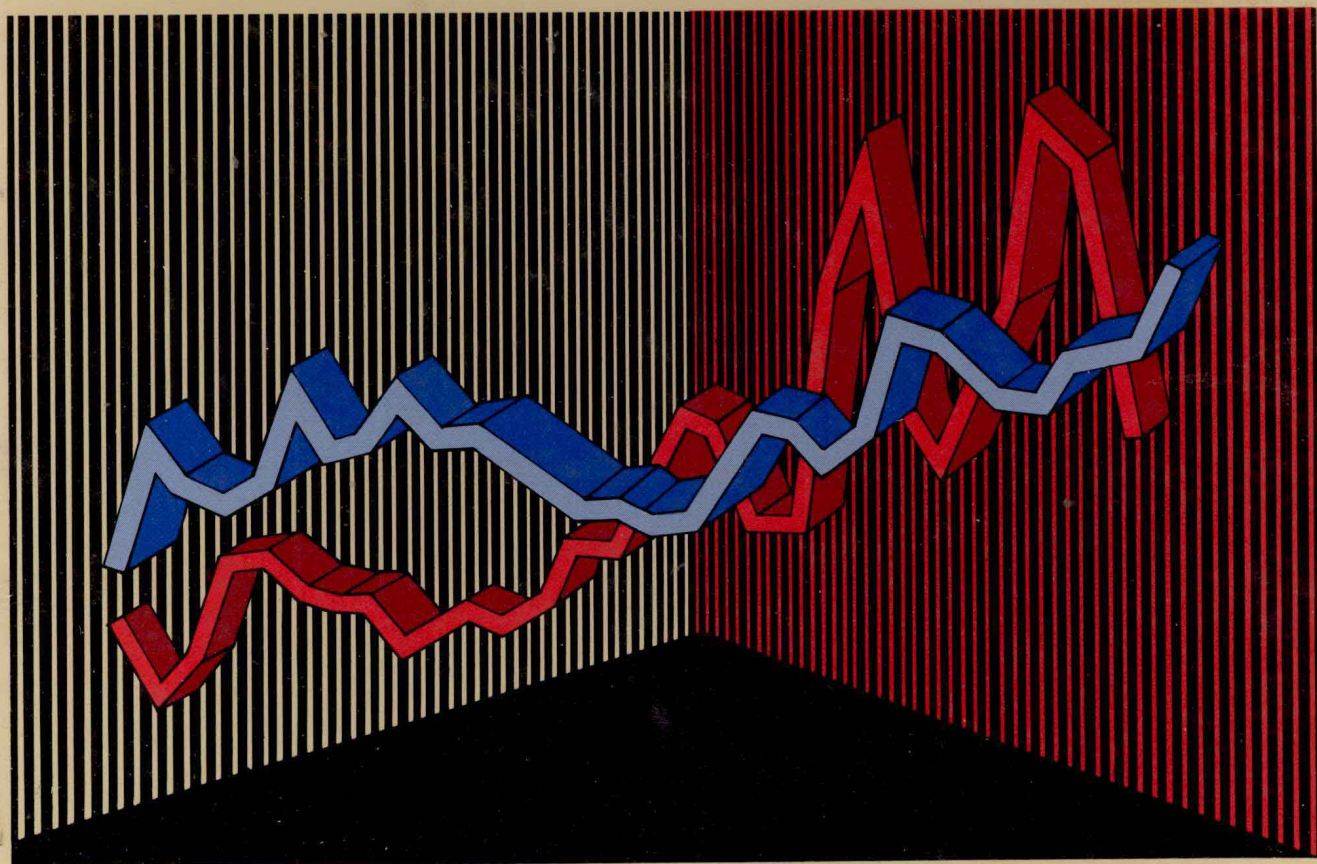


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THEORIES AND POLICIES

Richard T. Froyen



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About the cover: The figure on the cover is an abstract representation that approximates the percentage rates of inflation and unemployment from 1953 through August, 1982. The blue line is the unemployment rate and the red is the inflation rate.

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preface

The period since 1970 has been a challenging one for macroeconomists. The key variables in macroeconomics—the levels of output, inflation, and unemployment; rates of interest; and foreign exchange rates—while behaving in interesting ways have proved difficult to explain and predict. The period since 1970 has also been an active one in macroeconomic theory. It has been a period of controversy, but also of progress in at least clarifying the issues on which macroeconomists are divided. The decade of 1970's saw a broadening of the issues in the *monetarist–Keynesian* controversy. Additionally, a new challenge to the neo-Keynesian position, the *new classical* economics, emerged. At the end of the decade, neo-Keynesian policy prescriptions were also under attack from a group that has come to be called the *supply-side* economists. Finally, the post-1970 period has been an active one in terms of macroeconomic policy. The decade of the 1970s began with President Nixon's *New Economic Policy*, and the decade of the 1980s with President Reagan's *Economic Recovery Program*, with many major policy shifts in between.

