Week 1:
Introduction to Modern Macroeconomics

January 14, 2016

**** You are responsible only for the slides with a bold title**

Microeconomics vs. Macroeconomics

- Microeconomics
  - Object of analysis is a single market
  - Behavior of individual consumers and firms
- Macroeconomics:
  - Object of analysis is overall economy
  - Behavior of aggregate variables

Great Depression and Birth of Macroeconomics

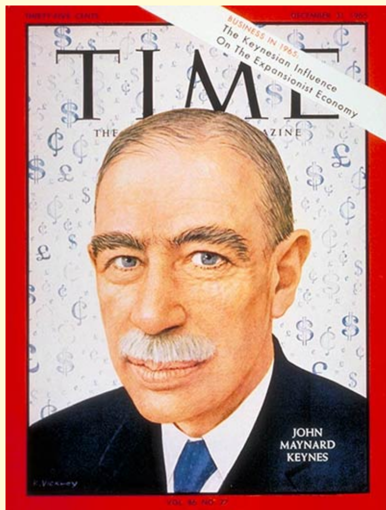
Great Depression and Birth of Macroeconomics

- Classical economic analysis assumes that markets always return to equilibrium
- For a long time, it was assumed that the macro economy behaved in the same way as an individual firm would
- In the 1930s, economies were clearly not in equilibrium: high unemployment and low production
- From a microeconomics perspective, this should not have lasted for such a long time
- Classical economics did not have an explanation for this disequilibrium

Great Depression and Birth of Macroeconomics

- Keynes (1936): *The General Theory of Employment, Interest and Money*
- Examined why we can be in a state of disequilibrium in the macro economy
- Keynes observed that microeconomic principles of markets clearing didn't necessarily apply to macro economics
- He argued that under-employment and under-investment are likely to be the natural state unless active measures are taken

Great Depression and Birth of Macroeconomics



Great Depression and Birth of Macroeconomics

- Keynes suggested a number of ways to get out of a slump:
  - People could be encouraged to consume more
  - The government could buy more goods and services
  - Businesses could be encouraged to spend more

Getting out of Depression

- In actuality, it was the high government spending associated with national mobilization for World War II that finally brought the Great Depression to an end
- That supports the argument for government intervention:
  - *Fiscal policy* is the manipulation of levels of government spending and taxation to raise or lower the level of aggregate demand
  - *Monetary policy* is controlling the supply of money in a country to ensure price stability and general trust in the currency

Post-WWII and Monetarism

- While Keynesian economics was greatly supported, there were economists who didn't agree with Keynes
- Milton Friedman, University of Chicago:
  - Argued that bad government policies were how economies tend to get into bad situations
  - *Monetarists* argued that governments should focus on keeping the money supply steady, and not try to take an active role in directing the economy, even when unemployment is high

1970s

- First mention of **a distinction between the long-run and the short-run**:
  - In the short run (months or years) we are in a primarily Keynesian world where fiscal and monetary policies can be effective
  - In the long run, however – after such a period of time that even “sticky’ markets can adjust – we are in a classical world, where money only affects prices

1976: Lucas Critique

Robert Lucas, University of Chicago

"*The most influential macroeconomist of the last quarter of the 20th century*"

– N. Gregory Mankiw

1976: Lucas Critique

- In Lucas's opinion macroeconomics started off on the wrong foot by being Keynesian
- Lucas (1976) argued that, instead of static econometric models, we should have dynamic macroeconomic models – only the latter can truly represent the actual economy
- The challenge was to construct an equilibrium theory, where the fluctuations of economic variables can be traced back to optimizing decisions made by economic agents
- Business fluctuations were no longer viewed as market failures
- Thus, governments should refrain from trying to prevent them

1980s: Real Business Cycles

- Kydland and Prescott (1982) tried to model business fluctuations as the result of real shocks to the economy
- Real shocks are shocks that directly affect the production process: for example, technological advances
- They were able to successfully mimic several important empirical traits of the fluctuations in the US economy
- **Before their paper, the general opinion was that such an enterprise was impossible!**

Real Business Cycles

Finn Kydland and Edward Prescott

Received Nobel Memorial Prize in Economics in 2004
"for their contributions to dynamic macroeconomics: the time consistency of economic policy and the driving forces behind business cycles"

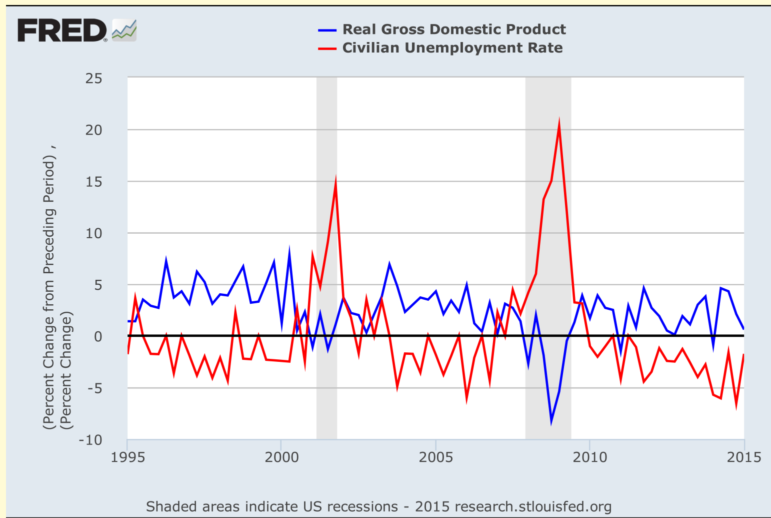
1990s: DSGE Modeling

- The methodological "fight" between classical and Keynesian economists continued until the 1990s
- They came to agree upon adopting a workhorse model that both considered appropriate – *Dynamic-Stochastic General Equilibrium (DSGE) model*
- Computers are becoming very powerful and more and more complicated models can be simulated

2000s: Enriching Macro Models

- Most economists agree on workhorse theoretical macro models
- Arguments are mostly policy-related
- Everybody is more or less on the same page until ...

The Great Recession and Financial Crisis



The Great Recession and Financial Crisis

- These events brought out at least two blind spots in modern macro models:
    1. Limited attention that had been given to the financial sector
    2. Exclusion in advance of the possibility of any pathology in the working of the market system
- New wave of macroeconomic research: macroprudential regulation
- Who will be the next Kydland and Prescott?

References

John Maynard Keynes. *The General Theory of Employment, Interest and Money*. Palgrave Macmillan, 1936.

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