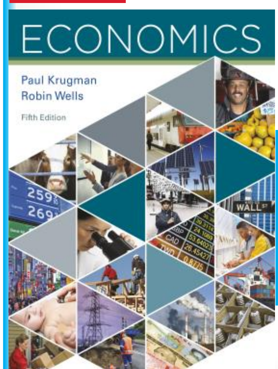


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**MACRO-ECONOMICS: EVENTS AND IDEAS**

## WHAT YOU WILL LEARN IN THIS CHAPTER

- Why was classical macroeconomics inadequate for the problems posed by the Great Depression?
- How did John Maynard Keynes and the experience of the Great Depression legitimize macroeconomic policy activism?
- What is monetarism and why did monetarists claim there are limits to the use of discretionary monetary policy?
- How did challenges lead to a revision of Keynesian economics and the emergence of the new classical macroeconomics?
- Why was the Great Moderation consensus undermined by the 2008 financial crisis, leading to fierce debates among economists emergence of two post–Great Recession viewpoints?

2

## TWO RECESSIONS, SAME PROBLEM


Thomas W. Elliott; akg-images/The Image Works

3

## CLASSICAL MACROECONOMICS

- **Ye olde economics:**
- **Before the Great Depression "classical" macroeconomics** reigned.
- Main ideas:
  - **The short run was unimportant.**
  - **Prices were assumed to be flexible, so the aggregate supply curve was vertical even in the short run.**


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## THE GREAT DEPRESSION AND THE KEYNESIAN REVOLUTION (1 of 2)

- **The Great Depression demonstrated that economists cannot safely ignore the short run.**
  - **The disastrous effects of the international depression helped Adolf Hitler's rise in Germany.**
- Economists were **conflicted in analysis and prognosis.**
  - **Classical economists** advocated **waiting it out**, but as the **depression deepened,** this approach was rejected.
  - Some thought **capitalism had failed** and only a **government takeover could end the slump.**
  - Some thought the slump could be cured without giving up the basic market economy.

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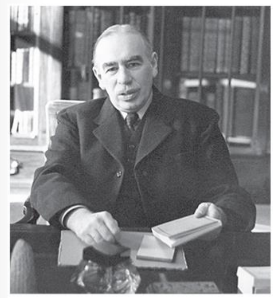
## KEYNES'S THEORY



Tim Gidal/Getty Images

- In 1936, Keynes published ***The General Theory of Employment, Interest, and Money***, one of the most influential books on economics ever written.

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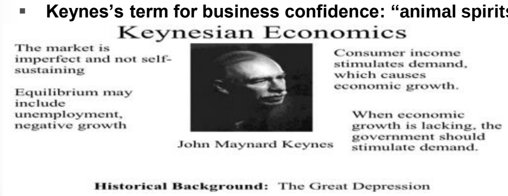
## THE GREAT DEPRESSION AND THE KEYNESIAN REVOLUTION (2 of 2)

- **Keynesian economics rests on two main tenets:**
  1) **Changes in aggregate demand affect aggregate output, employment, and prices.**
  2) **Changes in business confidence cause the business cycle.**
     - **Keynes's term for business confidence: "animal spirits"**

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## THE CLASSICAL VS. THE KEYNESIAN VIEW

- **Classical view:** flexible prices and focus on the long run mean a vertical SRAS; shifts in AD affect only aggregate price level
- **Keynesian view:** sticky prices and upward-sloping SRAS curve; shifts in AD affect the price level and output

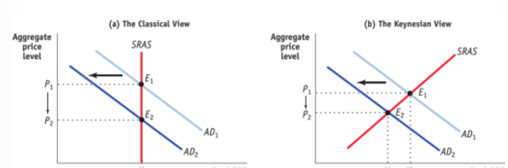


FIGURE 17-1 Krugman/Wells, *Macroeconomics*, 5e, © 2018 Worth Publishers

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## THE POLITICS OF KEYNES

- **Be careful not to confuse Keynes with socialism.**
  - ***Keynes himself was no socialist and not much of a leftist.***
- **When *The General Theory* was published, many intellectuals believed the capitalist system was dying.**
- **Keynes, in contrast, argued that all the system needed was a narrow technical fix.**
  - ***In that sense, his ideas were pro-capitalist and politically conservative.***

