Macroeconomics

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THE IRWIN SERIES IN ECONOMICS

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Preface

IN A RECENT review of a new intermediate textbook on Macroeconomics, William Silber observed that there were 16 intermediate Macro books in his bookcase; the work under review was number 17. The question may fairly be raised: Do we need an eighteenth?

The importance of the Macro field is in itself not an adequate answer—although I share the view that Macroeconomics remains at the very center of economic policy. Rather, the justification for yet another Macro text must lie in a substantial innovation. In the present work, I have aimed at a significantly different type of text.

Many of the present texts represent examples of competent scholarship; it is not my contention that I am presenting a "correct" version as contrasted to that of other texts. Rather, the problem with the other texts is one of focus. Their objective usually is to work the student through the basic macroeconomic model, culminating with a detailed description of the IS/LM analysis. There is nothing intrinsically wrong with this approach; indeed, much can be learned both about economic theory and economic policy in such an exercise.

Nevertheless, it does seem to me that something very important is missing. In the stress on the mechanics of the basic model, there is a loss of the sense of excitement over Macroeconomics as a study of big, controversial policy questions. One of the purposes of this book is to focus on the controversial questions at the center of Macroeconomics. What are the relative merits of fiscal and monetary policies as a means of controlling aggregate demand? Which is more effective? What are the practical problems and what are the delays in the operation of fiscal and monetary policies? What are the standards of performance which may reasonably be achieved? To what extent should policy-makers attempt to "fine tune" the economy? What are the strengths and weaknesses of Keynesian theory as an approach to Macroeconomics?

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These are not settled questions. Indeed, there is a less clear consensus of the economics profession on these matters than there was a decade ago. Many of the controversial points are, however, very basic and simple. They belong in an intermediate Macro text. One of the major objectives of the present work is to give the flavor of Macroeconomics as an *exciting, controversial,* and *developing* field. Thus, while there is a development of the standard IS/LM model (Chaps. 3–5), there is also a discussion of some of the weaknesses and limitations of that model (Chap. 6). Likewise, when Keynes' theory of aggregate demand is developed, so is the competing classical-monetary theory, with the strengths and weaknesses of the two approaches being a major topic. Included is a comparison of the Keynesian structural models and the Monetarist single-equation models as a means of predicting aggregate demand (Chap. 10).

Because this text attempts to give the flavor of the major past and present controversies in Macroeconomics, it is less assuredly Keynesian in its assumptions than is the typical Macro text. Given the failure of the real world during the past decade to behave in all respects as Keynesian theory suggests it should have behaved, other competing assumptions and theories deserve their day in court. There is, for example, a detailed review of the controversy over the Phillips Curve and the inflation-unemployment tradeoff in Chapter 11. (The dynamic process of inflation—a topic of obvious current interest, but one which is shortchanged in the standard textbook—is discussed in Chapter 12.) Throughout, an effort is made to emphasize a lesson which is essential to an adequate undergraduate training in economics: Students should be made aware of the importance of assumptions, and of the sensitivity of theoretical results to changes in assumptions. Thus, for example, embarrassing questions regarding the assumptions behind the multiplier theory are not avoided; rather, they are addressed explicitly (pp. 127–35). Similarly, an effort is made to leave the student with an open mind regarding the effect of wealth on consumption (pp. 136–38 and Chap. 13). In this, there is a contrast with the typical textbook dismissal of the real-balance effect. (Sometimes, textbooks dismiss the real-balance effect categorically and without explanation on the same page that they describe studies which suggest that wealth is an important determinant of consumption.)

The traditional division between Macroeconomics and Monetary Economics is in part artificial; any comprehensive treatment of macroeconomic questions must deal extensively with money and its effect on the economy. Thus, there is a detailed treatment of money in the present text (Part III). The appropriate design of the Macro course depends in part on whether students have been exposed previously to a course in Money and Banking. Where they have such exposure, it is feasible to go rather quickly through Part III (especially Chap. 7), and to spend more time on such topics as the Consumption function (Chap. 13) and Investment (Chap. 14).

In the preparation of this text, I have shamelessly accumulated intellectual debts to my undergraduate and graduate students at the University of Maryland, and to an extensive list of colleagues, including Richard Caves, Gail Huh, Paul Meyer, John Neri, Mancur Olson, Lloyd Reynolds, and Ron Wonnacott. I should particularly like to thank Harry Johnson and Dennis Starleaf, who have gone over the entire manuscript and given me their perceptive comments. And, most of all, special thanks should go to Lloyd Atkinson. Indeed, his suggestions and encouragement were so important in the development of this book, particularly in its formative stages, that I am tempted to dispense with the *pro forma* disclaimer and say simply: If you don't like this book, blame Atkinson.

