Macroeconomics

MACROECONOMICS

AN INTRODUCTION TO
KEYNESIAN–NEOCLASSICAL CONTROVERSIES

Second Edition

Rosalind Levačić

and

Alexander Rebmann

M
MACMILLAN

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First edition 1976

Reprinted 1977, 1978, 1979, 1980, 1982

Second edition 1982

Reprinted 1983, 1985, 1986

Published by

MACMILLAN EDUCATION LTD

Houndmills, Basingstoke, Hampshire RG21 2XS

and London

Companies and representatives

throughout the world

ISBN 978-0-333-34145-2

ISBN 978-1-349-86044-9 (eBook)

DOI 10.1007/978-1-349-86044-9

For Sasha

WEST BEAST: EAST BEAST

Upon an island hard to reach,
the East Beast sits upon his beach.
Upon the west beach sits the West Beast.
Each beach beast thinks he's the best beast.

Which beast is best? . . . Well, I thought at first
that the East was best and the West was worst.
Then I looked again from the west to the east
and I liked the beast on the east beach least.

DR SEUSS (1979)

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Preface

When I finally came to write a second edition of *Macroeconomics* I quickly realised two related facts. Over the last six years macroeconomics, like Topsy, had grown and the consensus in which I had been brought up had all too clearly broken down. To deal with these developments I did two things – recruited a co-author and completely restructured the book so that it uses the Keynesian–neoclassical conflict as an expositional device from beginning to end. This restructuring plus dealing with the new developments without overloading the book meant a complete rewrite. The second edition is really a new book, hence its new sub-title.

The ‘new’ *Macroeconomics*, to borrow a phrase much used by fellow economists of all persuasions, is divided into five sections. These are deliberately arranged in order of difficulty. The first section, which covers the Keynesian–neoclassical synthesis for a closed static economy and section II on money and the open economy, together with Chapter 20 on inflation and the last chapter, can on their own form the basis of an intermediate course on macroeconomic theory and policy. Sections IV and V are more advanced and deal with current theoretical controversies and the related policy issues.

We have found the Keynesian–neoclassical conflict a good framework for organising the whole book. However, we use the Keynesian–neoclassical distinction as a useful expositional device and not as two categories into which all economists can be neatly allocated. Individuals are often loath to put a label on themselves for fear that ideas which they do not hold will be attributed to them. Many individuals hold eclectic positions, taking ideas from the different schools of thought.

The Keynesian–neoclassical distinction gives a central and recurrent theme for the book. It enables us to emphasise that the differences in policy conclusions stem from different assumptions about how the economy works and that the crucial distinction between Keynesian and neoclassical macro theory centres on different conceptions about how the supply of output responds to changes in demand.

Since Keynesians believe that markets fail, whereas neoclassicists hold that markets work, the crucial difference in their specification of the aggregate

supply function follows quite obviously. However, until supply-side economics became fashionable it was standard practice to emphasise the demand side and related local skirmishes. One of the fascinating aspects of studying a subject for many years is the dawning realisation that changes are not necessarily brought about by new theories but by different ways of looking at old theories. Nuances and emphasises are crucial, especially for minds coming to a subject fresh and unformed.

Putting modesty aside there are several things we like about our textbook. We hope that within the framework of the Keynesian–neoclassical conflict we have developed an interesting exposition of current theory and policy so that they are closely and naturally related to each other and to their broad historical context. We feel pretty strongly that any macroeconomics textbook which relates to Britain or any non-US advanced mixed economy must deal with the theory of a small open economy. This we have done, in three chapters in section II, and in smaller sections in later chapters, including a discussion of the New Cambridge model in its proper context in Chapter 21.

Another strength of the book we feel is that it makes accessible to students recent important work on neo-Keynesian non-market-clearing models and on new classical market-clearing models with rational expectations.

