

4

1-2 Economic amounts or magnitudes may be nominal or real

Nominal: simply the actual value, \$15,000 a year in this year's dollars. The current yard stick.

Real: transpose the nominal values of a series of years to some one year's values, e.g. 1972. A common yard stick.

Figure 1-1: the middle graph represents nominal values; the top graph represents real values in terms of 1972; the two graphs cross at 1972, where the price index is 100.

The red graph gives the price index for years 1900-1976. It is named the implicit GNP deflator.

Divide the nominal by the deflator to obtain real.

Multiply the real by the deflator to obtain the nominal.

Logarithmic scale: $40/20 = 80/40$ etc.

Height of nominal and real graphs read on left hand side

Height of deflator read on right hand side.

Any change in GNP can be divided into two parts:

- a) to change in quantities exchanged
- b) to changes in prices

8

Figure 1-2: Frame 1, Percentage rate of change

It differs from graph of deflator: it tells how sharply or slowly the deflator is changing.

At zero, the deflator is not changing at all; at plus quantities, it is increasing sharply or slowly; at negative quantities ~~in~~ it is decreasing.

Frame 2: The graph for unemployment oscillates about a black line across the frame. The oscillating line represents actual unemployment: the number of workers out of work. The black line (which slowly rises) represents natural unemployment.

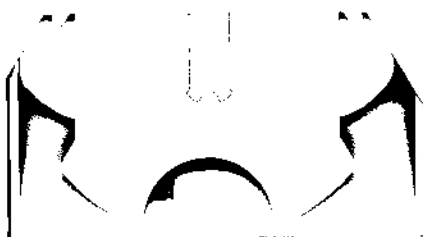
→ Natural unemployment is the amount of unemployment to be expected if accelerating inflation is to be ~~not~~ avoided.

Frame 3: Real output: actual and natural.

Real output is output measured not in current but in common yard-stick, in real vs nominal dollars.

Actual output is the red line: it is in terms of current yard-stick dollars. It is identical with top line in Figure 1-1.

Natural real output is what the output would have been if unemployment had been at its natural rate.



10 1-4 What is macroeconomics

Macron, Gk. large, macrocosm, the universe

Micron, Gk. small, microscope

Microeconomics deals with the relations between households and firms, particular prices, wages, etc.

11 Macroeconomics deals with aggregates: total production (GNP), total employment and unemployment, the average price level of all goods and services, the total money supply, etc.

Macroeconomics is neither less nor more important than microeconomics and it is not necessary to study one before studying the other.

It does not primarily consist in deduction from micro, still much of it rests on micro foundations: eg dependence of demand for money and for investment goods depends on the interest rate, and why consumption depends upon income

Macroeconomic analysis has two tasks: to analyse the causes of changes in important aggregates and to predict the consequences of alternative policy changes.

Target variables are the group of aggregates that society cares most about (inflation, employment and unemployment, the long-term growth of natural output).

Policy instruments (monetary policy eg interest rate, money supply; fiscal policy eg gov't spending, taxes; and a third miscellaneous group eg wage and price controls and manpower policy).

1-5 Stabilization policy and conflicting goals

Modern macroeconomics developed in the aftermath of the traumatic experience of the Great Depression. Its fundamental proposition is that changes in aggregate demand (total nominal spending) are the key to explaining why actual employment and output deviated from their natural (best) levels to give the pink and gray areas in Figure 1-2.

Since unstable aggregate demand is the cause of unstable output and employment, the basic task of macroeconomic policy is to stabilize aggregate demand. The term stabilization policy to describe features common to monetary and fiscal policy.



12

The Role of Stabilization Policy

Both fiscal and monetary policy can be used to control aggregate demand. Fiscal policy can raise output and employment by gov't spending that creates jobs by gov't hiring; and it can encourage private spending by reducing taxes. A monetary policy stimulus to output and employment takes the form of an increase in the money supply which reduces interest rates and may in turn boost stock prices and make lending institutions more willing to grant credit.

Policy should restrain in an inflation and stimulate in recession. But in 1969-70 and in 1973-75 inflation and recession were combined. Possible solutions are discussed in part III. We shall learn that the natural levels of output and employment are neither optimal nor immutable.

