

## MACROECONOMICS FOR MANAGERS

### I. Introduction

Q. What is macroeconomics all about?

Macroeconomics is the study of the structure and performance of the aggregate economy, taking into account the relationship among the markets for goods, labor, and assets. Macroeconomics can be distinguished from microeconomics by its focus on aggregate economic activity in a general equilibrium framework. In contrast, microeconomics - you may recall - is the study of the behavior of individual economic agents (e.g., consumers or firms) in a partial equilibrium setting.

The structure of the macroeconomy is represented in a simplified way by a macroeconomic model. Such a model embodies various assumptions about the way in which the decisions of literally millions of individual economic agents in thousands of interrelated markets collectively determine such aggregate economic magnitudes such as the Gross Domestic Product (GDP), which is a measure of economy-wide output, and the Consumer Price Index (CPI), which is a measure of the price level. Alternative sets of assumptions give rise to different models of the macroeconomy. The two most prominent frameworks are the so-called Classical (or New-Classical) model of macroeconomics and the (New) Keynesian model of the macroeconomy.

## **Macroeconomic (Monetary and Fiscal) Policies**

Macroeconomic policies are designed to affect the economic performance of the economy as a whole. There are two major types of macroeconomic policies: monetary policy and fiscal policy. Monetary policy determines the rate of growth of the aggregate money supply and is controlled by the central bank, which in the United States is known as the Federal Reserve System or simply the Fed. As we shall see, the long-run effects of monetary policy are limited to nominal variables such as the nominal interest rate and the price level. However, in the short-run (unanticipated) monetary policy can affect real variables, like GDP and employment.

Fiscal policy is the responsibility of local, state, and national governments and concerns the level of taxation and government spending. An important fiscal-policy issue in recent years has been the size of the federal budget deficit, or the excess of federal expenditures over federal tax revenues. It's useful to place the federal budget deficit both in the context of business cycles and in a longer historical perspective. Although small budget deficits (surpluses) have long been associated with economic contractions (expansions), large deficits occurred during both World War I and World War II. However, beginning around the 1974-75 recession and for most of the subsequent thirty years, there have been relatively large and persistent deficits even in an expanding economy. This latter trend is what has generated considerable debate, and has prompted recurring calls for a constitutional amendment to require a balanced federal budget. The concern about chronic deficits has largely taken the form of an argument that the federal

budget deficit, which must be financed by borrowing from the public, diverts private saving that might otherwise have been channeled into more productive uses, such as private-sector capital investment. If large-scale federal borrowing leads to increases in interest rates that bid away scarce funds from the private sector, there will be a "crowding out" of private investment by public spending. We will subject this argument to closer scrutiny later in the course.

### **Macroeconomic Policy Debates**

Debates among economists about macroeconomic theory and policy tend to occur in public forums. The nature and extent of disagreements among macroeconomists are probably exaggerated by the media because of the intense interest in the issues being debated. Nonetheless, despite substantial areas of agreement that are under-reported to the public, there are some areas of genuine importance where differences of analysis and interpretation exist. In thinking about policy debates in macroeconomics, it is important to keep in mind the distinction between positive and normative analysis. There is considerably less disagreement about positive analysis (e.g., what are the predictable macroeconomic consequences of a decrease in banking-system reserves?) than about normative analysis (are the redistributive consequences of such a monetary-policy change desirable?).

Most genuine disagreements within macroeconomics can be understood in the context of the two major intellectual traditions: Classical and Keynesian. The Classical

approach can be traced back to Adam Smith over 200 years ago and emphasizes two assumptions: (1) an "invisible hand" leads individuals - acting in their own self interests - to make decisions that maximize aggregate economic well-being; (2) wages and prices adjust rapidly in response to changes in supply or demand to attain a new equilibrium. These two assumptions logically imply a limited role for the government in trying to manage macroeconomic performance. The Keynesian approach dominated macroeconomics from the 1930's until 1970's. Until that time, most economists believed that the skillful application of tax and spending (fiscal) policy could, in principle, render the business cycle obsolete. And, indeed, the post-WWII recessions that the U.S had experienced were mild in comparison with the Great Depression, and inflation was low. However, the 1974-75 recession was accompanied by relatively high inflation, and the ensuing economic recovery or expansion was rather anemic. Thus, the economy was, throughout the rest of the 1970's, experiencing what was termed "stagflation." This combination of modest growth, or stagnation, and stubborn inflation called into question the faith in Keynesian-style management of the macroeconomy.

While the Keynesian model was coming under critical scrutiny for its failure to explain the emerging stagflation, there emerged a renewed interest in the Classical approach, suitably modified by new theories of the "rational" formation of individuals' expectations about the future values of important macroeconomic variables. Strong claims by this so-called New Classical school of thought were put forward that denied the possibility of a welfare-enhancing role for activist macroeconomic policy in combating the business cycle. Thus, the pendulum began to swing away from the Keynesian

approach and toward a modern version of the Classical model. However, it was eventually learned that the rehabilitation of the Classical model required very special assumptions about preferences and technology to generate its strongest conclusions about the futility of active intervention in the macroeconomy.

Skepticism about the theoretical robustness and practical importance of the New Classical paradigm gave rise to a renewed interest in understanding the sluggish process of wage and price adjustments that was the centerpiece of Keynesian analysis and which seemed to give a descriptively accurate picture of real-world market dynamics. The models that have been developed in this vein comprise a framework known as New Keynesianism. Presently, the best research being carried out in macroeconomics represents the intersection of the most appealing features of both the New Classical and New Keynesian approaches.

This unified approach can be characterized by the following features common to almost all examples of best-practice research in macroeconomics:

**General Equilibrium:** individuals, firms, and the government interact simultaneously in a general equilibrium of the goods market, the labor market, and the market for assets.

**Microeconomic Foundations:** individuals and firms behave in a self-interested way, with individuals maximizing utility subject to a budget constraint and firms minimizing costs subject to a technology constraint.

**Market Adjustments:** in the short run, prices and wages adjust slowly and incompletely to their new, general equilibrium values, but in the long run prices and wages adjust fully to their new equilibrium values.