Instructor's Introduction &
Chapter 5

The Evolution of
Macroeconomics
from
John Maynard Keynes
to the Present

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What is microeconomics?

A Historical Distinction

What is microeconomics?

Summary

What is the distinction between macro and microeconomics?

How did macroeconomics emerge and how has it evolved?

Microeconomics consists of two theories:

- The theory of determination of prices
- The theory of distribution of income

Micro and Macro Distinction

What is "macroeconomics" as opposed to "microeconomics"?

These two theories are from a particular perspective called Neoclassical or Marginalist school.

Neoclassical or Marginalist school came into being around 1870s with the publication of several works:

William Stanley Jevons's *The Theory of Political Economy* (1871),

Leon Walras's *Elements of Pure Economics* (1874),

Alfred Marshall's *Principles of Economics* (1890).

Classical school or classical political economy school is a school of economic theory which started as early as 17th century and lasted until mid 19th century.

What most classicals had in common was labor theory of price or value:

Price of a good is ultimately governed by how much labor it takes to produce a good.

What these works had in common was:

a) They believed in utility theory of price:

Price of a good is ultimately governed by utility or happiness that one gets from consuming a good.

b) They used "marginal" analysis.

Marginal means incremental, an infinitely small change.

This is a concept that in calculus is called derivative.

See Family Tree of Economists

"Neoclassical" means new classical

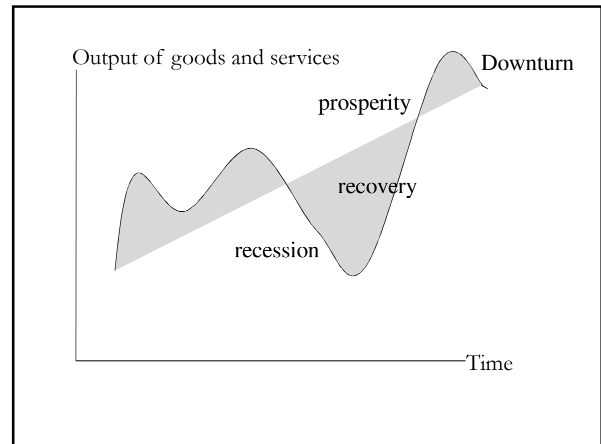
Some economists in the 20th century thought that the marginalist school was a continuation of the classical school.

Summary:

Microeconomics refers to a set of theories concerning determination of prices and distribution of income put forward by the neoclassical or, more correctly, marginalist economists.

What is macroeconomics?

Macroeconomics refers to the theories originally put forward by one neoclassical economist, **John Maynard Keynes**, during the **Great Depression.**



Def. Depression:
A severe recession

Def. Recession:
Two (consecutive) quarters decline in the value of goods and services.
A recession is a phase of business cycle.

Def. Business cycle:
Fluctuations in the output of goods and services

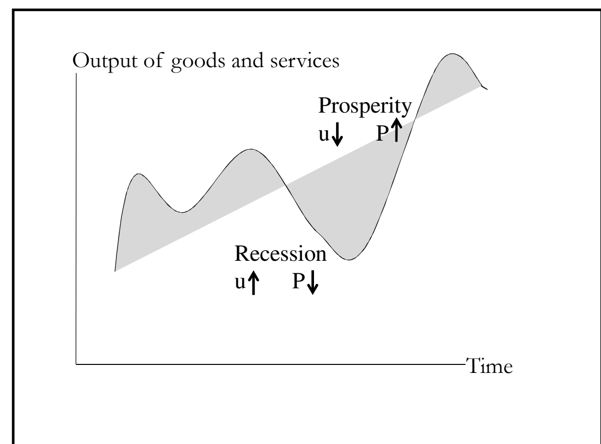
Note that generally in a recession **unemployment** (u) rises and **prices** (P) on the average decline.

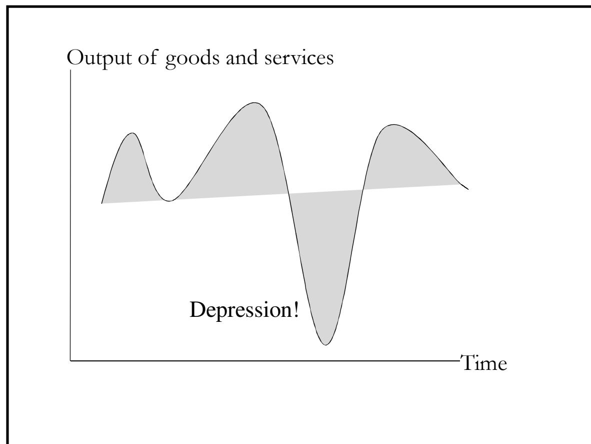
Note also that in prosperity **unemployment** falls and **prices** on the average rise.

