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Current Issues in Macro Theory and Policy

McGraw-Hill/Irwin

Causes of Macro Instability

- Mainstream view
  - Held by most economists
  - Price stickiness
  - Unexpected demand shocks
    - Variable investment spending
  - Unexpected supply shocks

Causes of Macro Instability

- Monetarist view
  - Government interference is the problem
  - Equation of exchange $MV = PQ$
  - Stable velocity
  - Monetary causes of instability
    - Inappropriate monetary policy

Causes of Macro Instability

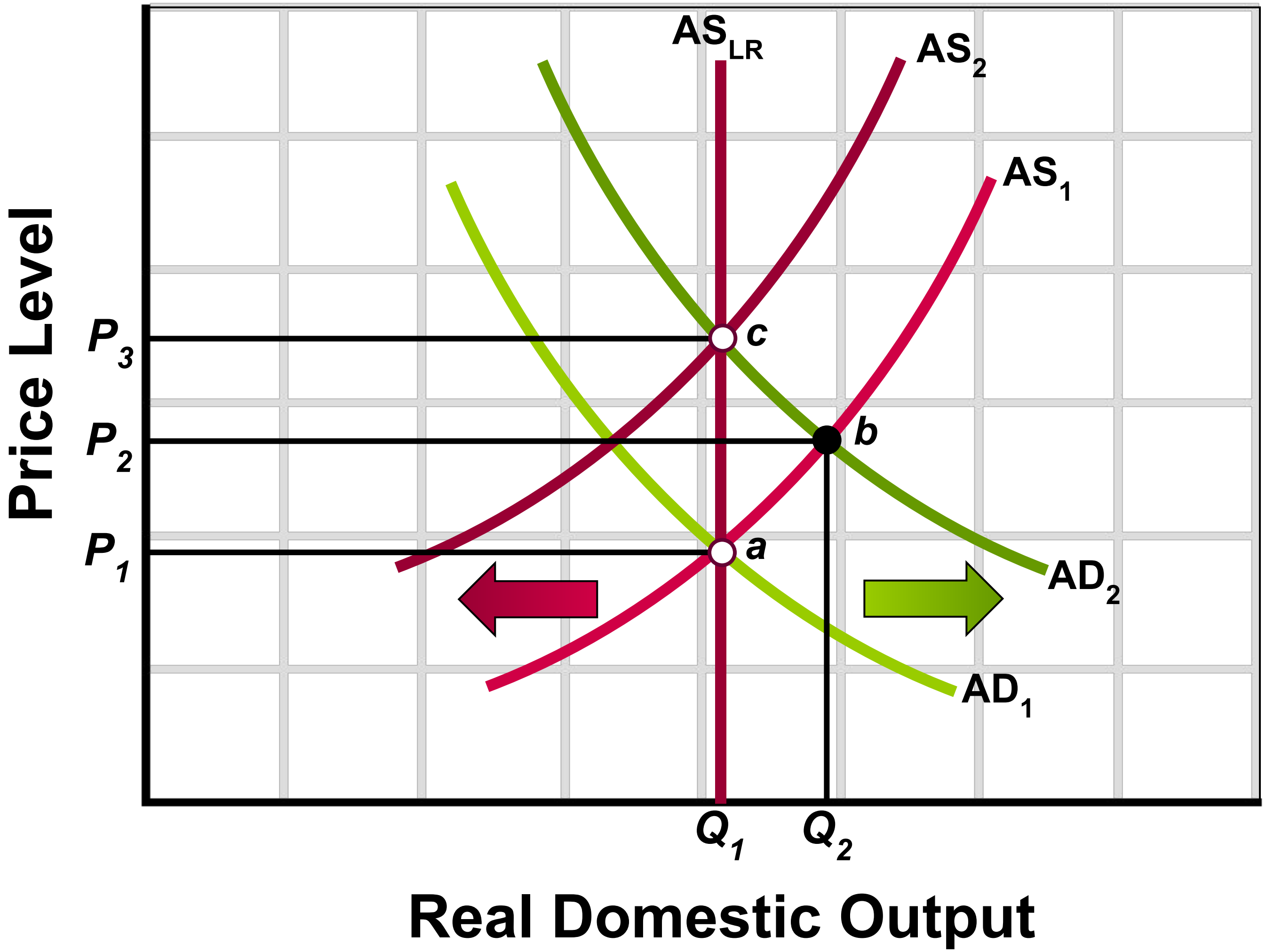
- Coordination failures
  - Fail to reach equilibrium because of lack of coordination mechanism
  - Limited information
  - Expectations and self-fulfilling prophecy
    - Unemployment equilibrium
    - Inflation equilibrium

Does the Economy Self Correct?

