

Disputes Over Macro Theory and Policy

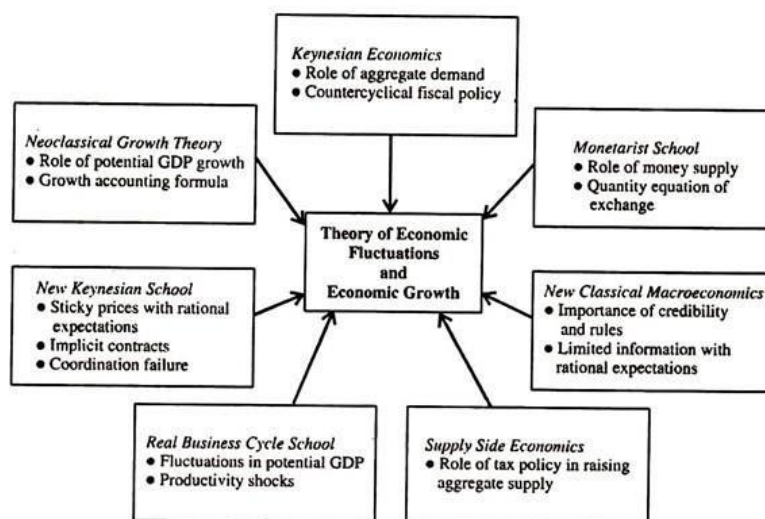


Fig. 14.1 The Evolution of Macroeconomics

Introduction: Disagreements about Macro Theory and Policy

- This chapter contrasts the classical and Keynesian macroeconomic theories.
- Contemporary disagreements on three inter-related questions are considered.
 - What causes instability in the economy?
 - Is the economy self-correcting?
 - Should government adhere to rules or use discretion in setting economic policy?

Some History: Classical Economics

- Classical economics dominated the discipline from Adam Smith (1776) until the 1930s. It maintained that full employment was normal and that a "laissez-faire" (let it be) policy by government is best.
- Keynes observed in the 1930s that laissez-faire capitalism is subject to recurring recessions or depressions with widespread unemployment, and contended that active government stabilization policy is required to avoid the waste of idle resources.
- Classical View.
 - The aggregate supply curve is vertical and located at the full-employment level of real output.
 - Stress that classical economists believed that real output does not change in response to changes in the price level because wages and other input prices would be flexible.
 - The economy would operate at its full employment level of output because of:
 - Say's law (See Chapter 9) which states "supply creates its own demand."

- responsive, flexible prices and wages in cases where there might be temporary over-supply.
- Money underlies aggregate demand. Classical economists theorize that aggregate demand will be stable as long as the supply of money is controlled with limited growth.
- The downward sloping demand curve is stable and is solely responsible for setting the price level. (See Figure 19-1a)
- Changes in the money supply would shift AD right for an increase and left for decrease, but responsive, flexible prices and wages will insure that full employment output is maintained.
- **Keynesian View.**
 - The core of Keynesianism is that product prices and wages are downwardly inflexible (don't fall easily). This is graphically represented as a horizontal aggregate supply curve. (See Figure 19-1b)
 - A decline in real output will have no impact on the price level. Once full employment is reached at Q_f , the aggregate supply curve is vertical.
 - Keynesian economists view aggregate demand as unstable from one period to the next, even without changes in the money supply.
 - The investment component of aggregate demand is especially likely to fluctuate and the sole impact is on output and employment, while the price level remains unchanged. (See shift AD_1 , to AD_2 in Figure 19-1)
 - Active government policies are essential to increase aggregate demand and move the economy back toward full employment.

What Causes Macro Instability such as Great Depression, Recessions, Inflationary Periods?

