



## Worksheet 12.2

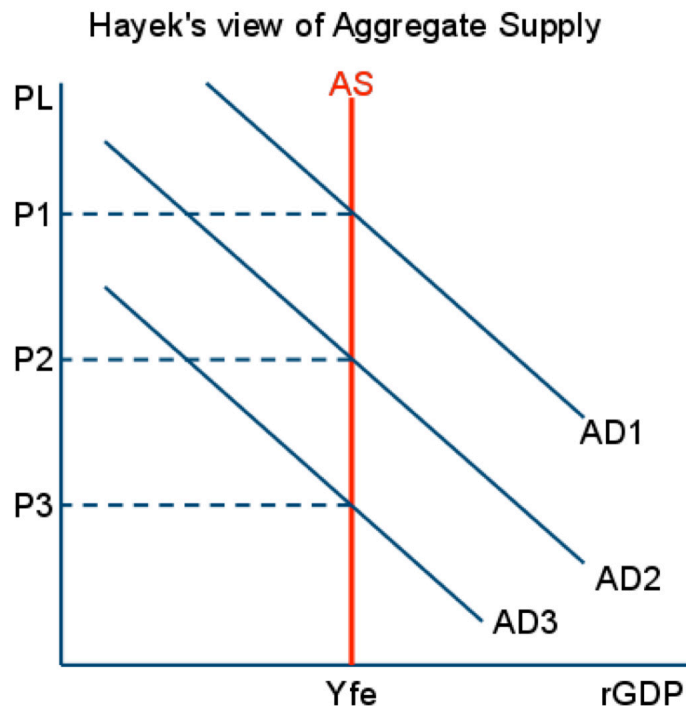
### The Battle of Ideas: Hayek versus Keynes on Aggregate Supply

**Introduction:** The two models below represent two very different views of a nation's aggregate supply curve. The theories behind the two models represent the ideas about the macroeconomy of two schools of Economic thought, the 'demand-side' school, advocated by John Maynard Keynes and the 'neo-classical, supply-side school', advocated by Friedrich von Hayek.

**Instructions:** The documentary film, 'Commanding Heights - the Battle for Ideas' introduces some of Keynes' and Hayek's theories about the role a government should play in the management of a nation's economy. Before completing the activity below, watch the video up to 38:30. The entire video can be viewed [here](#).

**Questions:** Once you've watched the first 38 minutes of 'Commanding Heights - the Battle for Ideas', study the different graphs below and answer the questions that follow each graph.

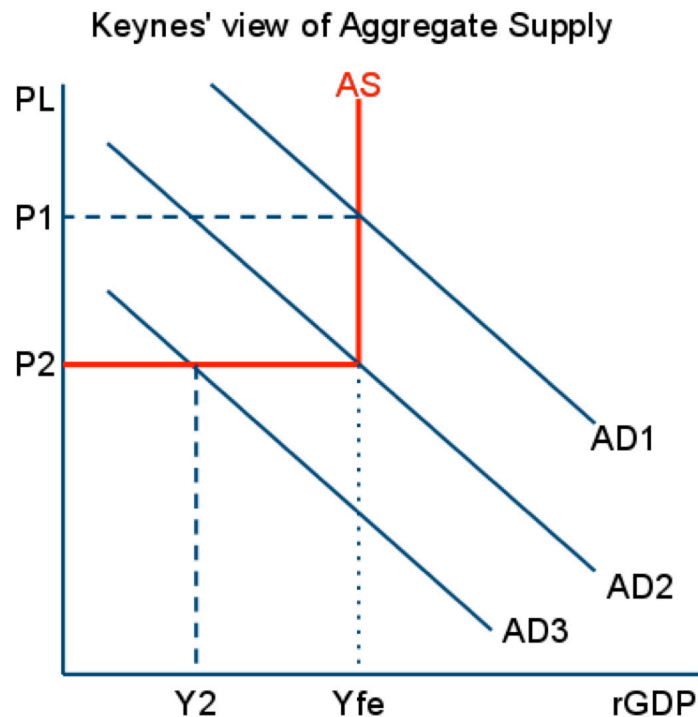
Figure 1: the neo-classical AD/AS model:





1. Why does the 'neo-classical' aggregate supply curve always lead to an equilibrium level of national output equal to the full-employment level of real GDP?
2. The vertical AS curve above is sometimes referred to as the 'flexible-wage and flexible-price' model of the macroeconomy. Why must wages and prices be perfectly flexible for this model to be an accurate representation of a nation's economy.
3. Hayek was an advocate for free markets, he felt that government intervention in a nation's economy would only interfere and disrupt the efficient allocation of resources. How does the model above reflect his belief that governments cannot improve a nation's level of output beyond what the free market is able to achieve?
4. Do you believe that the neo-classical model of aggregate supply is representative of the real world? Why or why not? What evidence is there from recent history that the model is or is not accurate?