Writing this book has been a challenging and enjoyable task but not one we have the stamina to repeat, at least not for a few years. We have been greatly assisted by friends and colleagues, in particular Jock Oliver and Laurence Harris, who spared us their time to comment on our efforts. Macmillan's anonymous reviewer also made an invaluable contribution to certain parts. We thank them and acknowledge the usual responsibilities for errors, omissions and lack of clarity. However, without Moira Hilder we doubt whether there would have been a typescript to read. If we had been forced to rely on the secretary who typed the first edition (Rosalind Levačić!) we could not have faced the task of rewriting the book. So we would like to express our heart-felt thanks to Moira for all her help. For once the author will not be thanking his wife and children for their forbearance while he neglected them in the furtherance of his academic output.

The Open University
Middlesex Polytechnic
July 1982

ROSALIND LEVAČIĆ
ALEXANDER REBMANN

List of Algebraic Symbols

This list is not exhaustive: a few symbols used only briefly within a single chapter are not listed here. Due to the limitations of the alphabet some letters have been used to symbolise more than one variable, though never in the same chapter. The chapters in which such a divergence from the most common use of the letter in question are indicated.

- A = absorption
- AE = autonomous expenditure (Ch. 14)
- An = annual income on bond (Ch. 3); annuity (Ch. 12)
- a = average cost of capital
- B = number of government bonds issued, each paying £1 per year in income (market value of firm's debt: Ch. 13)
- B^D = domestic bonds held by domestic residents
- B^F = domestic bonds held by foreigners
- B_p = price of bonds (Ch. 3)
- BOF = balance for official financing on the balance of payments
- b = marginal propensity to consume
- C = consumption (currency holdings of non-bank public: Ch. 9)
- CA = current account of balance of payments
- CAP = capital account of balance of payments
- c = desired currency–bank deposit ratio
- D = bank deposits (dividends: Ch. 13)
- D^S = sight deposits
- D^T = time deposits
- DC = domestic credit
- E = aggregate demand
- e = exchange rate defined as number of units of foreign currency exchanging for one unit of domestic currency
- e = cost of equity capital (Ch. 13)
- F = imports in terms of foreign currency (imports in terms of domestic currency: Ch. 21)
- FR = foreign exchange reserves
- f = marginal propensity to import

- G = government expenditure
 g = growth rate of some variable (growth rate of dividends: Ch. 13)
 g^e = expected growth rate of some variable
 H = high-powered money (hours of work available: Ch. 5)
 I = investment
 i = real interest rate
 i_D = rate of interest paid on time deposits
 i_f = foreign rate of interest
 i_L = interest rate on bank loans
 K = capital stock
 k = inverse of velocity (long-run MPC: Ch. 12)
 L = labour units
 L^D = demand for labour
 L^S = supply of labour
 L_R = central bank lending rate
 M = money stock
 M^D = demand for money stock
 M^S = supply of money
 m = bank multiplier
 N = firm's net cash flow (Ch. 13)
 NW/P = real net wealth
 P = price level
 Pd = domestic price level
 Pf = foreign price level
 P^T = price of tradables
 P^N = price of non-tradables
 $\dot{P}/P$ = inflation = π in Ch. 20
 $E(\dot{P})/P$ = expected rate of inflation = π^e in Ch. 20
 pk = price of a unit of real capital
 Q = labour productivity
 $\dot{Q}/Q$ = rate of change of labour productivity
 q = Tobin's $q = \frac{\text{Real rate of return on investment}}{\text{Cost of capital}}$
 R = cash reserves of banking system (Ch. 9) (leisure hours: Ch. 5)
 r = nominal rate of interest (banks' reserve ratio: Ch. 9)
 S = savings (total market value of shares: Ch. 13; hours worked: Ch. 5)
 s = marginal propensity to save
 T = tax revenues or state of technology
 t = tax rate
 U = unemployment
 U^N = natural rate of unemployment
 V = velocity of circulation of money (net present value of firm's net cash flows: Ch. 13)
 v = capital-output ratio
 W = money wage rate (wealth: Ch. 12)
 $w = W/P$ = real wage rate
 X = exports in terms of domestic currency

Y = nominal national income
 y = real income
 y_d = disposable income
 y_p = permanent income
 η_F = elasticity of demand for imports
 η_x = elasticity of demand for exports
 π = profits (inflation: Ch. 20)
 ρ = marginal efficiency of capital