

Macroeconomic Schools of Thought

Economics 1102

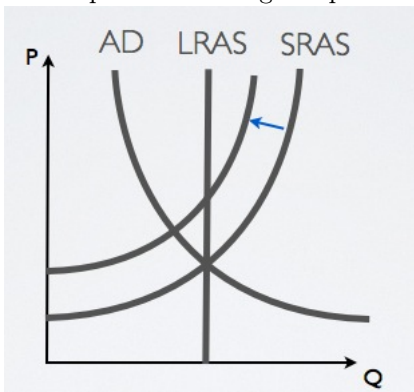
February 22, 2012

In class we studied four schools of thought on what causes business cycles: Keynesians, Monetarists, Real Business Cycles, Coordination Problems. Remember, we all about *history of events*, so oil prices shot up in the 70s and a recession happened. The financial crisis happened and a great recession followed. The question is *how do we connect these events*. The how and why certain events cause recessions is what these schools disagree about. Note that they are not mutually exclusive and can have quite a bit in common, but I will emphasize the differences here.

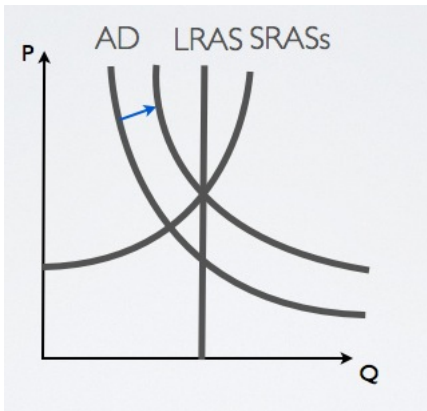
Let's work through the oil example again and see how each of the schools anticipates the event will impact the economy:

Keynesians (prices matter):

1. Oil shocks raise the costs of production and thus shift the short-run aggregate supply curve left as less can be produced at a given price:

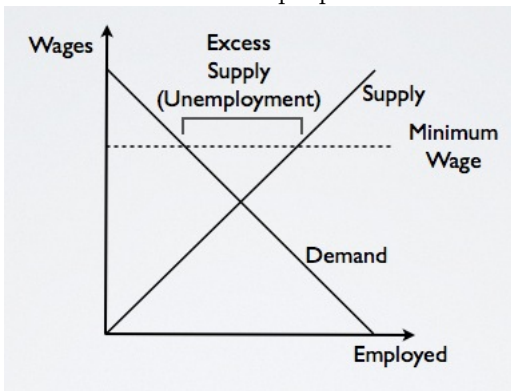


2. Because of sticky prices, the firm cannot immediately pass on the cost to consumers so in the short-run we are now producing below our natural rate of output (the LRAS) so we are in a recession until the economy readjusts (you could probably also come up with an argument for sticky wages)
3. The economy might return to equilibrium by some kind of stimulus to raise aggregate demand (depicted below)

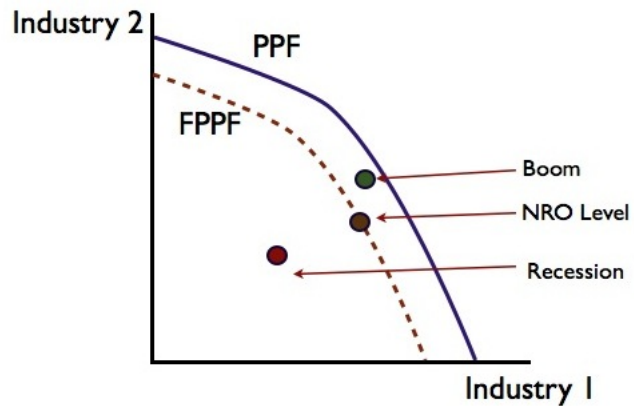
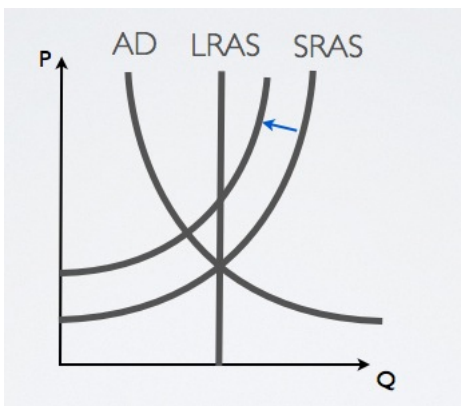


Monetarists (government policy is to blame):

1. Oil shocks raise the costs of production and thus **could shift** the short-run aggregate supply curve left but in a competitive market the firm can fire workers or lower wages to return to the original aggregate supply
2. Suppose the government imposed a **minimum wage** so the firm could not lower the wage (see below), then the firm must fire people:



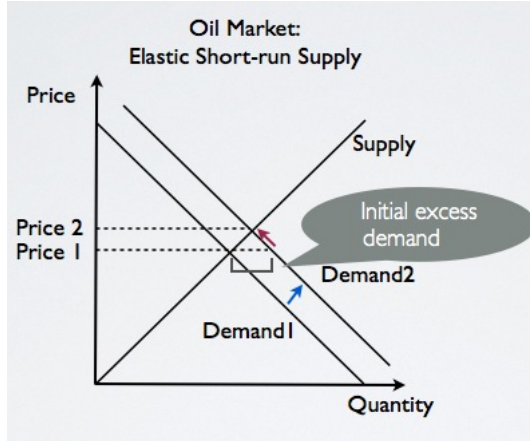
3. But firing people is less efficient than lowering wages, because firing people means that potential output will be lower. Think of this as an inefficient plan under "feasible PPF" because resources are not fully employed or a shift left in aggregate supply because output capabilities are simply lower than before



