Macroeconomics

Macroeconomics
A Critical Companion

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1
Macroeconomy versus Macroeconomics?

1.1 Overview

The purpose of this chapter is to highlight the nature of mainstream macro-economics both in terms of substantive content, conceptualisations and methods. Prior to the global financial crisis, it was argued that a wide consensus had been reached in macroeconomics over the passage of the previous 30 years or so, with compromise and convergence between monetarism and Keynesianism. Effectively, what was a consolidation around what is to constitute the prime subject matter of the field and how it should be explored, found a presence not only in academic research, but also across policymaking circles (particularly central banks) and undoubtedly teaching.

What should be acknowledged in this evolution of macroeconomics into the current consensus is a manifold reduction in the scope and method of the study of the macroeconomy, not only relative to previous theorising in classical political economy, but also at the expense of what has been excluded from other approaches at the time that macroeconomics emerged. These include, for example, structural characteristics and processes of the capitalist economy such as monopolisation, distribution of income, role of institutions, sources of productivity change and an integrated view of cycles and growth. This reductionism can be traced at a number of levels, not least through the prominence and division between macroeconomics and microeconomics; the subordination of the former to the latter, particularly, but not exclusively through convergence on general equilibrium; the division and narrow conceptualisation of the short and long runs; and all of this through the corresponding methods of inquiry.

In short, today's New Consensus Macroeconomics (NCM) views its primary object as the study of short-run deviations of macroeconomic aggregates from a given long-run equilibrium. The latter is fixed, whilst the deviations are presumed to be the outcome of exogenous disturbances to an otherwise stable system. Under particular conditions, there may be room for (primarily) monetary policy to stabilise the system. This framing is undertaken by

employing a very specific method, noticeably through deductive mathematical and quantitative modelling.

To understand the current state of macroeconomics, the following sections offer a brief overview of the evolution of some important aspects of mainstream theorising in (macro)economics. Whilst macroeconomic theory has offered, occasionally token, differences at particular times, and certainly has done so over time, there are common themes regarding how it has developed in conceiving the workings of the economy as a whole. These include how it should be disaggregated into its constituent parts (its structure), how markets are linked and rendered consistent with one another (an aspect of general equilibrium) and, related but distinct from the last theme, how the macroeconomy is aggregated back up to form a totality. In all these respects, microeconomics has been an increasingly essential influence, notably through the convergence of macroeconomics on general equilibrium and aggregation from optimising individual behaviour, as well as through the ethos of reliance upon formal models and mathematical, deductive reasoning.

Further, how time is treated in macroeconomics, specifically in distinguishing between the short and the long runs, has been conceptualised on many different levels, whilst these have been applied confusedly and interchangeably according to the question at hand. More specifically, short-run factors are narrowly understood, at least in part in order to maintain the distinction between it and the long run, with the latter an umbrella for a broader, but still narrow, range of other factors. This is illustrated, with considerable contemporary relevance, in how money and finance have been conceived within mainstream macroeconomics, with finance assigned predominantly to the domain of microeconomics and lying outside of the short/long-run dichotomy for macroeconomics.

Such neglect of finance in NCM theorising has been dramatically exposed by the financial crisis of the 2000s. It has demonstrated that money and finance cannot be treated as if separate – as if belonging, respectively, to macro and micro – and finance in particular straddles equally questionable dichotomies between short and long runs. Tensions involved between the micro and macro spheres and the role of money and finance are also reproduced in the various versions and concepts of the efficient market hypothesis (discussed in Box 1.1). In short, the crisis has exposed limitations of mainstream macroeconomics that cannot be rectified by simply improving the model, as it is the very methods and framing of the macroeconomy that are at issue. Despite this (and the same point does not apply to money and finance alone but to other great determinants of the macroeconomy that are subject to neglect within macroeconomics), the reaction to these omissions by the mainstream has been business as usual and to set aside the crisis as a cascade of inconvenient truths. This is a habitual vice

of the discipline, as will be seen, which is far from uncommon across the history of mainstream economics more generally, and one that is cumulative both intellectually and institutionally in its adoption in both breadth and depth, if not thereby verging on addiction. This is one way, at least, to understand why macroeconomics has (been) driven to such extremes with limited capacity to change let alone reverse direction.