- **Mainstream View:** This term is used to characterize prevailing perspective of most economists.
 - Mainstream macroeconomics is Keynesian-based, and focuses on aggregate demand and its components. $C(a) + I(g) + X(n) + G = \text{GDP}$ (Aggregate expenditures) = (real output)
 - Any change in one of the spending components in the aggregate expenditure equation shifts the aggregate demand curve. This, in turn, changes equilibrium real output, the price level or both.
 - Investment spending is particularly subject to variation.
 - Instability can also arise from the supply side. Artificial supply restriction, wars, or increased costs of production can decrease supply, destabilizing the economy by simultaneously causing cost-push inflation and recession.
- **Monetarist View:** This label is applied to a modern form of classical economics.
 - Money supply is the focus of monetarist theory.
 - Monetarism argues that the price and wage flexibility provided by competitive markets cause fluctuations in product and resource prices, rather than output and employment.

- Therefore, a competitive market system would provide substantial macroeconomic stability if there were no government interference in the economy.
 - It is government that has caused downward inflexibility through the minimum wage law, pro-union legislation, and guaranteed prices for some products as in agriculture.
 - Monetarists say that government also contributes to the economy's business cycles through clumsy, mistaken, monetary policies.
- The fundamental equation of monetarism is the equation of exchange. $MV = PQ$
 - The left side, MV , represents the total amount spent [M , the money supply $\times V$, the velocity of money, (the number of times per year the average dollar is spent on final goods and services)]
 - The right side, PQ , equals the nation's nominal GDP [P is the price level or more specifically, the average price at which each unit of output is sold $\times Q$ is the physical volume of all goods and services produced.]
 - Monetarists say that velocity, V , is stable, meaning that the factors altering velocity change gradually and predictably. People and firms have a stable pattern to holding money.
 - If velocity is stable, the equation of exchange suggests there is a predictable relationship between the money supply and nominal GDP (PQ).
- Monetarists say that inappropriate monetary policy is the single most important cause of macroeconomic instability. An increase in money supply will increase aggregate demand.
- Mainstream economists view instability of investment as the main cause of the economy's instability. They see monetary policy as a stabilizing factor since it can adjust interest rates to keep investment and aggregate demand stable.
- Real Business Cycle View: A third perspective on macroeconomic stability focuses on a aggregate supply. (See Figure 19-2)
 - The view that business cycles are caused by real factors affecting aggregate supply such as a decline in productivity, which causes a decline in AS .
 - In the real-business cycle theory declines in GDP mean less demand for money. Here, the supply of money is decreased after the demand declines. AD falls, but price level is the same because AS also declined.
- Coordination Failures: A fourth view relates to so-called coordination failures.
 - Macroeconomic instability can occur "when people do not reach a mutually beneficial equilibrium because they lack some way to jointly coordinate their actions."
 - There is no mechanism for firms and households to agree on actions that would make them all better off if such a failure occurs. The initial problem may be due to expectations that are not justified, but if everyone believes that a recession may come, they reduce spending, firms reduce output and the recession occurs. The economy can be stuck in a recession because of a failure of households and businesses to coordinate positive expectations.

Does the Economy "Self-Correct"?

- New Classical View of Self-Correction
 - Monetarist and rational expectation economists believe that the economy has automatic, internal mechanisms for self-correction.
 - Figure 19a-b demonstrates the adjustment process, which retains full employment output according to this view.
 - The disagreement among new classical economists is over the speed of the adjustment process.
 - Monetarists usually hold the adaptive expectations view of gradual change. The supply curve shifts, shown in figure 19-3 may take 2 or 3 years or longer.
 - Rational expectations theory (RET) holds that people anticipate some future outcomes before they occur, making change very quick, even instantaneous.
 - Where there is adequate information, people's beliefs about future outcomes accurately reflect the likelihood that those outcomes will occur.
 - RET assumes that new information about events with known outcomes will be assimilated quickly.
 - In RET unanticipated price-level changes do cause temporary changes in real output. Firms mistakenly adjust their production levels in response to what they perceive to be a relative price change in their product alone. Any change in GDP is corrected as prices are flexible and firms readjust output to its previous level.
 - In RET fully anticipated price-level changes do not change real output, even for short periods. Firms are able to maintain profit and production levels.
- Mainstream View of Self-Correction
 - There is ample evidence that many prices and wages are inflexible downward for long periods of time. However, some aspects of RET have been incorporated into the more rigorous model; of the mainstream.
 - Graphical analysis shown in Figure 19-3b demonstrates the adjustment process along a horizontal aggregate supply curve.
 - Downward wage inflexibility may occur because firms are unable to cut wages due to contracts and the legal minimum wage. Firms may not want to reduce wages if they fear problems with morale, effort, and efficiency.
 - An efficiency wage is one that minimizes the firm's labor cost per unit of output. Firms may discover that paying higher than market wages lowers wage cost per unit of output.
 - Workers have an incentive to retain an above-market wage job and may put forth greater work effort.
 - Lower supervision costs prevail if workers have more incentive to work hard.
 - An above-market wage reduces job turnover.

