LECTURE SIX - PART FIVE

Three Important Questions

1. What causes instability in the economy?
2. Is the economy self-correcting and, if so, what is the speed of adjustment?
3. Should the government adhere to rules or use discretion in setting economic policy?

Question #1: What Causes Instability?

- Keynesians believe instability arises from two sources.
- Changes in investment and consumption shift the AD curve in or out, causing recession or inflation.
- Adverse supply side shocks shift the AS curve in, causing stagflation.

The Monetarist View of Instability

- Bad government policies are the major cause.
- Monetarism is rooted in Classical Economics which relies on market processes for adjustment.
- Price and wage flexibility provided by competitive markets cause fluctuations in aggregate demand to alter prices rather than output.

Wage Inflexibility, "Government Failure"

- Wages can't adjust because of government policies like the minimum wage, farm price supports, and monopoly protections.
- The Monetarists blame instability on "government failure" rather than "market failure."

Is The Velocity of Money Stable?

- Recall the Equation of Exchange: MV=PQ
- If V is stable and Q is independent of P, increasing M can only lead to inflation.
- Unlike Monetarists, Keynesians take the view that velocity is actually unstable.

The Supply Side View of Instability

- Agree with Keynesians macroeconomic instability can result from supply side shocks.
- Share Classical/Monetarist view that government failures can also cause shocks.
- Supply Siders focus on high tax rates and regulations that reduce supply incentives.

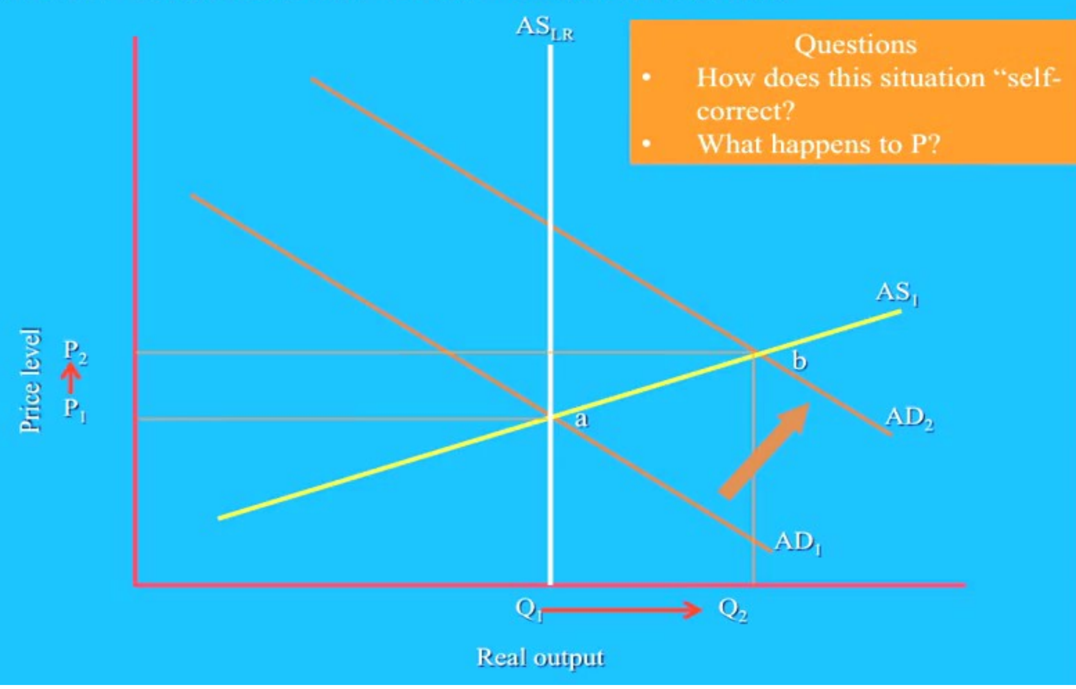
Question 2A: Does The Economy "Self Correct"?