Box 1.1
Efficient market hypotheses

Financial economics in the sphere of microeconomics has been heavily oriented around the efficient market hypothesis (EMH) since the early 1970s, especially under the influence of Eugene Fama's contributions. Significantly, the EMH has been subject to a number of different definitions and interpretations and can be difficult to pin down beyond saying that if markets work efficiently, then they work efficiently. But whatever the conundrums around operational definitions, behind the EMH lies the proposition that stock prices efficiently incorporate and reflect all available relevant information. Consequently, stock markets are impossible to predict (and hence beat), with speculators' profits, if any, being only temporary as any opportunities to make excessive profits will be competed away by other traders with comparable information to those doing better. More specifically, the EMH has been interpreted and tested in at least three different forms. In its weakest form, prices reflect all past (historical) information, while the semi-strong version conjectures that all new information is quickly absorbed and signalled through asset prices. Finally, in its strongest form, asset prices simply follow a random walk, and so are entirely unpredictable, merely reflecting, at any point in time, not only past but all public *and* private information (that is, not even insiders' private information can systematically beat the market – since other traders can follow the lead of those doing well even though we might reasonably believe this to be the source of speculative busts and booms rather than efficiency).

At the heart of the EMH rest neoclassical presumptions about rational expectations and calculable risk as well as perfect and complete information dissemination. More importantly, with financial markets viewed as the means of mobilising and allocating resources in the real economy, the EMH further postulates that asset prices are correctly valued, in the sense that they reflect the model's (the real economy's?) equilibrium prices (i.e. fundamental values). Hence, any deviations from the equilibrium prices will be random (rather than systematic). Despite these propositions having been open to dispute on their own terms, the vast financial deregulation that was witnessed from the 1970s helped to support the case for the supposed efficiency of financial markets. Inevitably, the EMH consolidated the reduction of macroeconomics to microeconomics, of finance to money (supply) within macroeconomics, and the presence of econometric estimation in place of theory.

1.2 The Short-Run and Long-Run Syndrome and Beyond

The division within economics between macroeconomics and microeconomics is well established and dominates the discipline in such a way that everything else, with the exception of the increasingly prominent econometrics, is a special subject or an option in teaching and, to some extent, research. Everyone does macro and micro, and econometrics, but no other field is compulsory in the same way and to the same extent. Even so, this conventional division, and form of hegemony and privilege, within the discipline is relatively new. It derives from the rise of Keynesianism in the 1930s, partly in response to the Great Depression. This gave us macroeconomics: an explicitly constructed concern with the workings of the economy as a whole, with a focus on the causes, cures and, if more occasionally, the consequences of massive unemployment.

Such a specification of macroeconomics left open a considerable space for other fields of study on which to focus. These can be loosely divided into two categories. One is equally concerned with the functioning of the economy as a whole but with issues overlapping with, but distinct from, the determinants of (un)employment and other, what would now be thought of as, Keynesian macroeconomic aggregates such as prices and output. Thus, economics can, and no doubt should, concern itself with the role of institutions, the distribution of income and wealth, the sources of technological change, monopolisation and formation of large-scale corporations, and trade unions, quite apart from problems of development and change around the world. The second, apparently much more mundane, category is the study of parts of the economy in isolation from the bigger picture, whether it be a household, an industry or a firm.

The second category is what has given us microeconomics. Not entirely by chance, it was in the process of being established, if with somewhat earlier origins than Keynesianism, in the 1930s, having gained a huge impetus from the marginalist revolution of the 1870s which gave birth to methods and concepts that are now familiar, such as marginal utility, marginal product and marginal cost, individual optimisation, and efficiency and equilibrium, and much more besides. The consolidation of microeconomics, alongside macroeconomics, as constituting the core of the discipline (with econometrics barely on the scene at this time) was completed in the second decade after the Second World War, not least with advances in general equilibrium theory.

With these three categories, macroeconomics, microeconomics and everything else, it is important to acknowledge that their weight within the discipline and the boundaries between them have not remained fixed. For boundaries there has been a double shift, with an uneven pace and incidence since the 1950s. One has been the increasing subordination of macroeconomics to microeconomics. The other has been the marginalisation of the 'everything else' category in terms of its methods, theories and conceptualisations except

where it has been incorporated into microeconomics (or possibly an increasingly, micro-like macro). Development economics, for example, has been declared by some, indeed an increasing number, as not requiring separate methods to those applied to developed economies. After all, effective demand is effective demand wherever it prevails, as is the optimising behaviour of individuals. The (initial) conditions might be different but the principles remain the same. Much the same applies to one 'optional' field after another within the curriculum.

