# ECON 222A
# Macroeconomic Theory I

## Introduction to Macroeconomics

## Lecture 2

# Announcements

- Special Math tutorial: January 20th from 7:00 to 8:30 PM in Dunning 14

- Midterm test: March 1$^{st}$ 6.30-8.30pm

- Problem Set 1 due Jan 28$^{th}$

# Today’s Lecture

- Summary of Key Concepts
- Two Views of Macroeconomics

# Summary of Key Concepts

- Economic Growth: Total output is increasing because of increasing population (i.e. the number of available workers), and increasing average labor productivity (the amount of output produced per unit of labor input).
- Growth rates of output (or output per worker) are determined by:
  - rates of saving and investment;
  - rates of technological change;
  - rates of change in other factors (namely physical and human capital).

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  - Trade surplus: exports exceed imports.
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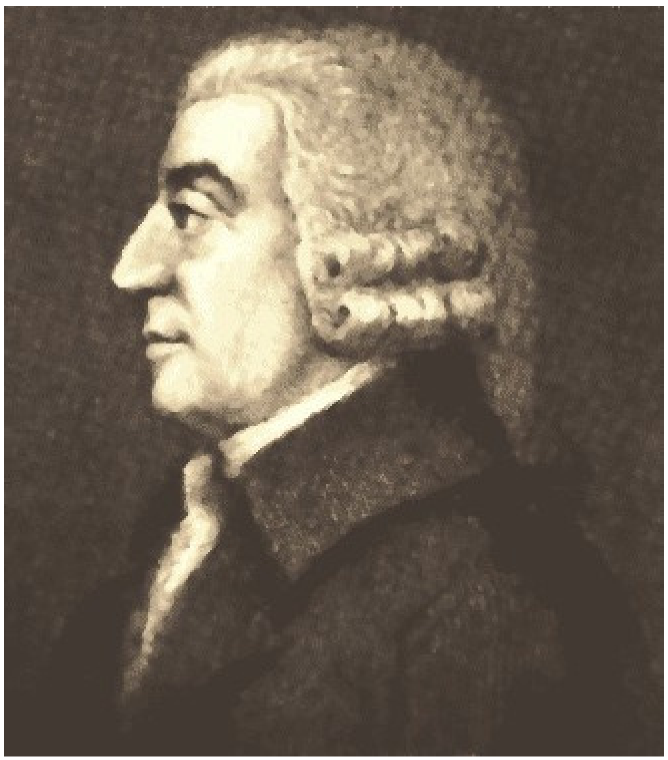
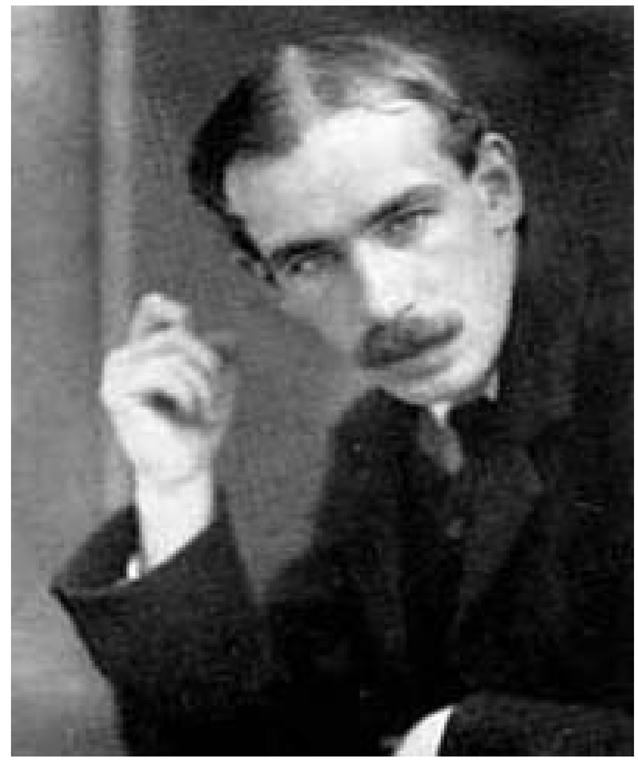
- Budget deficits: the excess of government spending over tax collection. The economy is affected when they are "too large" since public debt might crowd-out private productive investments.

# Two Views of Macroeconomics

**Adam Smith**



**John Maynard Keynes**



# Classical Theory

- Smith, *Wealth of Nations* (1776)
- Bentham, Malthus, Ricardo, Jevons
- "Invisible hand" - if markets are free and perfect, and individuals work in their best interest, the overall economy will work well and general welfare will be maximized
- Says nothing about the Wealth distribution

# Fundamentals

- Free and perfect markets
- Selfish people
- Prices and wages are flexible
- Prices and wages adjust rapidly enough until equilibrium ($S$=$D$) is obtained in all markets
- Total welfare is maximized, there is full employment and deviations are temporary
- Government policy: a limited role

