Good and bad times - A brief history of economic thoughts

ECON4310 Lecture 13

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Warning

Theories left behind will not be treated

- Marx's crisis theory
- Genuine sunspot theories
- (Electro)mechanical theories
- False empirical generalizations (e.g. Kondratieff)

Wicksell's theory

Knut Wicksell (1851-1926, Sweden)
Geldzins und güterpreise 1898

- Central bank sets interest rate r
- $r < f'(k)$ means high I, excess demand for goods, increasing price level, good times
- $r < f'(k)$ means falling price level, bad times
- real shocks change $f'(k)$. Inadequate response by CBs cause good or bad times
- Setting the right interest rate will stabilize both price level and activity level
- Environment where price stability is normal

The Cambridge School (Keynes'classics)

Marshall, Pigou

- The classical dichotomy
- Real variables determined in general equilibrium model
- Quantity theory of money
- $M = kPY$, Cambridge k, money supply determines price level
- "Frictions" create short-lived deviations from equilibrium, frictional unemployment
- Real wage rigidity (union power) may create more unemployment

Keynes'revolution

John Maynard Keynes (1883 - 1946, UK)
The GeneralTheory of Employment Interest and Money 1936

- $S = I$, but decisions about S and I made by different people
- Sometimes supply of savings will be greater than demand for real investment for any interest rate
- General equilibrium with flexible prices then does not exist
- Fortunately nominal wages are rigid downwards
- Equilibrium achieved by output falling and unemployment increasing until supply of saving is reduced to the level of investment demand
- Good times are when general equilibrium exists, bad times when investment demand is too low

More ideas from Keynes

- Good and bad times caused by shifts in investor sentiment
- More bad times as countries get richer
- Consumption depends primarily on actual income now, not on total wealth (the future income you hope to get)
- k depends on the difference between the long (bond) and short (money market) interest rates
- Because of downward rigidity of nominal wages, expansionary monetary policy is sometimes needed to avoid bad times
- Expansionary monetary policy can fail to bring down the important long interest rates, because of expectations of future higher interest rates (the liquidity trap)
- "Socialization" of investment

Internal instabilities: the multiplier-accelerator mechanism

Roy Harrod, John Hicks, UK)

- Investment depends on output growth (the accelerator)
- Output growth produces more output growth until output hits "ceiling" (capacity limit)
- Sine output growth stops, investment stops too
- Output drops to the "floor" (Keynes' bad equilibrium)
- Depreciation reduces the capital stock
- Investment pics up again

American Keynesians

Paul Samuelson, Lawrece Klein, James Tobin, Franco Modigliani

- The neo-classical synthesis: Classical GE-theory works provided that government and central bank creates sufficient aggregate demand.
- Adopted many of Keynes' ideas, but not the most radical ones.
- In favor of active fiscal and monetary policy
- Monetary policy has relatively weak effects
- Impulses to business cycles often come from the private sector

Monetarism

Milton Friedman (US)

- Propagation mechanism similar in structure
- Monetary policy much more powerful
- Revives quantity theory of money
- Shocks mainly from governments and central banks
- Rules rather than discretion

The rational expectation revolution

Robert Lucas, Thomas Sargent, Robert Barro

- Peoples expectations = Mathematical expectations from the economic model
- General equilibrium models, explicit maximizing behavior
- Ricardian equivalence
- Only unexpected changes in money-supply has real effects
- Cycles driven by unexpected monetary shocks, people mistake movements in general price level for movements in relative prices (Lucas' island model)
- Unemployment not important

New classical / Neoclassical macroeconomics

Prescott, Kydland, Lucas, Sargent

- Continuation from rational expectation revolution
- Identifies with Keynes' predecessors
- Technology shocks, real business cycles
- Incorporates search unemployment (recent)

Confusing terminology

- Classical economists: Originally from Adam Smith to John Stuart Mill, before the marginalist revolution in 1870s
- Keynes called all his predecessors "classics"
- Others then called those between Mill and Keynes neoclassicals
- Luca et al first adopted the term new classical macroeconomics for their approach
- Later neoclassical has taken over
- Neoclassical is still also used for all economics that rely on optimizing behavior

NeoKeynesian / Neo-Wicksellian macro

Woodford, Svensson

- optimizing behavior
- nominal rigidities
- interest rate used to reach inflation target
- shocks from multiple sources