There is, however, a bit of a paradox across this outcome. As observed, the emergence of, and division between, macro and micro arose out of particular focuses on particular problems (unemployment for macro, optimising behaviour in supply and demand for micro) and could do so only by neglecting other considerations, the concern of the other fields. Having established themselves, however, micro and macro have increasingly turned their attention to incorporating those other concerns that they had studiously avoided in order to get themselves up and running in the first place.

Of course, it may well be that by some hugely fortunate, intellectual accident the principles discovered by micro and macro via this route do, indeed, have a much broader and legitimate scope of application, specifically to subject matter beyond their original intent. This is, however, more than questionable. At the very least, it has to be acknowledged that the micro/macro divide, far from being a dynamic duo, only broadens its scope of application by excluding, and even precluding, other methods, theories, concepts and factors from consideration.

This is going far beyond the subject matter of this text, which is concerned with macroeconomics alone. But the point can be illustrated by considering what is or should be the subject matter of macroeconomics. On the one hand, especially for the uninitiated, it might be thought that the subject of macroeconomics would be the analysis of the workings of the economy as a whole. On the other hand, there is macroeconomics as it is constituted as an academic discipline which is seen to be considerably narrower than the previous definition. Following the Keynesian revolution, macroeconomics primarily became the study of short-run deviations in employment and output, together with other macroeconomic aggregates such as the general price level, around what has been generally taken to be a given trend, or even an equilibrium. More than occasionally, macroeconomics may stray into wider domains, such as growth, but these have become and remained far from central to the vast bulk of macroeconomics. Indeed, in many respects growth theory has stronger affinities to microeconomics than even to a narrowly defined macroeconomics.

This point can be made in a different way. Macroeconomics as the study of the workings of the economy as a whole long predates, if not in name, macroeconomics as currently constituted. The classical political economy of Smith, Ricardo and Marx, for example, certainly addressed the issue. But they did so with very different methods, concepts and objects of study, not least with a pre-

occupation with classes, distribution, the pace of accumulation and technical change and, indeed, whether capitalist growth could be sustained indefinitely. So, paradoxically, the emergence of macroeconomics as a commanding field within economics had the perverse effect of narrowing down what has been considered to be the workings of the economy as a whole, and not only in relation to what came before in the nineteenth century but also in relation to the 'other' economics that was present at the birth of macroeconomics itself, concerned with business cycles, institutions, distribution, technical change, monopolisation and so on.

Further, the process of narrowing the scope of macroeconomics, whilst marked by a distinct leap with the initial emergence of Keynesianism, has strengthened subsequently. It has done so through three processes that will be highlighted throughout the rest of this text. First has been the increasing attachment of macroeconomics to general equilibrium. This does itself have two distinct elements. On the one hand, there is the issue of consistency in the treatments of markets and market behaviour in the aggregate. Specifically, every (intended) sale must correspond to an (intended) purchase or, if interest is paid, someone else must receive it. Such reliance upon what is known as Walras' Law (or Say's Law in the absence of money, see Chapter 3), ties macroeconomics to general equilibrium. The contrast is with partial equilibrium in which, for example, the use of inputs by a producer, through which revenue accrues to the supplier, is examined no further.

Significantly, if not necessarily logically as a separate step, the consistency across all markets attached to Walras' Law, understood as the balance between supplies and demands in aggregate, is readily envisaged to lead to the presumption that all markets are linked through prices as a matter of adjustment, nominally over time, if out of equilibrium. Walrasian adjustment is one in which prices increase where there is excess demand and fall where there is excess supply. As is well known, as a consequence of developments within general equilibrium theory itself, it cannot be assumed except under stringent conditions that Walrasian adjustment will lead to equilibrium (let alone that it exists, and is unique and efficient). There is also the issue of whether production and trading take place before or after prices have had a chance to adjust to their equilibrium values (raising what is known as Hicksian false trading). The model of such Walrasian adjustment is explicitly seen as relying upon a Walrasian 'fictional' auctioneer, one who calls prices, assesses supplies and demands, and adjusts prices until they are correct. The problem is that we need the fiction, as so-called perfect competition depends upon everyone being a price-taker so there is no one to make the prices. James Meade, a Nobel Prize winner like John Hicks, who also invented the Keynesian IS/LM framework (see Chapter 5) wondered what the price of coffee would be, whilst traders were waiting for the auctioneer to decide their true equilibrium values.