# ?!?!?

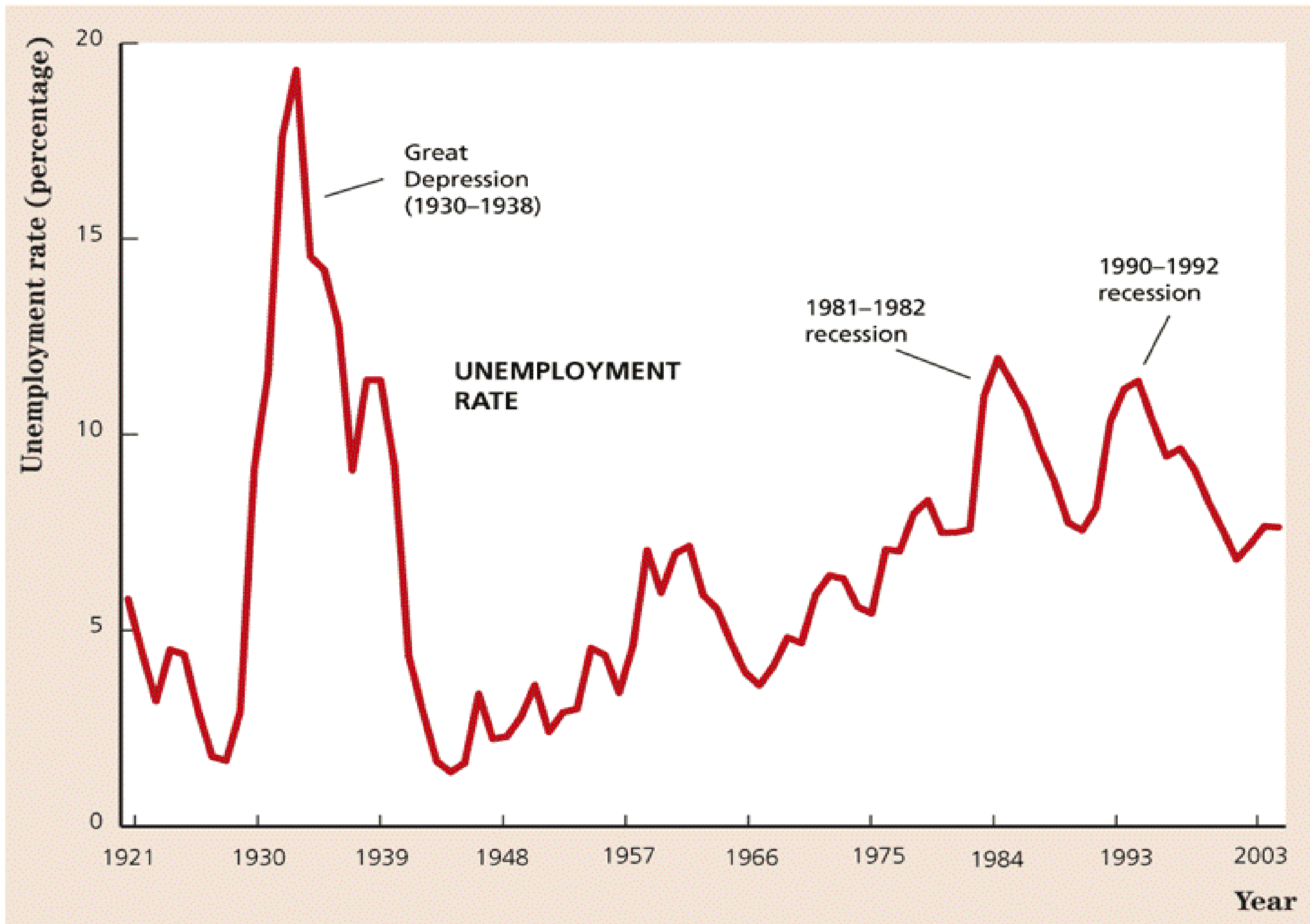
## The Great Depression was a period of high unemployment for years.

**FIGURE 1.3**

**THE CANADIAN UNEMPLOYMENT RATE, 1921–2003**

The figure shows the percentage of the labour force that was unemployed in each year since 1921. Unemployment peaked during the Great Depression of the 1930s and reached its low point during World War II. Since World War II the highest unemployment rates have occurred during the recessions of 1981–1982 and 1990–1992.

Sources: 1921–1975: *Historical Statistics of Canada,* Series D129, D132, D139, and D142; 1976–2003: Statistics Canada, CANSIM II series v2461119 and v2461182.



# Keynesian ‘Revolution’

- Keynes, *The General Theory of Employment, Interest and Money* (1936)
- Prices and wages are sticky, they adjust slowly
- The market system sometimes fails to allocate resources efficiently
- Thus, markets could be out of equilibrium for long periods of time (with $S>D$)
- Full employment is not necessary and unemployment can be persistent
- Government policy can do something about this

# Keynesian ‘Revolution’ (cont’d)

- Governments should not wait for markets to clear – it should take actions
- During recessions it should purchase goods and services, thus increasing demand, output and reducing unemployment
- Newly generated incomes would be spent and would raise employment even further

# Where is Macro Now?

- Nobody won
- After stagflation – high unemployment and high inflation – of the 1970s, the new classical approach appeared (Lucas, Prescott, Sargent, Wallace)
- Substantial communication and cross - pollination is taking place between the classical and the Keynesian approaches.

# Robert Lucas

# Lucas and the RE Revolution

- Key insight: people are forward looking and use the information they have in the best way
- Lucas' Critique: individuals have expectations on what policy makers do (i.e. about monetary policy)
- When people respond to expectations, predictions of Keynesian models can drastically change and policy desirability is unclear

# Unified Approach to Macroeconomics

- Individuals, firms and the government interact in goods, asset and labor markets.
- The macroeconomic analysis is based on the analysis of individual behavior.
- Keynesian and Classical economists agree that in the long run prices are flexible and wages adjust to equilibrium levels (Growth Theory).
- The basic model used with either assumptions about flexibility of wages and prices in the short run (Business Cycle Theory).

# Current Debate

- We posted two interesting articles in the "*Economics in the News*" section of the website:

1. Paul Krugman: "How Did Economists Get It So Wrong?"
2. John Cochrane's reply: "How did Paul Krugman get it so Wrong?"