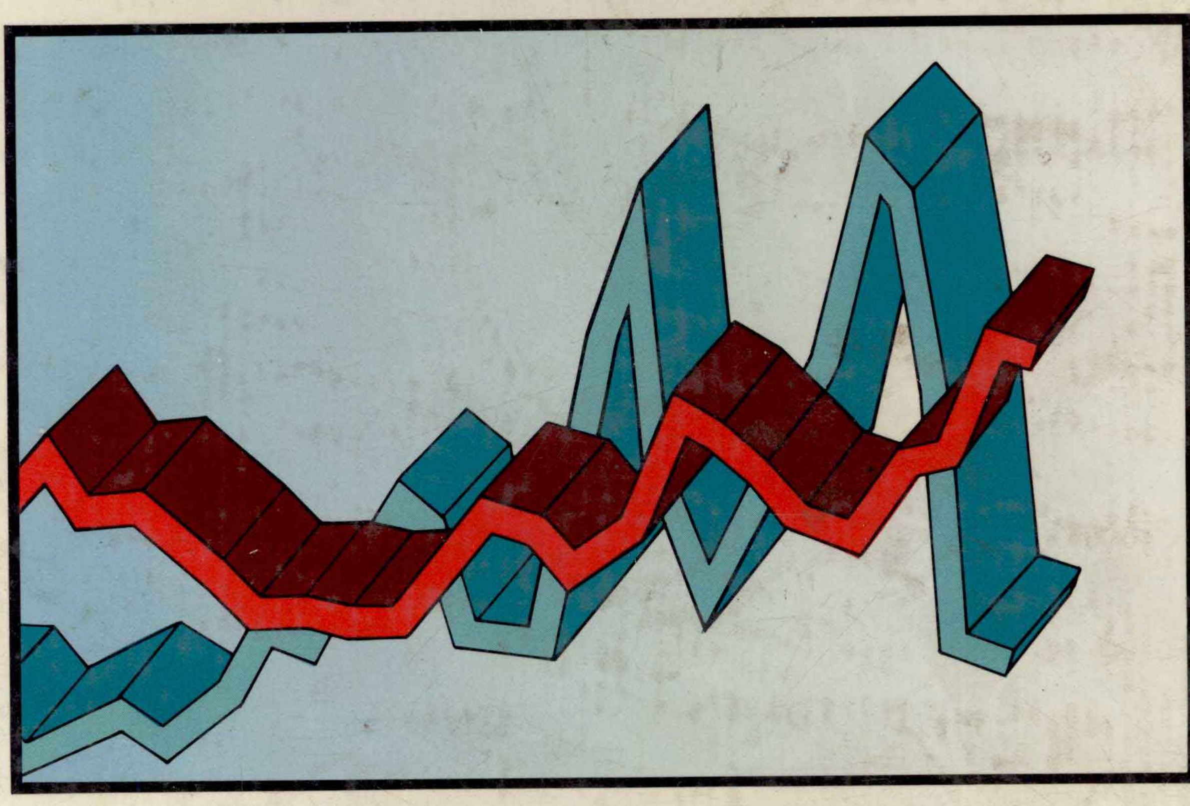
Richard T. Froyen

SECOND EDITION

MACRO-ECONOMICS

Theories and Policies



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Macmillan Publishing Company
NEW YORK
Collier Macmillan Publishers
LONDON

About the cover: The figure on the cover is an abstract representation that approximates the percentage rates of inflation and unemployment from 1960 through August, 1984. The red line is the unemployment rate and the green is the inflation rate.

PRINTED IN THE UNITED STATES OF AMERICA

Macmillan Publishing Company
866 Third Avenue, New York 10022

Coller Macmillan Canada, Inc.

Library of Congress Cataloging in Publication Data.