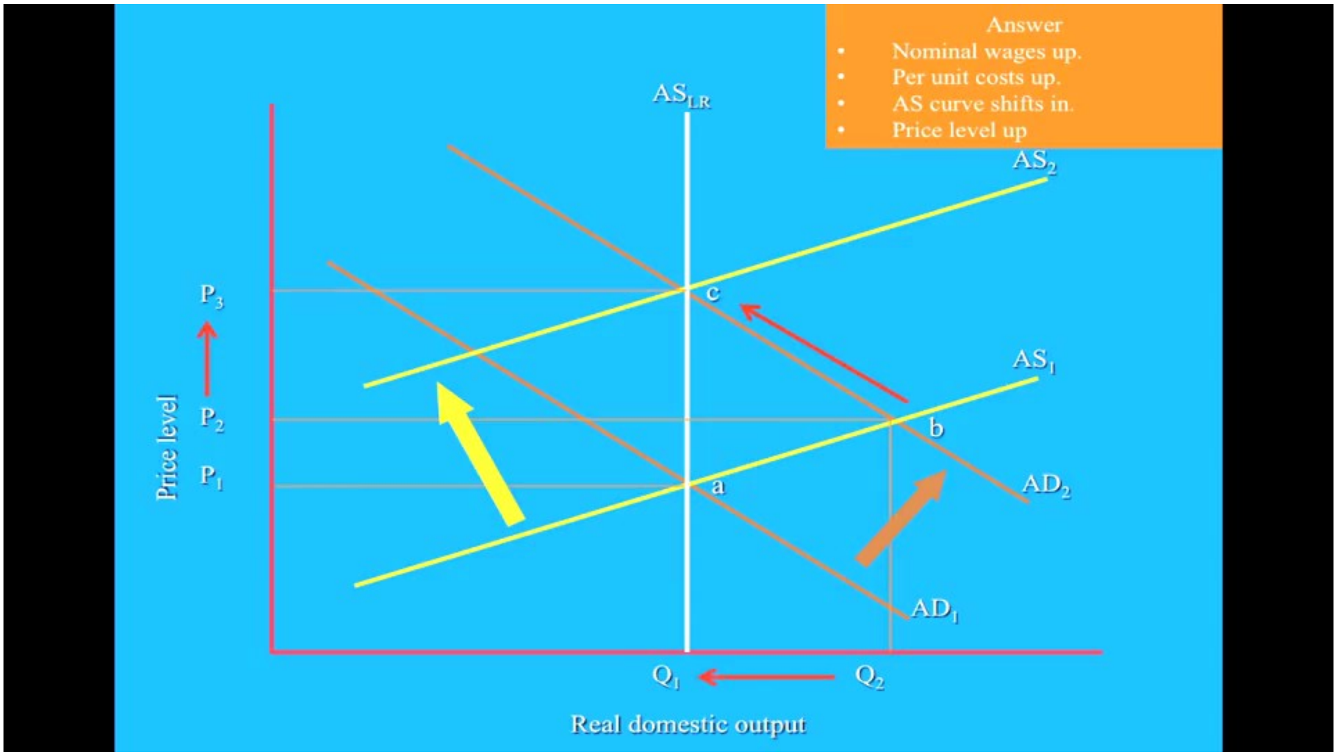
- Not just a question of whether an economy corrects itself.
- How long will – or should! -- it take for any such self-correction to happen?

The Monetarist & New Classical Views

- When the economy diverges from full-employment output, internal mechanisms automatically move it back.
- This perspective is associated with the theories of adaptive and rational expectations.

New Classical Self-Correction





Question #2B: What is the Speed Of Adjustment?

Key Concept

The faster the speed of the adjustment process back to full potential output, the less the need for activist fiscal and monetary policies!

Monetarists & Adaptive Expectations

- People form expectations on present realities.
- They only gradually change their expectations.

Key Point
With adaptive expectations, shifts of AS and AD curves and corrections are very slow.

Rational Expectations

- Workers anticipate future outcomes before they occur.

Key Point
With rational expectations, shifts of AS and AD curves and corrections are very fast or instantaneous.

The Keynesian & Mainstream Views

- Almost *all* economists acknowledge New Classical economics offers important lessons about the theory of aggregate supply.
- Most strongly disagree with New Classical rational expectations theory on the question of downward price and wage flexibility.

Which Markets Experience Rapid Prices Changes?

- Stock markets, foreign exchange markets, and certain commodity markets experience very rapid price changes.
- This is NOT true in many product markets and most labor markets.

The Economy Likely Is Slow To Adjust

- There appears to be ample evidence that many prices and wages are inflexible downward for long periods.
- Implication: In the Keynesian view, it may take years for an economy to move from recession back to full-employment output without help from fiscal and monetary policy.