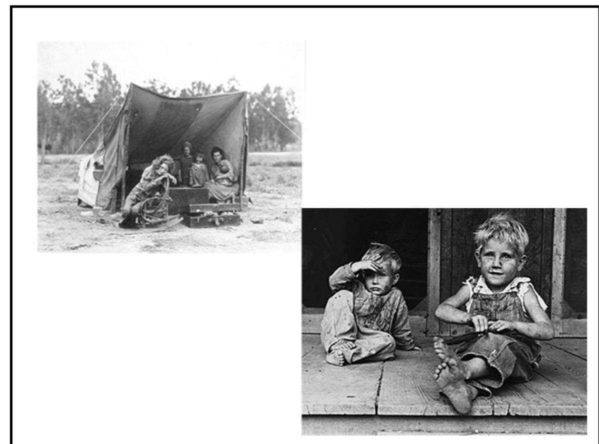
A business cycle has 4 phases:

Recession, recovery, prosperity, and downturn.

Sometimes we call the high point the **peak** and the low point a **trough**.





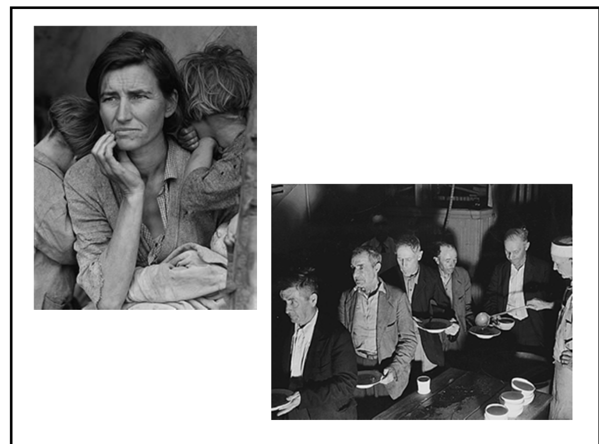


The Great Depression (1929-1939)

The Great Depression started with a **recession** in August of 1929 and a stock market crash on October 24.

This was not the only depression in the US economy; there had been, at least, 4 such depressions since 1780.

But this one became one of the most long-lasting depressions.

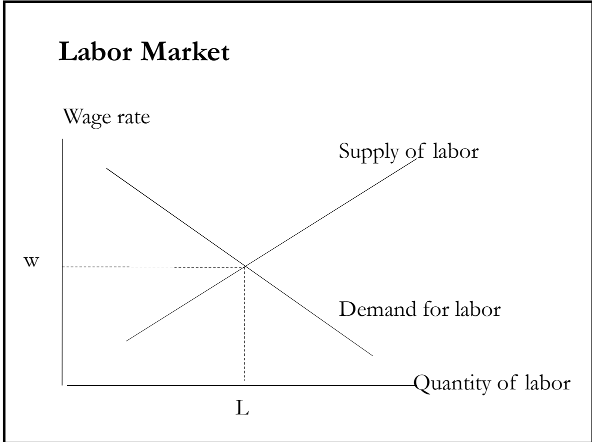


Moreover, the magnitude of the disaster was huge.
By 1933:

1) There was no new investment, even though the interest rates were very low,
2) Output was down by 1/3,
3) Unemployment was at 24%,
4) Money wages and prices were down by 1/3 (farm product prices fell by 50%),
5) The banking system collapsed, after nearly 11,000 banks closed in the US (40% of all banks).
6) Stocks lost 90% of their values.

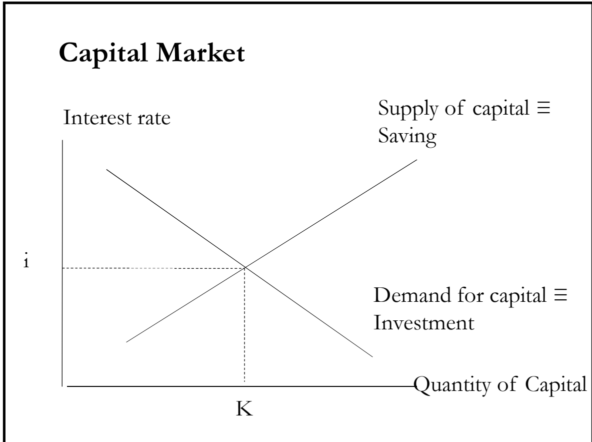
Three neoclassical tenets

- **Labor market**
- **Capital market**
- **Say’s Law**



What did the neoclassical theories have to offer?

Nothing!



Say's Law

Neoclassical economists also accepted **Say's Law of markets**:

> **Say's Law**: Supply of goods and services creates its own demand.

Jean-Baptiste Say was a French classical economist in the early 19th century (wrote his *Treatise on Political Economy* in 1803). He claimed that there could no "glut of commodities." In other words, Say believed there could be no depression.

The tenets of neoclassical theory were contrary to the reality of Great Depression.

