SEM 4: Macroeconomics

Unit 3: SCHOOLS OF MACROECONOMIC THOUGHTS

In this module we will understand what are the various schools of thoughts of macroeconomics. Macroeconomics concerns with the study of aggregate behavior in an economy, and is policy-oriented part of economics. According to Dornbusch and Fischer (1994), pp-3, macroeconomics is concerned with

"*the behavior of the economy as a whole – with booms and recessions, the economy's total output of goods and services and the growth of output, the rates of inflation and unemployment, the balance of payments, and the exchange rates. Macroeconomics deals with long-run economic growth and with the short-run fluctuations that constitute the business cycle.*"

The module has two sections. In Section I, there is a brief discussion on Mercantalism and Physiocracy. Section II includes a in-depth discussion of various Schools of Thought in Macroeconomics.

Section I

Mercantalisim

Mercantilism, economic theory and practice common in Europe from the 16th to the 18th century (preiod of proto-industrialization) that promoted governmental regulation of a nation's economy for the purpose of augmenting state power at the expense of rival national powers. most notable mercantalists are - Thomas Mun in England, Jean-Baptiste Colbert in France, and Antonio Serra in Italy. Precious metals, such as gold and silver, were deemed indispensable to a nation's wealth. If a nation did not possess mines or have access to them, precious metals should be obtained by trade. It was believed that trade balances must be "favourable," meaning an excess of exports over imports. Colonial possessions should serve as markets for exports and as suppliers of raw materials to the mother country. Manufacturing was forbidden in colonies, and all commerce between colony and mother country was held to be a monopoly of the mother country. **Mercantilism** is a national economic policy that is designed to maximize the exports, and/or minimize the imports, reduce a possible current account deficit , accumulate monetary reserves through a positive balance of trade. They emplasised on manufactured goods.

Physiocracy

Physiocracy is also known as the 'Agricultural System'. Economic thinkers who contributed to the growth and development of physiocracy have been called as physiocrats. Physiocracy belived that government policy should not interfere with the operation of natural economic laws and that land is the source of all wealth. It is generally regarded as the first scientific school of economics. Their theories originated in France and were most popular during the second half of the 18th century immidiately preceded classical economists. Physiocracy etymologically denoted the “rule of nature. They also pictured a predominantly agricultural society and therefore attacked mercantilism not only for its mass of economic regulations but also for its emphasis on manufactures and foreign trade at the cost of agriculture. Again, whereas mercantilists claimed that coin and bullion were the essence of wealth, the physiocrats asserted that wealth consisted solely of the products of the soil. They considered only agricultural labor to be valuable. As agricultural revolution was already taking place in England in France also attention was diverted to agriculture. The French farmers were largely expolited by the landlords who used to take bulk of the produce as well as all taxes were levied on poor farmers. Again the market for agricultural goods were restricted because of Mercantilists promoted markets for industrial goods. Physiocrats’ revolt against mercantalisim was on the ground that there policies are causing excessive harm to the nation.

Note: François Quesnay was called the father of physiocracy. The *Tableau économique* or *Economic Table* is written by him in 1759 laid the foundation of the physiocrats’ economic theories. It also contains the origins of modern ideas on the circulation of wealth and the nature of interrelationships in the economy.

