a specific time period. The wage reduction is practically not possible on account of pressure of labour union, minimum wage law etc. and thus, excess demand or excess supply in the labour market could not be removed through variation in wage rates.

On contrary , classical economists believed that the balance between aggregate demand and aggregate supply can be restored through the appropriate variation in wages and prices and it will help to tackle the problem of coexistence of inflation and unemployment.

3.Irrelevance of demand management policies:

Keynes emphasized upon the demand management policies by govt. and monetary authority such as-changes in money stock, variation in tax and public spending. However these policies will not work in case of stagflation e.g,- if restrictive fiscal and monetary policies are employed to tackle inflation, it will worsen the situation of unemployment in the economy and vice-versa.

According to new classical economists, real output, income and employment cannot be affected through the demand management policies alone, and also the condition of stagflation (1970s) can be cured through supply-side economics.