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## POLICY TO FIGHT RECESSIONS

- The main consequence of Keynes's work was that it legitimized macroeconomic policy activism.
- **Macroeconomic policy activism:** the use of monetary and fiscal policy to smooth out the business cycle
  - The **basic message** young economists took from Keynes in the 1930s was that **economic recovery requires aggressive fiscal expansion** to create jobs. Policy makers weren't convinced…
  - until World War II deficit spending created economic growth.

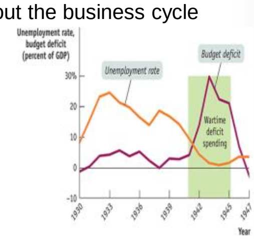


FIGURE 17-2 Krugman/Wells, Macroeconomics, 5e, © 2018 Worth Publishers
Data from: U.S. Census Bureau.

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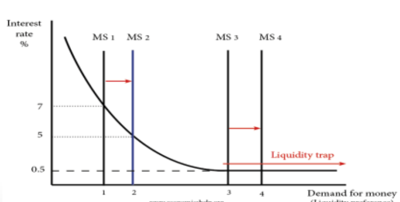
## CHALLENGES TO KEYNESIAN ECONOMICS

- **Keynes's ideas did not go unchallenged,** especially his assertion that **monetary policy was ineffective during recessions.**
  - **(Recall the liquidity trap, in which monetary policy is ineffective because the interest rate is down against the zero bound.**

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## MONETARISM (1 of 3)

- In 1963, Milton Friedman and Anna Schwartz published ***A Monetary History of the United States, 1867–1960.***

George Rose/Getty Images; TERESA ZABALA/The New York Times

- **They argued that business cycles were historically associated with fluctuations in the money supply. In other words, monetary policy mattered, especially in the Great Depression.**

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## MONETARISM (2 of 3)

- **A provocative idea emerged:**
- **The burden of managing the economy could be shifted away from fiscal policy…**
  - **…and economic management could largely be taken out of the hands of politicians.**
- **This could make macroeconomics a more technical and less political issue.**

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## MONETARISM (3 of 3)

- Milton Friedman led the **monetarism movement,** which sought to **eliminate macroeconomic policy activism while maintaining the importance of monetary policy.**
- **Monetarists** asserted that:
  - **attempts to stabilize the economy with fiscal OR monetary policy would make things worse.**
  - **GDP would grow steadily if the money supply grew steadily.**
- Friedman didn’t favor activist monetary policy either; he favored an autopilot approach.
- **A monetary policy rule** is a formula that determines the central bank’s actions.

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## FISCAL POLICY WITH A FIXED MONEY SUPPLY

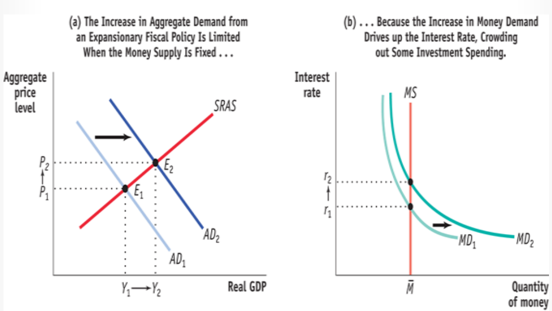


FIGURE 17-3 Krugman/Wells, *Macroeconomics*, 5e, © 2018 Worth Publishers

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## MONETARIST POLICY IDEAS

- **The velocity of money** is the ratio of nominal GDP to the money supply.
  - ***A measure of how many times the average dollar bill is spent each year in the country.***
- **The velocity equation:** $M \times V = P \times Y$
  - ***Where* M *is the money supply,* V *is velocity,* P *is the aggregate price level, and* Y *is real GDP.***
- Monetarists believed that ***V*** **was stable, so if the Fed kept** ***M*** **on a steady growth path, nominal GDP (*P* × *Y*) would also grow steadily.**