- Wages fell, but there was no increase in employment
- Interest rates fell, but there was no new investment
- Supply did not create its own demand

In a barter economy, a moneyless world, Say's law might be possible.

Def. Barter: Exchange of one good for another, direct exchange.

Keynes and his *General Theory*

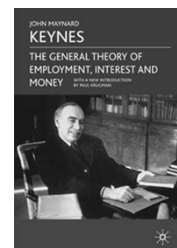
John Maynard Keynes 1883-1946

Laissez faire aspect of the neoclassical theory

In general, neoclassical economists believed in laissez faire:

> If you leave the markets to themselves, they will take care of any problem.
>
> As such, neoclassicals saw no role for the government in economy.

***The General Theory of Employment, Interest and Money* (1936)**



Preface
Book I
Introduction
Chapter 1: The General Theory
Chapter 2: The Postulates of the Classical Economics
Chapter 3: The Principle of Effective Demand
Chapter 13: The General Theory of Interest Rate

In the *General Theory* Keynes challenged:

1) Some aspects of the neoclassical theory of **labor market**.

2) Some aspects of the neoclassical theory of **interest rate**.

3) Some aspects of the neoclassical concept of **money**.

Keynes attacked Say's law by arguing that it is **wrong to assume**:

Saving ≡ Investment demand.

Keynes also dismissed Say's Law.

He interpreted Say's Law (supply creates it own demand) in the following way :

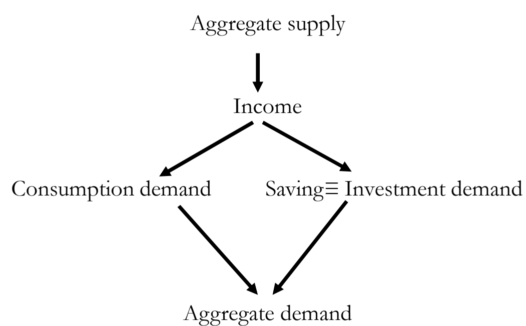
Keynes then went on to develop **new theories** concerning what determines **output, employment,** and **interest rate** in the economy.

In the determination of interest rate money became an important issue.

So Keynes worked on a new theory of **money**.

That is why Keynes's book is called
A *General Theory of Employment, Interest and Money*.

According to Keynes, Say implied:



This was the beginning of the
Keynesian Revolution!

Neoclassical Synthesis, Neo-Keynesianism, or Keynesianism

Keynes did not challenge the neoclassical theories of price determination and distribution of income.

His own theories were incorporated into the neoclassical framework soon after he published them.

Neo-Keynesian Domination of Economic Theory

Economic textbooks:
After the neoclassical synthesis, most textbooks were written in a micro-macro format.

Government and central bank policies:
Keynesian theories became the backbone of fiscal and monetary policies.

This was the beginning of the

Neoclassical synthesis or Neo-Keynesian economics:

Neoclassical theories of price determination and income distribution
+
Keynesian theories of determination of output, employment, interest rate and money.

Fiscal policy:
taxing and spending policy by the government

Monetary policy:
changing the money supply by the Federal Reserve System to influence the short term interest rate

Micro and Macroeconomics

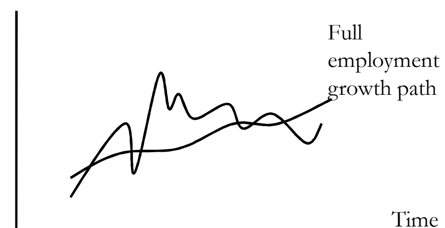
The neoclassical part of this synthesis became known as **microeconomics**, and the Keynesian part, **macroeconomics**.

It appeared that the neoclassical theories deal with individual decision makers, such as utility maximizing consumers and profit maximizing firms.

Keynesian theories seemed to deal with the economy as a whole.

It is assumed that monetary and fiscal policies can play counter cyclical, smooth out business cycle and put economy on a path of full employment growth

Output of goods and services



3 Goals of Macroeconomics:

- Full employment
- Growth
- Price stability

Summary:

Macroeconomics refers to the theories concerning output, employment, interest rate, and money put forward by Keynes, theories which were subsequently debated, dismissed, reformulated and appear in its current form.

Cracks in the Keynesian Revolution

In the 1970s and early 80s, the US economy faced a unique situation:
the simultaneous existence of stagnation (rising unemployment) and inflation (rising price levels), the so-called **stagflation**.

Let us go to the text.

The first three chapters are introductory :

Chapter 1 is the authors' introduction to economics.

Chapter 2 is on opportunity cost and production possibilities frontier.

Chapter 3 is on the neoclassical demand and supply analysis.

Challenges to the Keynesian Revolution

•Challenges from the Left
•Challenges from the Right:

Monetarism ("adaptive expectation")

Chicago School: Milton Friedman

New Classicals ("rational expectation")

See Family Tree of Economists