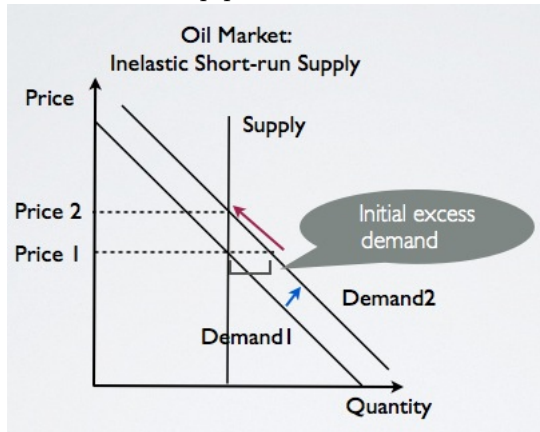
Real Business Cycle (only shocks to real factors matter):

1. Oil shocks imply that the demand exceeds supply in the oil market. As a bit of micro review, let's go through three cases of supply and demand curves to see why this would be the case. Note that these graphs are only a snapshot of a part of the economy and so behavior of firms and consumers is different than in the aggregate:

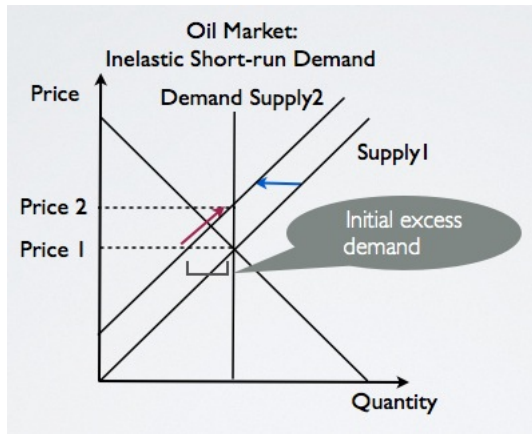
- (a) Elastic demand and elastic supply: This is the most unreasonable case. Why? We generally claim that demand for oil is inelastic, that is demand does not change that much in response to price because we need it too much. Also, we found in micro that, in general, supply and demand are both more inelastic in the short-run than in the long-run because there is little time to find substitutes for a product for consumers or implement alternative production plans for firms. Below, though, let's say there is a demand shock for oil (i.e. demand expands), we can see that there is an initial excess demand, which drives up price, as expected:



- (b) Elastic demand and inelastic supply: The result is the same in the case of a demand shock. Excess demand drives up price



- (c) Inelastic demand and elastic supply: This is the case we are probably most familiar with. In reality, most oil shocks are caused by *production shortages*. Currently, Western countries are dealing with shortages because of restraints on trade with Iran, a major oil producer. So we can see that with a supply shock and inelastic demand, we have a problem of excess demand, which drives up prices.

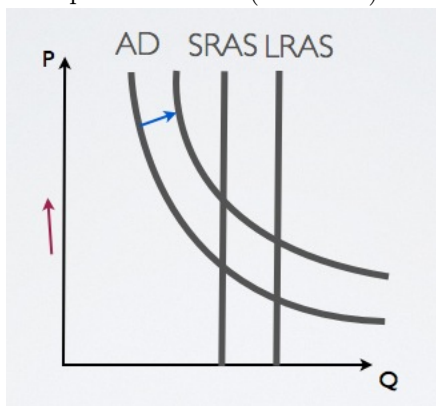


2. If oil is more costly and demand exceeds supply, then there must be some factors of production that are in need of oil and cannot produce
3. If **machines that are normally used cannot produce**, then output must fall

Coordination Failure (expectations exacerbate recessions):

1. Oil shocks imply that there will be higher prices for nearly all goods because of its ubiquity in production chains
2. Higher prices make firms believe that consumers will consume less, and thus they decide to produce less
3. Higher prices makes consumers believe that higher prices will lead to this income shock and thus do, in fact, spend less
4. Lower production means labor must be suffering so wages must fall or people must be fired
5. People then actually have lower wages and reduce spending
6. Etc.

So in this nice case we have our event, oil prices increase, and our conclusion, output falls and a recession begins, but each school of thought presents a different story. You can also see, then, that if we want to curb a recession, the appropriate response changes. For Keynesians, raising aggregate demand would return us to equilibrium. For “RBCists” raising aggregate demand might exacerbate the problem by raising prices but output is still fixed at a lower level—represented by a more inelastic short-run supply and here for simplicity as an inelastic short-run supply curve fixed below the “natural rate of output,” which is technically not a concept for RBCists (see below).



These are the two groups that typically argue most in the States about how to respond to recessions. If you are interested in more information, a good blog of a Keynesian is [Brad DeLong's](#) (he is a professor at Berkeley). You can also read Paul Krugman's column in the NYT, but he tends to be ... loose in his economics now. Tyler Cowen at [Marginal Revolution](#) more closely follows the RBC side of the argument.