# MACROECONOMIC THEORIES

| | Classical | Keynesian |
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| **Theory** | • Emphasis on long-run.<br>• Supply-side theory<br>  o Aggregate Supply is driver of economic growth in the long-run.<br>  o output is determined by capital investment and technology.<br>• Say's Law holds<br>  o Impossible to have insufficient aggregate demand.<br>  o Crucial assumption: markets clear.<br>  o Supply creates its own demand. i.e. output generates sufficient income to buy all that is produced.<br>• Involuntary unemployment should not occur:<br>  o Unemployment is caused by wages that are too high (falling demand or increased supply)<br>  o Normal market adjustment will reduce unemployment.<br>  o Rigidities (such as government policies) in labor market may interfere with market adjustment.<br>• Interest rate determined in market for loanable funds.<br>  o supply = private savings<br>  o Demand = investment.<br>  o Adjusting market ensures that savings = investment (S = I).<br>• Investment depends on interest rate and current profit.<br>  o Increased savings will lower interest rate and lead to greater investment spending.<br>  o Higher investment spending will lead to upturn in the economy.<br>• Increase supply of savings available for investment by:<br>  o Encouraging thrifty behavior by households.<br>  o Cutting government borrowing which uses private savings. | • Emphasis on short-run.<br>• Demand-side theory<br>  o Aggregate Demand is driver of economic growth in the short-run.<br>  o output responds to current and expected demand.<br>• Say's Law is rejected.<br>  o Possible to have deficient aggregate demand.<br>  o Recessions/depressions occur when aggregate demand fails to absorb all of output, and businesses decide to cut production.<br>• Involuntary unemployment occurs:<br>  o Economy can get stuck at underemployment equilibrium.<br>  o Wages are determined by bargaining and long-term contracts. Do not adjust quickly to changing market conditions.<br>  o Wages may be slow to fall – or prevented from falling by custom, legal contracts, etc.<br>• Interest rate determined in Money Market<br>  o Short-run interest rate determined by monetary authorities (Federal Reserve).<br>  o Long-run interest rate determined by short-run interest rate plus uncertainty and expectations.<br>• Investment depends on expectations of profit (expected growth of GDP), and interest rate.<br>  o Increased savings will lower aggregate demand (decreased consumption).<br>  o Lower aggregate demand will lead to downturn in economy. Economic downturn will discourage investment.<br>  o Stimulate Investment by increasing aggregate demand and expectations of GDP growth.<br>• Savings is a residual from consumption and taxes.<br>  o Savings will increase in short-run only if income increases.<br>  o Cutting government borrowing (spending) during a recession will lower aggregate demand which will reduce income and savings. |

| Government Policy | | |
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| **Government Policy** | • Economy viewed as inherently stable and naturally self-adjusting:<br>○ Imbalances, surpluses, shortages, etc. will be automatically eliminated.<br>○ Market adjustment is inhibited by government policies which introduce distortions in price signals.<br>○ Thus, imbalances in the economy are short-run unless aggravated by government interference.<br>• Classical policy is generally laissez-faire, i.e. opposed to any policy that affects the economy.<br>○ Unemployment compensation ultimately interferes with labor market adjustment.<br>○ Government stimulus projects: impact aggregate demand, but do not have long-term impact on aggregate supply.<br>○ Lower taxes on households: Desirable for reducing size of government, but more important to cut taxes on businesses or wealthy individuals who can supply savings for investment.<br>• Modern variations on Classical are less likely to be laissez-faire purists.<br>○ Do not oppose <u>all</u> government economic policies.<br>○ Favor policies aimed at businesses or business investment. i.e. policies aimed at Aggregate Supply.<br>○ More emphasis on role of business confidence on investment spending (rather than interest rate). Often argue that less government regulation will improve business confidence and increase investment.<br>○ Continue to oppose policies that affect households, i.e. aimed at Aggregate Demand. | • Economy viewed as not self-adjusting due to:<br>○ Effect of uncertainty and changing expectations on business investment.<br>○ Market adjustment is inhibited by imperfect competition and institutions which introduce rigidities.<br>○ Tendencies toward self-adjustment apply only to long-run. Long-run may be a very long time, i.e. economy might get “stuck” at low level, e.g. Great Depression.<br>○ Short-run imbalances may persist indefinitely unless government takes action.<br>• Role for government to boost aggregate demand and reduce unemployment during a recession<br>○ Automatic stabilizers: transfers to households that increase during downturns, e.g. unemployment compensation, increase income and aggregate spending.<br>○ Government stimulus projects: inject demand directly into the business sector encouraging increased output and unemployment.<br>○ Lower taxes on households: Increase disposable income and spending. Important to cut taxes where most impact on spending will occur.<br>○ In general, increased government spending preferred to tax cuts because impact on economy likely to be greater. Also, increased disposable income from lower taxes may be saved rather than spent.<br>• Modern variations on Keynesian<br>○ Greater emphasis on institutional constraint that may increase lags. For example, political process may delay implementation of stimulus policy (increased government spending or tax cuts). There may also be a lag between political process and actual implemention, i.e. bidding process for new projects, etc.<br>○ Greater concern about reducing government spending or raising taxes when economy is no longer in a recession. |