*Figure 2: The Keynesian AD/AS model*

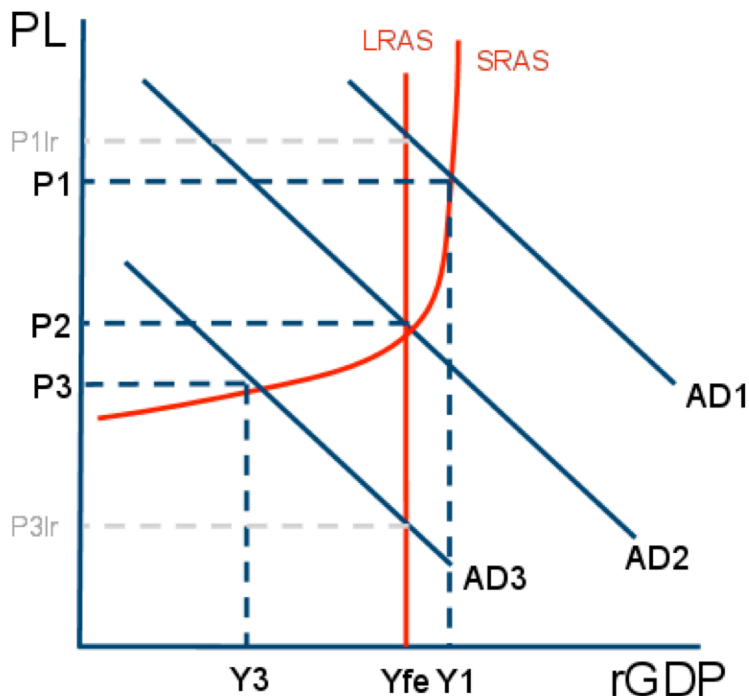


1. Based on the model above, which level of aggregate demand corresponds with the macroeconomic goals of 'full-employment and stable prices'?



2. Changes in which factors could cause aggregate demand to shift from AD2 to AD3? If AD falls to AD3, what happens to the price level in the economy? What happens to the level of output of goods and services? What happens to employment and unemployment?
3. Sometimes the Keynesian AS model is known as the ‘sticky-wage and sticky-price model.’ How does the model reflect the idea that wages are downwardly inflexible, in other words, will not fall even if demand for goods and services fall? For what reasons might wages in an economy be downwardly inflexible (in other words, not fall even as total demand in the economy falls)?
4. How realistic is the Keynesian model of aggregate supply in the real world?
  - a. Can you point to any evidence from the last few years that it might be correct (in other words, that a fall in AD will lead to decrease in national output)? Find data on the GDP’s of two Western European countries from 2008 and 2009 to support your findings.
  - b. Can you point to any evidence from the last few years that the model might be flawed (in other words, that a fall in AD actually does lead to a fall in the price level)? Find data on inflation in the same two Western European countries to examine whether or not wages and prices are completely inflexible downwards as the model suggests.

Figure 3: The IB Economics AD/AS model



The diagram above represents a compromise between the neo-classical AD/AS model and the Keynesian AD/AS model. This graph is the one we will use throughout the IB and AP Economics



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course when illustrating a nation's macroeconomy. Answer the questions that follow about the diagram.

1. How does the above model represent a compromise between Keynes' and the neo-classical view of aggregate supply?
2. Why are there two aggregate supply curves? What is the difference between the two?
3. What happens in the SHORT-RUN when AD falls from AD2 to AD3 to the price level and output? What will happen in the long-run? In macroeconomics, the short-run is known as the 'fixed-wage period' and the long-run the 'flexible-wage period'. The main factor that can shift the SRAS curve is the level of wages in the economy (in other words, a change in wages will shift the SRAS). How does this help explain the adjustment from the short-run equilibrium and the long-run equilibrium following a fall in AD?
4. What happens in the SHORT-RUN when AD increases from AD2 to AD1? What will happen in the long-run? How does the long-run flexibility of wages explain why output always seems to return to its full employment level of output in the long-run?
5. What does the model above indicate about the possible need for government intervention to help an economy achieve its macroeconomic goals of full-employment and price level stability in the short-run?