Chapter 36: Current Issues in Macro Theory and Policy

What causes economic instability? Will the economy self-correct? Should the government take action to stabilize the economy? If so, how? These are the burning issues in the "battle of the economists." Chapter 36 explores the differences among the most prominent economic theories today, as economists use theoretical and empirical evidence to support their views of economic performance and the role of government in economic stabilization.

The mainstream view holds that macroeconomic instability is caused by price stickiness and shocks to aggregate supply and aggregate demand. These economists point to changes in investment spending as the primary factor in causing macroeconomic instability.

Monetarists instead argue that the macroeconomy's competitive features would maintain stability, if it weren't for government interference in the economy. Monetarists use the equation of exchange as a model to illustrate economic performance. $MV = PQ$, with M standing for the money supply, V for velocity (the average number of times a dollar turns over in a year), and PQ representing nominal GDP. According to monetarists, velocity remains stable. Therefore, changes in the money supply directly affect nominal GDP (especially prices), and monetarists cite inappropriate monetary policy as the primary cause of economic instability.

Economists who support the real-business-cycle theory argue that instability is caused by factors that affect aggregate supply, not aggregate demand. According to these economists, changes in resource availability and technology are the real source of economic instability. Because resources and technology drive productivity, changes in those factors significantly affect long-run economic growth.

New Classical economists, who tend to support either monetarist or rational expectations theories, argue that the economy will correct itself. These economists believe that prices and wages are flexible, both upward and downward, so the economy will eventually self-correct to full-employment output and the natural rate of unemployment. While monetarists argue that the adjustment process is gradual, those who believe in the rational expectations theory (RET) argue that workers anticipate economic changes, so adjustments happen very rapidly. As a result, RET economists argue that government stabilization policies are ineffective because workers simply anticipate them and work to ensure they are not affected.

Mainstream economists argue that the economy does not easily self-adjust, disputing the RET new classical notion that prices and wages are easily flexible downward. Instead, mainstream economists argue that wages are "sticky" because of labor contracts and the minimum wage. Even if wages could freely fall, the reduction in worker effort and morale, increased supervision costs, and increased worker turnover would overwhelm any reductions in costs resulting from the lower wages. Such "sticky" wages make it difficult for the economy to adjust to downturns, resulting in high unemployment and requiring months or years to reach full-employment output again in the absence of fiscal or monetary policy.

At one time, monetarists and other new classical economists argued that the government should adhere to a monetary rule, requiring that the money supply only be increased at the rate of the average increase in production capacity, regardless of the state of the economy. They wanted to ensure enough money was available for

purchasing the increased output, but they did not want the Fed to attempt to stabilize the economy, believing it created even more stability. In recent years, these economists have instead called for "inflation targeting," urging the Fed to use its monetary policy tools to keep the inflation rate within a specific range. They also promote a balanced federal budget and argue against the use of fiscal policy, claiming that increased borrowing for expansionary policy only crowds out private investment, reducing the effectiveness of the fiscal policy and harming long-run economic growth.

Mainstream economists, however, argue that discretionary fiscal and monetary policy hold an important role in achieving short-run economic stability and long-run economic growth. They note that the equation of exchange breaks down in the short run, because the velocity is in fact variable and unpredictable—violating one of the primary assumptions of monetarist theory. Further, mainstream economists can point to specific historical examples where monetary policy effectively addressed economic instability, refuting the contention that it only causes greater instability. Economists also support the use of fiscal policy, noting that crowding out (if it occurs at all) is very unlikely during recessions, when investment is already quite low. Further, any requirement that government balance its budget is, in fact, pro-cyclical. At a time when consumer and investment sector spending is declining, reducing government revenues, the government would also be forced to reduce spending, exacerbating the recessionary spiral!

As economists gather empirical evidence to test theories and conventional wisdom, economic theories continue to evolve. This process deepens our understanding of the economy and helps us to find the most effective means to promote economic stability and growth.

Material from Chapter 36 tends to appear in a few multiple-choice questions on the AP Macroeconomics Exam, primarily involving differences between the Keynesian (mainstream) and Monetarist views, though a question about Classical or Rational Expectations Theory is possible. It is most important to focus on the differences in beliefs about the ability of the economy to self-correct, whether changes in the money supply work through the equation of exchange or through interest rates, whether prices and wages are flexible or downwardly "sticky," and the effectiveness of fiscal and monetary policy in resolving economic instability.