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## THE VELOCITY OF MONEY

- **Monetarism made more sense before 1980.**

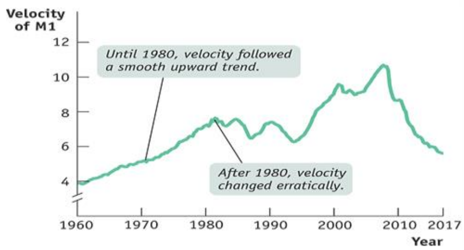


**FIGURE 17-4** Krugman/Wells, *Macroeconomics*, 5e,

*Data from:* Federal Reserve Bank of St. Louis.

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## THE FED'S FLIRTATION WITH MONETARISM

- **In the late 1970s, the Fed used a policy rule:**
- **It started announcing target ranges for the money supply and stopped setting targets for interest rates.**
- **But since 1982 the Fed has pursued a discretionary monetary policy, which has led to large swings in the money supply.**


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## INFLATION AND THE NATURAL RATE OF UNEMPLOYMENT (1 of 2)

- In the 1960s, economists began to worry that expansionary policies could cause inflation problems.
- 1968: Milton Friedman and Edmund Phelps argued that there is a **natural rate of unemployment**.
- **Since the government can't keep unemployment below its natural rate, it should just try to keep it stable.**
- And if inflation gets embedded in the public's expectations, it will continue even if unemployment is high.

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## INFLATION AND THE NATURAL RATE OF UNEMPLOYMENT (2 of 2)

- **The natural rate of unemployment is also the NAIRU (nonaccelerating inflation rate of unemployment).**
- **The natural rate hypothesis:** because inflation is embedded in expectations, **to avoid accelerating inflation over time the unemployment rate must be high enough that the actual inflation rate equals the expected inflation rate**

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## THE POLITICAL BUSINESS CYCLE

- A final challenge to Keynes:
- **What if politicians use Keynesian theory as an excuse to pump up the economy during election years to appeal to voters?**
- A **political business cycle:** political use of macroeconomic policy to serve political ends
- ***Nixon, "King of the political business cycle" campaigns, 1972***

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## RATIONAL EXPECTATIONS, REAL BUSINESS CYCLES, AND NEW CLASSICAL MACROECONOMICS

- In the 1970s and 1980s, some economists argued that **aggregate demand didn't matter as much as Keynes believed.**
- **New classical macroeconomics** evolved in two steps:
  - **rational expectations theory**
  - **real business cycle theory**

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## RATIONAL EXPECTATIONS

- **New classical macroeconomics** returns to the classical view that shifts in the aggregate demand curve affect only the aggregate price level, not the aggregate output.
- **In the 1970s "rational expectations" came into favor.**
  - **Rational expectations:** the view that individuals and firms make decisions optimally, using all available information
  - **Expansionary policies will have no effect if the markets adjust wages now in anticipation of future inflation.**

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## NEW KEYNESIAN CRITIQUE

- In the 1990s, new Keynesian economics became influential and criticized rational expectations.
- **New Keynesians argue that market** imperfections interact to make **many prices in the economy temporarily sticky.**
  - **Rational expectations theory has become less influential, but it did serve as a useful caution for those who were too optimistic about their ability to manage the economy.**

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## REAL BUSINESS CYCLES

- In the 1980s some economists argued that **recessions are caused by slowdowns in technology (and productivity) growth.**
- **Real business cycle theory:** the idea that fluctuations in the rate of growth of total factor productivity cause the business cycle
  - **Proponents saw no role for policy activism, since they believed the aggregate supply curve was vertical.**

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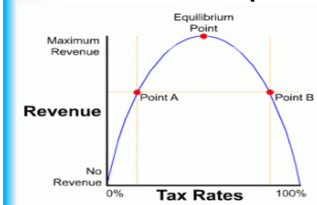
## Laffer Curve and Supply- Side Economics (will discuss later)




**The equilibrium points is the rate of taxation at which maximum revenue is generated. However, we don't really know what is that rates..**