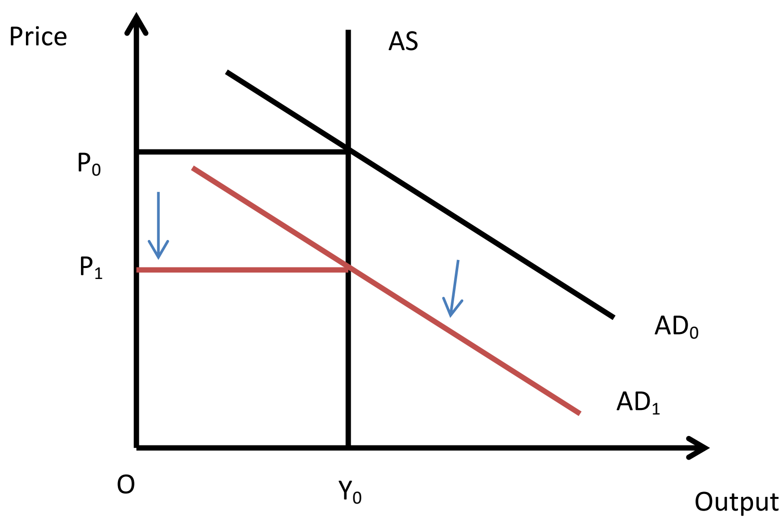
Section II

Most of the time macroeconomists fail to agree among themselves on wide range of macroeconomic issues. But over the years two important schools of thought in macroeconomics have evolved, and other schools of thought came up from the synthesis of these two schools. These two schools are: classical and Keynesian. Later on, the debate on government intervention and role of central bank gain importance, which give rise to monetarist school of thought. Lets discuss these schools.

(1) Classical Approach

The term “Classical Approach” was coined by John Maynard Keynes to refer to the ideas presented mainly by the famous Scottish Philosopher-Economist Adam Smith who in *The Wealth of Nations (1776)*, set forth the famous idea of *invisible hand*. He explained that the unnecessary heavy government regulation in Great Britain at that time is hampering efficient functioning of the market. In absence of such regulation prices will act as invisible hand to remove all imbalances between supply and demand and thus markets will be clear. There will be no excess demand or supply. David Ricardo, Thomas Malthus, and John Stuart Mill are among the other leading classical economists. They believed that market, and hence the economy operates on the notion of “*supply creates its own demand*”, the famous Say’s Law, named after the economists J.B. Say. Classical economists view that prices, wages and interest rates are flexible enough such that market always clear. There will be no unemployment, and the growth will depend on the supply side factors. Classical economists believed in the dichotomy between the real and the monetary sectors of the economy, i.e., due to wage-price flexibility, there is no role of money in the determination of output or income in the economy. Full-employment will always exist without inflation. Any deviations from the full-employment level of output will be corrected within the economy. Government's role is limited only to the maintenance of law and order and defence. They suggested that if there is "*Laissez Faire*" system of trade, i.e., there is free trade among countries, and hence market forces will determine the output and income in the economy. Hence, the major view of the classical economists is a vertical aggregate supply curve, where due to wage-price flexibility; there is no change in the equilibrium level of income and output (see Figure 1). If there is any change in the demand, wages and prices will adjust such that full-employment level of output will be maintained. For instance, in figure 1, aggregate demand decreases from AD0 to AD1, creating excess supply at prevailing price level of P0. Due to wage-price flexibility, wages will fall in the labour market, and prices will fall in the goods market, bringing the output back to its full-employment level of Y0. Prices will fall to P1 keeping income and output unchanged.

Fig 1

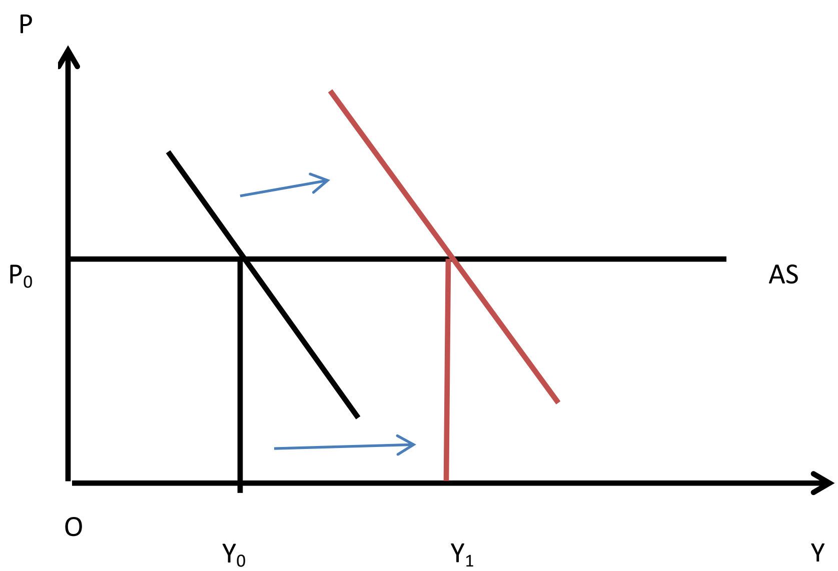


(2) Keynesian Approach

The free market mechanism got a major set back when the Great Depression started in the USA in 1929 and quickly spread to the other parts in the globe. Unemployment was astronomically high with persistent decline in output and income showing the ineffectiveness of the invisible hand mechanism. Clearly, there was a dearth in approach to macroecomic policy.