So there is plenty of prestige behind the questioning of the validity of Walrasian adjustment for understanding the workings of the macroeconomy. As with many other such conundrums, despite increasing reliance upon general equilibrium, macroeconomics has tended to ignore whatever mathematical or technical results derived from it that are unpalatable for its model building. But the Walrasian architecture of equilibrium and adjustment has increasingly become part and parcel of macroeconomics, focusing on how supply and demand are formed and adjust around quantities and prices, on the basis of given preferences, resources and technologies, in conditions of greater or lesser competitiveness or market (im)perfections. Other issues profoundly affecting the macroeconomy tend to be excluded by a Walrasian framing drawn from general equilibrium.

To a large extent, then, whilst it is more or less taken for granted in principle, if not always in practice, that macroeconomics needs to incorporate Walras' Law, it is a moot point whether such corresponding consistency in the analysis of markets as a whole dominates much that has been excluded from macroeconomic analysis. Be this as it may, it is important to recognise that commitment to Walras' Law is entirely independent of the underlying theories of supply and demand over which it exerts its command. For, on the other hand, in the convergence of macroeconomics on general equilibrium there is the separate increasing reliance upon aggregating over optimising individuals as the foundation for macroeconomics. In short, and as a second overall feature of macroeconomics, it has increasingly become subordinated to microeconomics (with general equilibrium in the lead in this respect but not exclusively so).

These different aspects of the second theme (the convergence upon general equilibrium) is all related to the third theme running through the evolution of macroeconomics – how it relates the short run to the long run. Here, it is important to be careful over three different ways in which the distinction between the short and the long run are made. One, and the most obvious and common in popular parlance, is to refer simply to the passage of time. Clearly the short happens before the long run, although the two are ultimately connected to one another with the passage of time itself.

Second distinguishing short and long runs is also related to the passage of time but, in addition, includes in part an empirical and in part a theoretical content. After all, it is traditional within economics to place variables in a hierarchy of the speeds with which they are presumed to adjust. For a firm, for example, it is considered relatively easier and quicker to vary the level of output, although this might create strains until more employment is taken on. This is itself easier and quicker to vary than installing new capital equipment in order to be able to respond more fully and easily to increased demand. Accordingly, output is deemed to respond in the very short run, employment in the short run, and capital in the long run. Other variables, such as institutions, might

be taken to change even more slowly. However, this hierarchy of variables by speed of adjustment is not merely an empirical matter of how quickly things change in practice, as this can itself vary by time and circumstance. Rather, the relative speed of adjustment of variables also reflects theoretical choices, with one of the biggest differences in this respect being between Keynesianism and monetarism: the former considers that outputs can adjust very quickly (to demand), whereas the latter considers that prices will adjust quickly to equate supply and demand at full employment.

The third notion of the long run as opposed to the short run has nothing to do with time as such. It is simply the definition of equilibrium where all variables are assumed to have had the opportunity to change, whereas not all can change for the short run. There can be no presumption that movement to such an equilibrium takes place through time. And, indeed, the parameters that define this long-run equilibrium, or even the structure of the economy itself, however defined, might change faster than any passage to the equilibrium itself.

It is characteristic of mainstream macroeconomics to use these very different notions of short and long runs interchangeably. This is precisely what allows for the short run to be understood as deviations around a long-run equilibrium which is both unchanging and unaffected by what happens in the short run. This is so even though, for example, the short run involves variability in levels of investment that surely have an impact on 'long-run' productive capacity and productivity.

But this incoherence around the short and long runs are of much deeper consequence because of the associated narrowness with which short-run factors are themselves understood in part in order to sustain its putative relationship with the long run. Of necessity, those factors that are incorporated into such macroeconomics, and how they are incorporated, conform to how the short and long runs are conceived and related to one another. The point can be illustrated by reference to how money and finance are treated in mainstream macroeconomics. Money is predominantly seen as a simple asset that also serves to transmit income into demand through serving as a means of payment. Typically, the demand for and (fixed) supply of money are set to be equal with one another. Finance, on the other hand, in terms of the mobilisation and allocation of resources for investment, is primarily seen as residing (with efficiency taken for granted) at the microeconomic level and is set aside in examining short and long runs (see Box 1.1).