In this book I have tried to explain macroeconomics, inclusive of the above-mentioned recent developments, in a coherent way, but without glossing over the fundamental disagreements among macroeconomists on issues of both theory and policy. The major modern macroeconomic theories are presented and compared. Within this framework, the important topics and is-

sues in macroeconomics are developed in full. Important areas of agreement as well as differences are discussed. An attempt is made to demonstrate that the controversies among macroeconomists center on well-defined issues that have their basis in theoretical differences in the underlying models.

An effort is made to interrelate macroeconomic theory and policy, recent policy actions as well as not so recent ones. The behavior of economic variables is considered in relation to developments in economic theory; for example, the simultaneously high inflation and unemployment rates of the 1970s are considered in relationship to the development of the monetarist theory of the *natural rate of unemployment* and the new classical *rational expectations* view. The development of the original *classical economics* and the Keynesian revolution against the classical view are also explained with reference to their historical settings.

Specific distinguishing features of the approach taken here are:

- a detailed analysis of the monetarist and new classical challenges to the neo-Keynesian position
- an up-to-date summary of the modern neo-Keynesian position, including the neo-Keynesian response to the monetarist and new classical critics
- an extensive treatment of monetary policy which considers the optimal strategy for monetary policy including the merits of intermediate targeting on monetary aggregates. Also, the question of reserves versus an interest rate as a short-run operating target for money stock control is examined within the context of the recent shift in Federal Reserve operating procedure.
- an analysis of the recent slowdown in output growth, capital formation and growth in labor productivity in the United States. It is within this context of intermediate-run growth that the views of the *supply-side* economists are considered, along with the neo-Keynesian perspective on such intermediate-run growth. Also, within this context the economic policy initiatives of the Reagan administration that have come to be known as “Reaganomics” are analyzed.
- a thorough coverage of money demand which discusses recent difficulties in predicting money demand, the effects of ongoing innovations in the financial sector, and the recent redefinition of the monetary aggregates.

—an analysis of the question of rules versus discretion in macroeconomic policymaking. Rules for monetary policy as well as a constitutional amendment for balancing the Federal budget are considered. These issues are examined in the context of the interventionist versus noninterventionist policy positions of the different schools of macroeconomic theory. The *public choice* view of macroeconomic policymaking is also examined.

The organization of the book is as follows. Part I (Chapters 1–2) discusses the subject matter of macroeconomics, the recent behavior of the U.S. economy and questions of measurement. Part II presents the major macroeconomic models or systems, beginning with the classical system (Chapters 3–4). Consideration of the classical system at the start is useful because the Keynesian model can then be viewed as an attack on the classical orthodoxy. The recent challenges to the neo-Keynesian position can then be rooted in the parts of the classical model that provide starting points for their analysis: the quantity theory of money for the monetarists and the classical labor market clearing assumptions and choice-theoretic based behavioral functions for the new classical economists. The classical analysis is also useful for a later examination of the policy prescriptions of the supply-side economists.

The Keynesian model is analyzed in detail in Chapters 5–8. Beginning from a very simple model, more complex models are built up to incorporate: monetary influences, wage and price flexibility, changing price expectations and shocks to aggregate supply. Chapters 9 and 10 present the monetarist model. Chapter 9 focuses on the monetarists' view of the importance of money and Chapter 10 develops the monetarists' theory of the natural rate of unemployment. Chapter 11 examines the new classical view, often termed the *rational expectations* theory, as well as the neo-Keynesian critique of this view. Chapter 12 summarizes and compares the different models.

Part III presents extensions and considers parts of the models in greater detail. The chapters here and in Part IV are designed to be self-contained so that the instructor can choose topics as time and interest allow. Chapter 13 is a more detailed examination of the components of private sector demand: consumption and investment spending. Chapter 14 considers money demand and Chapter 15 the money supply process. Chapter 16 returns to the supply side of macroeconomic models to discuss long-run equilibrium growth and the determinants of growth over inter-

mediate-run periods, periods too long to fit the short-run framework of the models in Part II, but not necessarily situations of long-run equilibrium. As noted above, it is in this context that supply-side economics is examined. Chapter 17 considers *open-economy* macroeconomics. An appendix to the chapter develops an open-economy macroeconomic model.

Part IV deals with macroeconomic policy, fiscal and incomes policies in Chapter 18 and monetary policy in Chapter 19. An appendix to Chapter 19 considers the supply-side economists' proposal for monetary policy, a return to a gold standard. A historical appendix to Part IV describes major macroeconomic policy actions over the period since the Great Depression of the 1930s.

In the section on macroeconomic models, the conceptual approach taken here is to develop each model within the aggregate demand-aggregate supply framework in order to facilitate comparisons among the models. Throughout the book the aim is to provide a clear and rigorous, primarily graphical and verbal analysis. Other pedagogical features are the explanatory captions provided for the graphs in the text, end-of-chapter questions, and a list of selected readings following each chapter.

An instructor's Manual to accompany the text contains summaries of chapter objectives, answers to all end-of-chapter questions, and test materials that include problems, essay questions, and multiple-choice questions. A Study Guide, co-authored by Lawrence Davidson and myself, contains a review outline, problems, multiple-choice questions, and exercises on concepts and techniques for each chapter.

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Weaknesses or errors that remain, despite such aid, are my responsibility.

R.T.F.

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