Module Overview: The Warring Schools of Macroeconomics

In our first five modules, we have looked closely at both the historical evolution and the distinguishing features of four important schools of macroeconomics: Classical Economics, Keynesianism, Monetarism, and Supply-side Economics. In this lecture, we are first going to take an in-depth look at a fifth school, so-called New Classical Economics and then take an in-depth look at the "warring schools" of macroeconomics.

New Classical economics is based on the controversial theory of "rational expectations. " If you form your expectations "rationally, " you will take into account all available information including the future effects of activist fiscal and monetary policies. The idea behind rational expectations is that such activist policies might be able to fool people for a while. However, after a while, people will learn from their experiences, and then, you can't fool them at all. The central policy implication of this idea is profound: rational expectations render activist fiscal and monetary policies completely ineffective so they should be abandoned.

Once we complete our discussion of New Classical economics, we are going to take a very systematic look at how the five major schools of macroeconomics differ on three interrelated questions: (1) What causes instability in the economy? (2) Is the economy self-correcting? (3) Should the government adhere to rules such as setting monetary targets or should it instead use discretionary fiscal and monetary policy? These disagreements are important to understand because they lie at the heart of many of the macroeconomic policy debates that involve the Federal Reserve, Congress, the White House, and ultimately your own economic welfare.

Key Questions:

1. What are the three major questions about which the major schools of macroeconomics differ?
2. Explain the difference between rational and adaptive expectations?
3. What is the central policy implication of rational expectations theory?
4. Use the Aggregate Supply-Aggregate Demand framework to contrast the adjustment process of the economy with adaptive versus rational expectations.
5. Provide an economic and political critique of New Classical economics.
6. Explain the Keynesian view of what causes macroeconomic instability.
7. Explain the Classical-Monetarist view of what causes macroeconomic instability.
8. Explain and illustrate the New Classical view of a self-correcting economy,
9. Explain the Keynesian-based mainstream view of a self-correcting economy.
10. Contrast the Monetarist versus New Classical views on the speed of adjustment of the economy.
11. For the Monetarists, why does the enactment of a monetary rule make the most sense? Illustrate the Monetarists' rationale for a monetary rule.
12. Why do New Classical rational expectations economists also support a monetary rule?
13. Provide the Keynesian defense of discretionary monetary policy.
14. Provide the Keynesian defense of discretionary fiscal policy.
15. Explain and illustrate "crowding out."

16. Summarize the Keynesian versus Monetarist views on the size of the crowding out effect and their policy implications.
17. Why do Keynesian-based economists oppose a balanced budget rule?
18. Summarize the Supply-side view of rules versus discretion.
19. On what issues do the warring schools of macroeconomics converge?