Then evolved the Keynesian school of thought which was developed by John Maynard Keynes in the year 1936 in his book "*The General Theory of Employment, Interest, and Money*. Keynes pointed out that the reason behind the Great Depression is the low aggregate demand in the economy, which created low levels of income and high levels of unemployment. The concept of Keynesian economics was completely opposite to classical economists. He came up with the notion of "*Demand creates its own Supply*". Keynes argued that in the short-run, wages and prices are rigid and do not adjust to fluctuations in aggregate demand. Wages are rigid due to various labour market contracts and legislations. Thus, in figure 1, when aggregate demand falls, wages do not fall immediately, and they are maintained at higher levels. Consequently, output declines, and there is a recession. If wage could have falled down as per Classical mechanism then that would have made the situation even worse by reducing the purchasing power of the worker. This would further dampen the aggregate demand rather than stimulating it. In the Keynesian economics, aggregate supply curve is assumed to be horizontal in the short-run, and vertical in the long-run. Thus, Keynes believed that these kinds of business cycles can be managed by active government intervention through fiscal policy (spending more in recessions to stimulate demand) and monetary policy (stimulating demand with lower rates) (see figure 2). An increase in demand increases output, without any change in the price level, due to wage-price rigidity.

Fig 2



The success of Keynesian policy was spectacular in fighting Great Depression and was dominant macro economic policy until 1970. This was the era of *'stabilisation optimism'*. In 1970, the US economy was hit by prolonged stagflation, i.e., simultaneous presence of inflation and stagnation. But Keynesians didnot give a thought to the inflation until there is unemployed resources for which their policy prescription was seriously questioned.

(3) **Monetarist**

Monetarist school of thought evolved after the Nobel Prize winner, Milton Friedman, who criticised the Keynesian model for neglecting the role of money and role of expectation in analysing inflation. He emphasized the role of money supply and the monetary policy in the determination of output and income in the economy.

(4) New Classical Approach

Inspired by the monetarists, the New Classical School emerged in the late 1970s. Economists like Robert Lucas, Thomas Sargent, Robert Barro, Edward Prescott, and Neil Wallace characterize this school of thought. They believed with the notion of "*Rational Expectations*", i.e., economic agents act rationally in their own self-interest to maximize their welfare or profits. The two main issues that are usually discussed in new classical school are rational expectations and real business cycles.

Rational expectation hypothesis (by Robert Lucas) modeled agents as rational and forward looking. Any policy change will be ineffective, as economic agents would anticipate inflation and adjust to higher price levels before the start of the monetary expansion, that could boost employment and output. Only unanticipated monetary policy change could increase employment. Real business cycle theory (RBC theory) assumes that business cycle fluctuations can be accounted for by real shocks, rather than nominal shocks. RBC theory sees business cycle fluctuations as an efficient tool in response to the exogenous changes in the real economic variables. They do not represent a failure to market clearance, but the best solution to the structure of the economy. They reject the Keynesian views of government intervention to smoothen out economic short-term fluctuations, and argued that government should concentrate on long-run structural policy changes.

(5) Neo-Classical School of Thought

In response to Keynesian economists and monetarists, the neo-classical economists, like John Hicks, Paul Samuelson, and Robert Solow, synthesize the work of Keynesian and classical economists. The revolutionary work was done by Sir John Hicks who came up with the IS-LM Model which integrated the classical and Keynesian ideas on real and nominal macroeconomic variables. The neoclassical growth model by Robert Solow, known as Solow Model helped in studying the long run growth trajectory of an economy and the attainment of steady state level of growth.

(6) New Keynesian School of Thought

The New Keynesian School attempts to add microeconomic foundations to traditional Keynesian economic theories. This school of thought includes economists like George Akerlof, David Romer, Olivier Blanchard, and Greg Mankiw. They do not believe that markets clear, but explain why the market fail to clear. They argue that wages and prices are neither rigid nor flexible. They adjust slowly to the shocks due to imperfect information, existence of monoploy poer in the product market, coordination failiure etc.

The general consensus seems to be that the Keynesian approach is valid in the short-medium run while in the long run Classical approach is more appropriate.