Ch1: Macroeconomics:- *Definition, Evolution and Different schools of economic thoughts*

1.1. Important issues in macroeconomics

Macroeconomics: –

is the study of the **structure** and **performance** of national economies,

and of the **policies** that governments use to affect economic performance.

It is the study of the economy **as a whole**; and addresses many topical issues such as,

- Why does the **cost of living** keep rising?
- Why are millions of people **unemployed,** even when the economy is booming?
- What causes **recessions**?
- Can the government do anything to combat recessions? Should it?

1.2. Macroeconomics vs. Microeconomics

Microeconomics

- Decisions of individual units
  - No matter how large

    example: Price decision of a large firm

Macroeconomics

- Behavior of entire economies
  - No matter how small

    example: inflation in a very small country

Macroeconomics & Aggregation

- Economic aggregates: aggregate output, inflation, unemployment.

- Aggregation combines many individual markets into one overall market

- Why we aggregate?

During economic fluctuations, markets **move** up or down **together**.

1.3. Focuses of macroeconomics policies

The **goal** of macroeconomics is **to explain** the economic changes that affect many **households**, **firms**, and **markets** at once.

The **objectives** of Macroeconomic policies are:

- Economic **growth**
- **Stability** of the economy
- Reducing or addressing **unemployment, etc.**

The most important **instruments** to achieve this include: **monetary** policy, **fiscal** policy, **income** policy, and **labor** policy.

1.4. Evolution of Macroeconomics

- From the very early stage of human civilization, Macroeconomics has been a part of our society.

It has changed its shape and size many times, but without macroeconomics civilization cannot sustain or survive.

- The term '**MACRO**' was first used in economics by RAGNER FRISCH in 1933.

But **as a methodological approach** to economic problems, it originated with the **Mercantilists** in the 16th and 17th centuries.

- In the **18th century**, the mercantilists adopted it in their '***Tableau Economies***',

to show the '**circulation of wealth**' among the three classes represented by **farmers**, **landowners** and the **sterile class**.

- MALTHUS, SISMONDI and MARX in the **19th century** dealt with macroeconomic problems.

- WALRAS, WICKSELL and FISHER were the **modern contributors** to the development of macroeconomic analysis before KEYNES.

- Certain economists, like CASSEL, MARSHALL, PIGOU, ROBERTSON, HAYEK and HAWTREY, developed a theory of money and general prices.

- However, credit goes to **Keynes** who finally developed a **General theory of income**, **output** and **employment** in the wake of the Great Depression.

The orthodox macroeconomics

- Includes macroeconomics thinking evolved **between 1776 and 1975**.
- They did not have a macroeconomic theory as such
- **Mercantilists** believed that:
  - Precious metal is used to measure wealth
  - Advocate government intervention
- Even today there are still various groups who believe that these principles hold true.

1.4.1. The classical school of thought

Classical economists focused on

- **real assets** - determined the productive capacity of an economy.
- **markets** would act to co-ordinate people's plans - i.e., the "**invisible hand**" of Adam Smith.
  - This view can also be captured by **Say's law**.
- Say's Law states that the sum of the values of all commodities produced always equals the sum of the values of all commodities bought.

⇒Supply creates its own demand

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Basic tenets of the classical school

- The **economy** is inherently **stable**
- All economic **agents are rational** and aim to maximize their profits or utility
- All **markets** are **perfectly competitive**
- All **agents** have **perfect knowledge** of market conditions
- Trade takes place only when **market-clearing prices** have been established
- Economic **agents** have **stable expectations**.

- The dominant idea of the Classical school of thought was the **invisible hand** or **laissez-faire**

Adam Smith also described the ***government*** as the necessary evil.

1. 4. 2. The Keynesian macroeconomics

- In the **1930s** a major world event occurred that gave rise to a new way of thinking about the operation of the macro-economy, that was "**The Great Depression**".

- The Great Depression was a period of unprecedented decline in economic activity.

- It is generally agreed to have occurred **between 1929 and 1939**.

- Although parts of the economy had begun to recover by 1936, high unemployment persisted until the Second World War.

- The **Great Depression** was a severe worldwide **economic depression** in the decade preceding World War II.

- It was the longest, most widespread, and deepest depression of the 20th century.

- Classical economists did not seem able to explain something like the Great Depression.

- Before the Depression, the prominent ideology was **laissez-faire** - keep the government out of the economy.

- Classical economics didn’t have any solution to the practical problem of Great Depression,

except that **to rely on market** forces **to act** and overtime, in long run, **to balance relative price equilibrium**.