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February 1974 PAUL WONNACOTT

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Introduction

I want, *so to speak, to raise a dust; because it is only out of the controversy that will arise that what I am saying will be understood.*

John Maynard Keynes, in a letter to Roy Harrod

1

Economic goals and the performance of the economy

Economy is the art of making the most out of life.
George Bernard Shaw

SINCE the Industrial Revolution, economic growth has been the most conspicuous feature of the economies of Europe and North America. The total production of goods and services has grown to give us an unprecedented level of economic welfare.

But there have been problems. Periodically, our economies have suffered from recession, with able-bodied men unable to find jobs in spite of their eagerness to work. In 1933, at the depth of the Great Depression, the unemployment rate in the United States rose to 25 percent of the labor force, and the annual unemployment rate never fell below 14 percent during the whole decade from 1931 to 1940. There was a tremendous economic loss: men out of work, producing nothing, while people's basic economic needs went unmet. There was a tremendous social cost: men out of work, feeling useless, in a trap of frustration and despair. And there were unmeasurable, but perhaps even greater, political consequences: the international depression was one of the factors bringing Hitler to power, with his promises of full employment and military conquest.

The disasters of the interwar period laid the foundation for modern macroeconomics. "Never again" was the determination of the economic scholar, the politician, and the man on the street alike. This determination was clearly reflected in the Employment Act of 1946, in which the Congress declared that "it is the continuing responsibility of the Federal Government to use all practicable means . . . to promote maximum employment, production, and purchasing power." And politicians and economic scholars have worked together to see that the 30s did not happen again: Economic problems in the postwar period have been mild compared to those of the prewar decade.

But, in spite of successes, problems have remained. After the successful conversion to a peacetime economy in the immediate postwar years, the economy suffered a pause in 1949, and the unemployment rate rose to 5.9 percent (compared to the average of about 4 percent in the preceding three years). Again in 1954, there was a pause, with a 5.5 percent unemployment rate. Then, during the late 50s and early 60s, there was an extended period of softness in the economy, with annual unemployment rising almost to 7 percent in 1958, and never falling below 5.5 percent until the Vietnam war began to escalate in 1964–65. During this six-year period of slack from 1958 to 1963, the economy lost an estimated total of $200 billion in output foregone (measured at 1958 prices); $200 billion more could have been produced if men and machines had been kept working at high employment levels. More recently, in 1971, the unemployment was again high by postwar standards, rising to 5.9 percent for the year.

MACROECONOMICS AND MACROECONOMIC GOALS

Economics is divided into two basic categories: macroeconomics and microeconomics. *Macro*economics is the study of economic aggregates: the total amount of employment, the level of aggregate output, the growth of aggregate output, and changes in the average level of prices. *Micro*economics, on the other hand, deals with the detailed behavior of individual economic units. How does a business firm maximize its profits? What forces determine the prices of individual goods? What determines the amount of a particular good which will be produced?

The division between macroeconomics and microeconomics is particularly significant because the overall response of the economy may differ quite sharply from the response of individual units. For example, when the wages paid by an individual firm decline, then the firm is likely to expand output and add to its labor force. But not necessarily so for the economy as a whole: If the general level of wages falls, the level of incomes and the consumption of the labor force will also decline. Thus, producing units will face conflicting forces: a reduction in their costs, which should encourage them to expand; and a reduction in the demand for their products, which discourages production. Which of these forces is stronger is not immediately clear (and, indeed, this question was the source of considerable controversy during the Great Depression). The important point: One cannot argue that the response of the economy as a whole to an economic change is necessarily the same as the response of an individual unit; to do so is to commit *the fallacy of composition.* Macroeconomics—the study of economic aggregates—does not constitute a simple set of deductions from microeconomics.

As they deal with different levels of aggregation, macroeconomics and microeconomics naturally focus on different economic objectives. Macroeconomic policy objectives are *full employment, stable prices,* and a *satisfactory rate of economic growth.* The key microeconomic objective is the efficient use of productive resources.

Macroeconomic policies and economic goals: The simple case

For extreme illnesses, extreme treatments are most fitting.[1]

Hippocrates

At times, the economy falls so short of an important objective that policy makers should clearly concentrate on that objective. This was most obviously the case during the 1930s, when the economy was operating far short of capacity output, and men and machines were idle. It has also been the case in countries suffering from hyperinflation (very rapid rates of inflation), such as Germany in the early 1920s.

The central policy message of macroeconomics is that *changes in aggregate demand are the key* to dealing with these pathological conditions. If the economy is suffering from a 1930s-type depression, then demand should be expanded, and quickly! Large-scale unemployment was a sign that there was insufficient total demand; an increase in the demand for goods and services was needed to put men back to work. On the other extreme, the hyperinflation in Germany in the 20s was a result of a rise in aggregate demand which was much too rapid. Too much demand was chasing too few goods. The appropriate policy in those circumstances: Cut down the rate of growth of aggregate demand.

Two major policy levers are available to the authorities to control aggregate demand:

1. *Fiscal policy* involves changes in government spending or in taxa-

[1] From *Aphorisms.*

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