- New classical view
  - Rational expectations theory
  - Monetarists
  - Automatic correction will occur
    - Speed of adjustment
    - Unanticipated price-level changes
    - Fully anticipated price-level

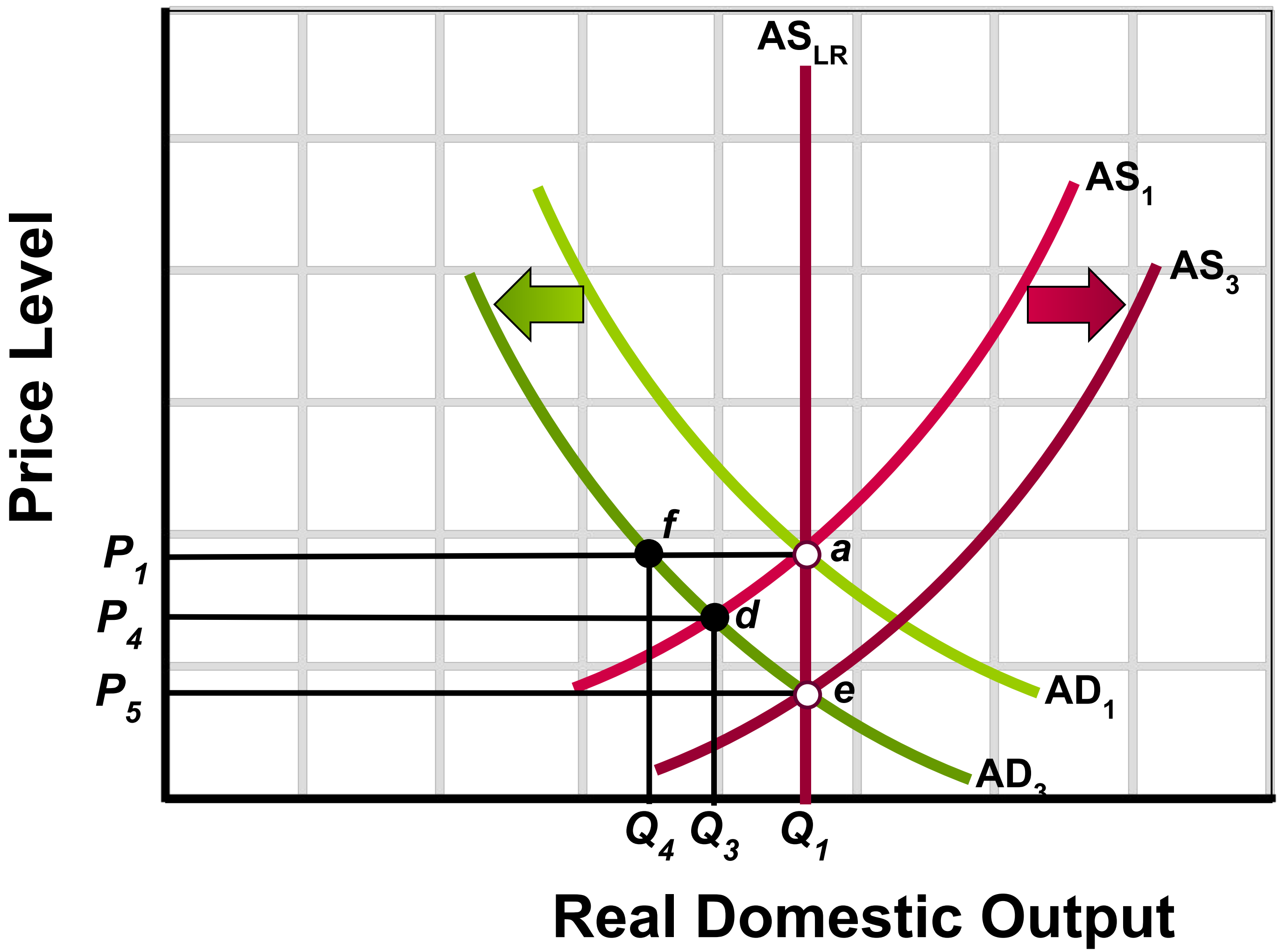
Does the Economy Self Correct?

- New Classical View of Self-Correction



Does the Economy Self Correct?

- New Classical View of Self-Correction



Does the Economy Self Correct?

- Mainstream view
  - Downward wage inflexibility
  - Efficiency wage theory
    - Greater work effort
    - Lower supervision costs
    - Reduced job turnover
- Insider-outsider relationships

Rules or Discretion?

- In support of policy rules
  - Reduce macro instability
  - Monetary rule
    - Shift AD to keep up with AS
    - Price stability achieved
  - Inflation targeting
  - Balanced budget

Rules or Discretion?

- Defense of discretionary stabilization policy
  - Discretionary monetary policy
    - Velocity is not stable
  - Discretionary fiscal policy
    - Useful during recession
  - Policy successes

Rules or Discretion?

Issue	Mainstream Macroeconomics	New Classical Economics: Monetarism	New Classical Economics: Rational Expectations
View of the private economy	Potentially unstable	Stable in long run at natural rate of unemployment	Stable in long run at natural rate of unemployment
Cause of the observed instability of the private economy	Investment plans unequal to saving plans (changes in AD); AS shocks	Inappropriate monetary policy	Unanticipated AD and AS shocks in the short run
Assumptions about short-run price and wage stickiness	Both prices and wages stuck in the immediate short run; in the short run, wages sticky while prices inflexible downward but flexible upward	Prices flexible upward and downward in the short run; wages sticky in the short run	Prices and wages flexible both upward and downward in the short run
Appropriate macro policies	Active fiscal and monetary policy	Monetary rule	Monetary rule
How changes in the money supply affect the economy	By changing the interest rate, which changes investment and real GDP	By directly changing AD, which changes GDP	No effect on output because price-level changes are anticipated
View of the velocity of money	Unstable	Stable	No consensus
How fiscal policy affects the economy	Changes AD and GDP via the multiplier process	No effect unless money supply changes	No effect because price-level changes are anticipated
View of cost-push inflation	Possible (AS shock)	Impossible in the long run in the absence of excessive money supply growth	Impossible in the long run in the absence of excessive money supply growth