Keynesian View of the Great Depression

- **Keynes** emphasized the importance of a fundamental **disequilibrium** in real output.

He saw the **Great Depression as evidence** that the classical models of economics were flawed.

- Classical economics assumed Real Output would automatically return to equilibrium (full employment levels);

  but the **great depression** showed this to be not true.

- Keynes said the problem was **lack of Aggregate Demand** (**AD**).

Keynesian Era (Post 1936)

- JOHN MAYNARD KEYNES, (5 June 1883 – 21 April 1946), is a British economist,

whose ideas fundamentally affected the theory and practice of modern macroeconomics; and the economic policies of governments.

- Keynes built & widely considered to be one of the most influential economists of the 20th century and the **founder of modern macroeconomics**.

- His ideas are the basis for the school of thought known as **Keynesian economics** and its various offshoots

- Modern macroeconomics can be said to have begun with Keynes and the publication of his book,

“The General Theory of Employment, Interest and Money” in 1936.

- Keynes expanded on the concept of **liquidity preferences** and built a general theory of how the economy worked.

- Keynes's theory brought together both **monetary** and **real economic factors** for the first time,

explained unemployment, and **suggested policy** to achieve

economic stability.

Basic tenets of the Keynesian School

- The **Economy** is **inherently unstable** and is subject to erratic shocks
- The economy can **take a long time** to return to being close to full equilibrium after being subjected to a shock
- Need for **government intervention**
- Aggregate Demand (**AD**) is **the predominant determinant** of output and employment, and AD can be altered by the authorities
- Government can use **Fiscal** and **monetary** policies to stabilize the economy.
- **Information** is the **key**

1.4.3. The recent/contemporary macroeconomics schools

- **1. Monetarist Macroeconomics**

- **Monetarism** is an **empirical** doctrine. It was more about describing how the macro-economy worked and was thus really an empirical argument.

- **Milton Friedman** was the intellectual leader of the monetarists.

- In the **1960s**, debates between ***Keynesians*** and ***monetarists*** dominated the economic headlines.

The debates centered around three issues:

1. **The effectiveness of monetary policy versus fiscal policy.**
2. **The Phillips curve.**
3. **The role of policy.**

Basic tenets of the Monetarist school

- Importance of the **quantity stock of money**.
- Inflation and the **balance of payments** are essentially **monetary** phenomena
- **No long-run trade-off** between inflation and unemployment
- **Stable** macro-economy
- **Policy rules**
- Monetarists argued that the only way to increase output permanently was to make **markets work better**

- Friedman challenged the view that **fiscal policy** could affect output faster and more reliably than **monetary policy**.

- In a 1963 book, *A Monetary History of the United States, 1867-1960*, **Friedman and Anna Schwartz** reviewed the history of monetary policy and concluded that,

monetary policy was not only **very powerful**, but that **movements in money** also explained most of the fluctuations in output.

- They interpreted the **Great Depression** as the **result of** major **mistake** in monetary policy.

The Phillips Curve

- The Phillips curve provided **a convenient way to complete Keynesian model**,

which always had trouble explaining **why prices failed** to equilibrate markets and **how** the **price level adjusted overtime**.

- Friedman(1968) and Phelps(1967), took aim at the **weakest link** in the Keynesian model :

the **Phillips curve trade-off** b/n inflation and unemployment.

- **Phelps**(1967) and **Friedman**(1968) argued that the **trade-off** b/n inflation and unemployment would **not hold in long run**, when classical principles should apply, and money should be neutral.

- The **trade-off** appeared in the data because, in the **short run**, inflation is often **unanticipated** and unanticipated inflation can lower unemployment.
- The mechanism that Friedman suggested was **money illusion** on part of workers.

- By the mid 1970s, the **consensus** was that there was **no long-run trade off** between inflation and unemployment.

The Role of Policy

- **Skeptical** that economists knew enough to stabilize output and that policy makers could be trusted to do the right thing,

Milton Friedman argued for the use of **simple rules**, such as **steady money growth.**

- Friedman believed that **political pressures** to “do something” in the face of relatively mild problems **may do more harm** than good.

***1.4.4. New Classical Macroeconomics

- New classical economics was initiated by **Robert Lucas** for two reasons: **theoretical** and **empirical**

Stagflation and Aggregate supply

- The Phillips curve relationship found in 1958 and elaborated on in the 1960s seemed to promise that there was a stable trade-off between inflation and unemployment.
- The **experience of** the **late 1960s** and the **1970s** blow this relationship apart.