**Supply-side economics is a school of macroeconomic thought that argues that overall economic well-being is maximized by lowering the barriers to producing goods and services (the "Supply Side" of the economy). By lowering such barriers, consumers are thought to benefit from a greater supply of goods and services at lower prices. Typical supply-side policy would advocate generally lower income tax and capital gains tax rates (to increase the supply of labor and capital), smaller government and a lower regulatory burden on enterprises (to lower costs).**

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## THE 1970S IN REVERSE

- If the theory of the natural rate of unemployment argues that sustained low unemployment leads to accelerating inflation… **shouldn't the opposite be true?**
- **The Great Recession tested this idea. Although the United States had lower inflation, it never entered the deflation predicted by the model.**
- **The old-fashioned Keynesian view that unemployment can be permanently reduced gained ground after 2008.**

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## CONSENSUS AND CONFLICT IN MODERN MACROECONOMICS

- After the stormy 1970s and the first half of the 1980s, things settled down.
- **The great moderation:** the period from 1985 to 2007, when the U.S. economy had relatively small fluctuations and low inflation
- The **great moderation consensus** combines a **belief in monetary policy as the main tool of stabilization** with **skepticism about the use of fiscal policy** and an **acknowledgment of the policy constraints** imposed by the natural rate of unemployment and the political business cycle.

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## FIVE KEY QUESTIONS ABOUT MACROECONOMIC POLICY

| | Classical and new classical | Keynesian and new Keynesian | Monetarism | Great Moderation consensus | Post–Great Recession era Inflation bears | Post–Great Recession era Secular stagnationists |
|---|---|---|---|---|---|---|
| 1. Is expansionary monetary policy helpful in fighting recessions? | No | Not very | Yes | Yes, except in special circumstances | No | Not very |
| 2. Is expansionary fiscal policy effective in fighting recessions? | No | Yes | No | Yes | No | Yes |
| 3. Can monetary and/or fiscal policy reduce unemployment in the long run? | No | Yes | No | No | No | Yes |
| 4. Should fiscal policy be used in a discretionary way? | No | Yes | No | No, except possibly in special circumstances | No | Yes |
| 5. Should monetary policy be used in a discretionary way? | No | Yes | No | Disputed | No | Yes |

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## CRISIS AND AFTERMATH: DEBATES

- **The debate over fiscal policy during the financial crisis and aftermath in 2009**
- ***Supporters of fiscal stimulus argued:***
  1. Fiscal policy was needed, since interest rates were near zero.
  2. Crowding out was unlikely to be a problem in a depressed economy.
  3. Because the recession was likely to be a long one, lags in fiscal policy didn't matter much.
- ***Opponents of fiscal stimulus argued:***
  1. New government spending would be ineffective, since people would increase their savings (and cut their spending) in anticipation of higher taxes in the future (Ricardian equivalence argument).
  2. Spending programs might undermine investors' faith in the government's ability to repay its debts, leading to an increase in long-term interest rates despite loose monetary policy.

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## CRISIS AND AFTERMATH: AUSTERITY

- By 2010, many economists argued that the **best solution was to cut government spending,** which they hoped would **increase confidence** and growth.
- This **"theory of expansionary austerity"** was especially popular in Europe, explained in part by their rising borrowing costs.

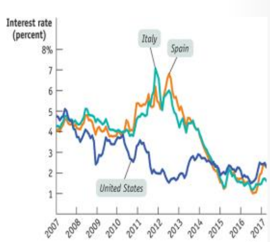


FIGURE 17-5 Krugman/Wells, *Macroeconomics*, 5e, © 2018 Worth Publishers
*Data from:* Federal Reserve Bank of St. Louis.

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## THE FED'S UNCONVENTIONAL MONETARY POLICY

- In 2008–2010, the **Fed got creative in trying to stimulate the economy by buying longer-term government bonds.**
- **This QE ("quantitative easing") was controversial.**
  - **Some thought it would be hard to undo.**
  - **Some thought it would be ineffective.**
  - **Some thought the Fed should increase its inflation target instead so that we wouldn't be so close to the zero bound on interest rates.**

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