Keynsianism vs. Monetarism

Prior to the Great Depression, most economists believed that economies were self-correcting. If economic activity declined, then both wages and prices would fall until they were so cheap that businesses would start hiring and activity would pick up as people began consuming again. However, the prolonged depression led many to question this theory.

In 1936 an economist named John Maynard Keynes published the "General Theory of Employment, Interest & Money." He argued that falling wages and prices would depress incomes and lead to decreased spending. People with money would hoard it and would not hire no matter how cheap labor became. He coined the term "animal spirits" to describe the fact that *consumer sentiment* was an essential factor in aggregate demand. He also posited that wages were "sticky" on the downside; that is, there was a wage level below which people would not be willing to work because it was not enough to live on. Keynes' main tenet was that government should engage in deficit spending during a downturn to encourage job creation and revive spending. Unfortunately, politicians were very good at spending during downturns, but they ignored the second part of Keynes' theory: governments should also accumulate surpluses during upturns to prevent economic overheating and to help finance deficit spending during recessions. By the 1960s excessive government spending eventually led to rising inflation, and Keynesian economics was (temporarily) discredited.

In 1963, Milton Friedman and fellow economist Anna Schwartz, published "A Monetary History of the United States, 1867-1960." Friedman blamed poor monetary policy for the prolonged depression, arguing that the Fed had failed to maintain an adequate money supply, which put downward pressure on prices. Conversely, a rapidly expanding money supply would lead to inflation. An adherent of the Chicago School of economic theory, Friedman's quantity theory of money holds that the amount of money in circulation determines general price levels. Therefore, stable prices are the sole responsibility of the Federal Reserve.

During the 1970's, monetarist theory replaced Keynesian theory as the dominant economic framework. In the 1980s and 1990s, monetarism was supplanted by "supply-side" economics, based on the notion that government spending and regulation is a hindrance to economic growth. While monetarists focus on the role of the central bank in controlling inflation through the money supply, supply-siders argued that if the Central Bank were to keep prices stable, and taxes were lowered, investors would start to create jobs and the economy would thrive. The idea was that putting money into the hands of the *producers* would ipso facto get them to build factories, invest in businesses and, most importantly, hire people. The term "trickle-down economics" described the belief that if the people at the top of the income ladder were doing well, the benefits would "trickle-down" the economic ladder and everyone would do well.

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