- Some economists believe wages don't fall easily because already employed workers (insiders) keep their jobs even though unemployed outsiders might accept lower pay. Employers prefer a stable work force. (Key Question 7)

Rules or Discretion?

- Monetarists and other new classical economists believe that policy rules would reduce instability in the economy.
 - A monetary rule would direct the Fed to expand the money supply each year at the same annual rate as the typical growth of GDP.(See Figure 19-4)
 - The rule would tie increases in the money supply to the typical rightward shift of long-run aggregate supply, and ensure that aggregate demand shifts rightward along with it.
 - A monetary rule, then, would promote steady growth of real output along with price stability.
 - A few economists favor a constitutional amendment to require the federal government to balance its budget annually.
 - Others simply suggest that government be "passive" in its fiscal policy and not intentionally create budget deficits or surpluses.
 - Monetarists and new classical economists believe that fiscal policy is ineffective. Expansionary policy is bad because it crowds out private investment.
 - RET economists reject discretionary fiscal policy for the same reason they reject active monetary policy. They don't believe it works because the effects are fully anticipated by private sector.
- Mainstream economists defend discretionary stabilization policy.
 - In supporting discretionary monetary policy, mainstream economists argue that the velocity of money is more variable and unpredictable, in short run monetary policy can help offset changes in AD than monetarists contend.
 - Mainstream economists oppose requirements to balance the budget annually because it would require actions that would intensify the business cycle, such as raising taxes and cutting spending during recession and the opposite during booms.They support discretionary fiscal policy to combat recession or inflation even if it causes a deficit or surplus budget.
- The U.S. economy has been about one-third more stable since 1946 than in earlier periods. Discretionary fiscal and monetary policy were used during this period and not before.This makes a strong case for its success.
- A summary of alternative views presents the central ideas and policy implications of four main macroeconomic theories: Mainstream macroeconomics, monetarism, rational expectations theory and supply side economics.(See Table 19-1)

Last Word: The Taylor Rule: Could a Robot Replace Alan Greenspan

- Macroeconomist John Taylor of Stanford University calls for a new monetary rule that would institutionalize appropriate Fed policy responses to changes in real output and inflation.
- Traditional "monetarist rule" is passive. It required Fed to expand money supply at a fixed annual rate regardless of economic conditions.
- "Discretion" is associated with the opposite: an active monetary policy where Fed changes the money supply and interest rates in response to changes in the economy or to prevent undesirable results.
- Taylor's policy proposal would dictate active monetary actions that are precisely defined. It combines monetarism and the more mainstream view.
- Taylor's rule has three parts:
 - If real GDP rises 1% above potential GDP, the Fed should raise the Federal funds rate by 0.5% relative to the current inflation rate.
 - If inflation is 1% above its target of 2%, the Fed should raise Federal funds rate by 0.5% above the inflation rate.
 - If real GDP equals potential GDP and inflation is 2%, the Federal funds rate should be about 4% implying real interest rate of 2%.
- Taylor would retain Fed's power to override rule, so a robot really couldn't replace the Board. But a rule increases predictability and credibility.

Critics of the proposal see no reason for this rule given the success of monetary policy in the past decade.