Such a perspective has been cruelly exposed by the global crisis of the 2000s (as admitted to some extent by economists). As analysed by a variety of approaches across heterodox economics, deploying the term financialisation, the global crisis has been closely related to the excessive expansion of financial markets for speculative purposes at the expense of what might be termed both real investment and its effectiveness. In short, financialisation has witnessed a

disproportionate expansion of finance relative to GDP (this ratio has roughly grown three times over the last 30 years) and has a number of features, such as: involving a proliferation of different types of speculative assets increasingly removed from real economic activity; witnessing the penetration of finance into ever more areas of economic and social life; and having a profound effect on the distribution of income and wealth, with a corresponding strengthening of the economic, political, ideological and institutionalised power of finance (usually denoted by the term neoliberalism).

Of course, this is far from offering a full account of what financialisation is and what has been its impact and significance for contemporary capitalism. But it suffices to expose the limitations of a mainstream macroeconomics organised around independent short and long runs and general equilibrium. And, whilst this has been forcibly exposed by the global crisis through the unavoidable example of the treatment of money and finance within mainstream macroeconomics, this is only the tip of the iceberg as far as other topics are concerned, which make the same point either because they are ill-treated or absent from the mainstream, such as distribution, monopoly, technical change, conflict and the exercise of power, and the role of institutions, especially the state.

However, if these issues are brought to bear, and are highlighted by the global crisis, the huge divide between what macroeconomics is and what it ought to be is readily emphasised. Just before the crisis, or even after it had begun to break, macroeconomics was congratulating itself on having learned how to deal with what were taken primarily to be the consequences of random shocks on the stability and prosperity of the economy. In its wake, little has changed in the theory other than to have lost its self-confidence and complacency whilst policy measures, such as quantitative easing taken to the extreme of minimal interest rates, have proven powerless to restore sustained growth, not least as austerity measures have also been relied upon after a brief flirtation with some Keynesian stimulus.

This is all particularly striking and even paradoxical given that the 'fundamentals' underpinning the economy have been so favourable. Fundamentals might be thought to refer to levels of deficits and the like, but at a more fundamental level – the fundamental 'fundamentals' as it were, related to underlying material conditions – the prospects for the global economy have been extraordinarily strong both over the last 30 years of relatively slow growth compared to the post-war boom and into the current crisis. To be specific, if simply listing and unduly overgeneralising for brevity, the following features have been most favourable for capitalist growth: the capacity for productivity increase arising out of a huge diversity and range of application of new technologies; the decline in the strength and organisation of working class and progressive movements, especially across trade unions, political parties and anti-imperial struggles; huge increases in the global labour force through

migration, the Chinese road to capitalism and increasing female labour market participation; high levels of advanced country cooperation under the hegemony of the USA, not least with the collapse of the Soviet bloc; and the triumph of neoliberalism, not least in the form of containment of the social as well as the monetary wage.

The point to emphasise, then, is two-fold: that the short and long runs are inseparable and that the factors that underpin them tend to be absent from mainstream macroeconomics. This point is further reinforced once account is taken of broader institutional considerations. There can be little doubt that the neoliberal ideology of targeting minimal state intervention and leaving as much as possible, especially finance, to the free market has taken something of a battering in the wake of the global crisis, if only possibly token and temporary. For the policy responses in practice have remained extraordinarily timid and limited in scope. If, for example, the state is making a comeback, it certainly is not along the lines experienced during the post-war boom when Keynesian macroeconomic policies were complemented by a whole, arguably more important, sheaf of interventionist policies around health, education, welfare, and industrial and regional development.

Rather, as symbolised by 'quantitative easing', the top priority is to restore the viability of the financial system. This is accompanied at most by weakening and token deference to reregulation and the clawing back of disproportionate rewards to those in the financial sector. Stimulus to effective demand has primarily been adopted in the mildest forms of Keynesianism through monetary policy whilst directed fiscal stimuli take a back seat (or are thrown off the transport altogether, as the deficits that have accompanied support to finance dictate austerity measures to cover interest payments to the very financial system that has created the problem and had, accordingly, to be rescued). This is all despite what is a unique characteristic of the current crisis: the common acceptance that it is in general, if with notable exceptions, in no way due to excessive wage demands or state expenditure to furnish a social wage. Nonetheless, the blameless in working and social conditions are being hit very hard by recession and austerity.

One reason for this has already been identified, in terms of the favourability of conditions for macroeconomic performance – the weakness of progressive movements that are, in turn, more aligned to state intervention. In addition and equally, though, the last 30 years has witnessed the emergence, growth, strengthening and institutionalisation within governance and beyond of financial elites at domestic and international levels. This implies not only particular sets of policies towards promoting private capital both directly, through privatisation for example, and indirectly through fiscal austerity, but also the transformation of the capacity to conceive and formulate alternative policies themselves.