Froyen, Richard T.
Macroeconomics, theories and policies.
Includes index.
1. Macroeconomics. I. Title.
HB172.5.F76 1986 339 85–10507
ISBN 0–02–339410–2

PRINTING: 2 3 4 5 6 7 8 YEAR: 6 7 8 9 0 1 2 3 4

ISBN 0-02-339410-2

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 the 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. During the 1980s, neo-Keynesian policy prescriptions have also been 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 *Reaganomics*, with many policy shifts along the way.

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 issues 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.

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.
—an analysis of the post-1970 slowdown in U.S. output growth, capital formation, and growth in labor productivity. It is within this context of intermediate-run growth that the views of the supply-side economists are considered. The effects of *Reaganomics* on the performance of the economy in this somewhat longer-run context are examined.
—a thorough coverage of money demand which discusses recent difficulties in predicting money demand, and effects of on-going innovations in the financial sector.
—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 intermediate-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. Chapter 17 considers *open-economy* macroeconomics.

Part IV deals with macroeconomic policy, fiscal policy 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.

New Features in the Second Edition

In revising the book for the second edition, I have expanded the discussion relating macroeconomic theories to events in the actual economy. I have, in particular, increased the amount of such discussion within Part II where the differing macroeconomic models are first presented. For example, the monetarist–Keynesian dispute is discussed within the context of the recent behavior of the money–income relationship. The new classical economics is evaluated with reference to the costly disinflation of the early 1980s.

To increase the interrelation of theory and events, including policy actions, a number of *Perspectives* sections have been added. These discuss such subjects as the monetarist explanation of the Great Depression, the new classical view of the same event, and the supply-side view of the effects of tax cuts.

Other new features include:

—a section on the determinants of the natural rate of unemployment, as well as the causes of an apparent upward secular drift in unemployment (Chapter 10).
—an expanded discussion of the economic consequences of recent fiscal policy shifts and resulting large federal deficits (Chapter 18).
—a section analyzing the U.S. experience with floating exchange rates with periods of rapid change in the value of the U.S. dollar (Chapter 17).
—appendices providing a thorough algebraic treatment of the *IS-LM* curve model (Chapters 6 and 7).
—a more extensive treatment of Friedman's permanent income hypothesis about the consumption function. (Chapter 13).

Acknowledgments

Many people have been helpful in preparing this book. Readers recruited by Macmillan have provided useful comments that led to many substantial improvements. These readers were: Lawrence Davidson and Willard Witte, Indiana University; Ed Day, University of Louisville; Gary Gigliotti, Rutgers University; John Lapp, North Carolina State University; Thomas McCaleb, Florida State University; Richard Selden, University of Virginia; John Trapani, University of Texas-Arlington; Doug Waldo, University of Florida; Warren Weber, Federal Reserve Bank of Minneapolis; Jack Adams, University of Arkansas; Michael Bradley, George Washington University; Lawrence DeBoer, Ball State University; Mario Pastore, Ithaca College; John Vahaley, University of Louisville; and H. W. Whitmore, University of Cincinnati. I am particularly grateful to Lawrence Davidson for his comprehensive reviews of the first edition and to Willard Witte for his detailed comments on the second edition.

I have also received helpful comments on the first edition from: Patrick Conway and Allin Cottrell here at the University of North Carolina; David Van Hoose, Indiana University; Thomas Havrilesky, Duke University; Michael Loy and Lawrence Ellis, Appalachian State University; Rexford Santerre and Michael Tucci, Bentley College; and David Bowles, Clemson University.

My editors at Macmillan, Anthony English, Charles Place, Chip Price, and Jack Repcheck, have provided encouragement and numerous good suggestions. John Travis has competently supervised the production process. I am indebted to Arthur Benavie, Michael Salemi, and Roger Waud, colleagues here at the University of North Carolina, for their comments and suggestions and for the great deal I have learned from them on the subject matter of this book. I am likewise indebted to the many graduate and undergraduate students whom I

have taught here for what I have learned from them about the teaching of macroeconomics and the subject itself.

A last important debt is to Linda Froyen who prepared the index and helped in many other aspects of preparing this manuscript.

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

R.T.F.

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