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In summary the following occurred:

- **Unemployment** and **inflation** were equally likely to **change** in the **same direction** as the opposite direction.

The simultaneous (the same direction) movement of unemployment and inflation is known as **Stagflation**.

- The changes in **inflation**, **unemployment**, and **output** were a lot larger than predicted by ***adaptive expectation*** theories and models.

- The **economic shocks** that were occurring were **not of the normal types**. And the IS-LM/AS-AD and PC models **couldn't capture** all these phenomena. A puzzle indeed!

New Classical Economics - the Rational Expectation Revolution

- **Expectations** are ***backward looking*** in the **Keynesian** and **monetarist** worlds; and so they **change slowly** with people making **systematic predictable mistakes**.

- In the early 1960s an economist called **John Muth** developed a model where agents had ***forward looking*** expectations. He argued that:
  - People would **look to the future**
  - People would **use information intelligently**
  - People would **not make systematic errors**

- **Phelps**(1967) and **Friedman's**(1968) **natural rate hypothesis** put **expectation** on the **center stage** of Macroeconomic Literature.

- ***Rational Expectations*** are forecasts that use all the relevant information available about **past** and **present** events, and that have the **least possible errors**.

- This development had obvious differences compared to the previous schools of thought:
  - Different from **classical economics**
  - **Keynesian** and **monetarist** economists argue that **expectations** are **not formed rationally**

Basic tenets of New Classical economics

- **Expectations** are formed **rationally**
- **Markets** continuously **clear**
- **Short-run** aggregate supply is **upward - sloping**
- **Long-run** aggregate supply is **vertical**
  - Economy is **self-correcting**
  - Policy **ineffectiveness** postulate
- They introduced two ideas:
  - i. **Rational** Expectation
  - ii. **Micro foundation** of Macroeconomics

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1.4.5. Real Business Cycle Macroeconomics

- **Lucas** (1973) proposed a **business cycle theory** based on the assumptions of, **imperfect information**, **rational expectations** and **market clearing**.

In this theory, **monetary policy** matters **only to the extent** to which it surprises people and confuses them about relative prices.

- **Sargent and Wallace**(1975) pointed out a key policy implication:

because it is impossible to surprise rational people systematically, **systematic monetary policy** aimed at stabilizing the economy is **doomed to fall**.

Basic tenets of Real Business Cycle (RBC) School of Economics

- Expectations are formed **rationally**
- Markets are **always clearing**
- **Money** is **neutral**
- Economic **fluctuations** are due only to ***supply side factors***
- **Output** and **employment** change because of changes to things like:

- The rate of **technology** change
- **Tax** rates
- **Input prices** changes
- **Natural disasters** or **good growing seasons**, etc

1.4.6. New Keynesian Macroeconomics

- While the **new classical** and **RBC schools** of thought assumed clearing markets,

it appeared to some economists that in recessions some people who were unemployed did not want to be.

- **No convincing reason** as to why there should be "**involuntary unemployment**".

- **New Keynesian economics** is-

a school of contemporary macroeconomics that strives to provide **microeconomic foundations** for Keynesian economics.

It **developed** partly **as a response** to criticisms on Keynesian macroeconomics by adherents of New Classical macroeconomics.

- **Like** the **New Classical** approach, New Keynesian macroeconomic analysis usually assume that
  - **households** and **firms** have **rational expectation**.

However, they assume
  - **imperfect competition**, with **sticky prices and wages**.

Basic tenets of New Keynesian school

- Market **imperfections** exist
- **Prices** and wages are **sticky** in the short-run and do not adjust fast.
- Money is **non-neutral**
- Thus, the implication is that there is a **need for government interventions**. This means, Government **policies are effective**.
- What they have in common with neo-classical economists is that:
  - i. **Expectations** are **rational**; and
  - ii. **Micro foundation** of macroeconomics.

1.4.7. Recent development in Macroeconomics

- **New neo-classical synthesis**

is the **fusion** of
the **new classical** economics and
new Keynesian economics

into a **consensus** on the best way **to explain short-run fluctuations** in the economy.

New growth theory

focuses on
the determinants of **technological progress** in the **long run**,
and the role of **increasing returns** to scale.

This work drew **attention away** from **short-run fluctuations**,

which had dominated the field of macroeconomics since its birth half a century earlier.

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2008-09 Keynesian resurgence:

In 2008 and 2009, there was a worldwide resurgence of interest in Keynesian economics among prominent economists and policy makers