There are further problems. It may not be possible to stabilize aggregate demand instantly and precisely. There may ^{be} a long delay before it becomes operative and then it may prove unwelcome. The debate between fine-tuning or activism on the one hand and a monetary rule on the other is central theme of Parts IV and V.

Closed and open economies.

Most problems in the US economy can be handled sufficiently without going into international trade. There is a brief but significant attention given to the relevant variables in chapter 19.

1-6 Uses of Macroeconomic Theory

14

Why theory? There are almost limitless economic variables, but our purpose is not to compile an almanac. To be useful correlations must be determined between variables, and macro is concerned with correlations between aggregates. To be useful it must:

- 1) Isolate the important variables that help explain the behavior of the goals or target variables.
- 2) Create useful generalizations to describe the relations among groups of variables.
- 3) Test whether the generalizations have predictive power. Economic theories are not unrealistic ivory tower statements but must continuously be adjusted to reflect new information.



For instance the theory of inflation most commonly used in the 1960's did not succeed in predicting acceleration of inflation in 1968-69 nor the stagflation of 1970-71.

Usefulness of Theory

Economists use theory for two quite different purposes: positive economics explains the behavior of important variables; normative economics recommends changes in economic policy.

Most disagreements among economists no longer focus on on different explanations of major phenomena; rather they center on the proper conduct for economic policy.

Most policy disagreements stem from the incompatibility of worthy economic goals. As economic in general, so macro-economics is the science of choice in the face of limitations. Is it more important to reduce inflation than to reduce unemployment?

15 1-7 Development of Modern Macroeconomics: Post-Keynesians and Monetarists

Most of the analysis of this book has been developed by economists writing since the publication in 1936 of John Maynard Keynes revolutionary The General Theory of Employment Interest and Money. Keynes discarded theories that had no explanation for unemployment. Subsequent development has emphasized the inherent instability of private economy operating free of gov't control and the need for countercyclical gov't intervention to stabilize trends toward booms and recessions.

16 But is this development valid? Why were the problems of the mid-1970's regarding inflation and unemployment more serious than any since WW II? Gordon explains that the major problems of the 1960s and 1970s were caused not by an inability to understand what caused changes in output, but by three other factors: an overoptimistic approach to inflation, the impact of supply shocks, and policy mistakes.

Underestimating inflation

A number of post-Keynesian economists thought that unemployment could be reduced to 3.5 or 4% with only minor inflationary results. Against this optimistic view a group now named monetarists argued that to reduce unemployment



ever-

below its natural rate gave rise to an accelerating inflation. Unemployment below the natural rate demands not a single increase in the money supply ~~x~~ but an ongoing increase as long as U remains below U^* . See footnote on contributions by Milton Friedman* and Harry G. Johnston, p. 16, note 7.

Changes in the growth rate of the money supply alter real output temporarily, but in the long run they only raise or lower the rate of inflation.

The debate continues but its focus has shifted. The nonmonetarists favor intervention. The monetarists prefer a do-nothing rule fixing the growth rate of the money ~~supply~~ supply. Hayek.

17

Supply shocks

Eg crop failures and other special factors caused farm prices to double in 1973. OPEC decided to quadruple the price of oil in late 1973 and 1974.

Policy mistakes

That economists had foreseen and warned against.

President Johnson's administration failed to raise taxes to pay for the Vietnam war in 1965-66. The resulting gov't deficits were the fundamental cause of the inflation that began in 1965-66 and was still going strong a decade later.

The second mistake was the imposition of price and wage controls in 1971. This policy achieved a temporary slowdown in inflation but when controls were removed in 1974 the price level bounced back up, aggravating the effects of 1973-74 supply shocks.

The third major mistake was the restrictive ~~xxx~~ response of ~~xxxx~~ gov't monetary and fiscal policy in the events of 1973-74. More unemployment than necessary was created and the 1974-75 recession was aggravated.

1--8 The Paradox of Convergence without Agreement

General agreement on the IS-LM model. Cf. Chapter IV.

Also that in the long-run stabilization policy cannot permanently reduce unemployment (actual) below the natural rate, and that permanent changes in inflation must be accompanied by permanent changes in the money supply

But monetarists and nonmonetarists disagree sharply in their recommendations for stabilization policy... Monetarists

