SIZE DOES MATTER

In defense of Macroeconomics

SYNOPSIS: Defends the study of Macroeconomics as a useful science. World events clearly show the effects of Macro problems and need Macro solutions.

If you use the term "microeconomics" in a WordPerfect document, the spelling checker will flag it and suggest "macroeconomics" instead. The spelling checker has a point. You see, macroeconomics has gone out of fashion. Not only academic economists but also some of our most influential economic pundits seem to regard it as bad manners to talk about recessions and recoveries and how governments might alleviate the former and engineer the latter. Ordinarily reasonable people now argue that the business cycle is a trivial matter, unworthy of attention when compared with microeconomic issues like the incentive effects of taxes and regulation. Trying to do anything about recessions is bad for growth, they say, and even thinking about the business cycle is a bad thing, because it distracts people from what really matters.

What is so peculiar about this attitude, which seems to become more prevalent each year, is that we live in a world in which those old-fashioned macroeconomic concerns are more pressing than they have been for generations. Not since the days of John Maynard Keynes have his questions (if not necessarily his answers) been so relevant. So an occasional reminder that the big things do matter, that getting microeconomic policy right is no help if you stumble into a depression, is welcome from any source--even a deficient dictionary.

To see what I'm talking about, consider a recent Washington Post column by Robert Samuelson, in which he seems to dismiss all macroeconomic analysis--all attempts to understand the behavior of aggregates such as gross domestic product and the price level--as useless, even malign. "What we've learned," declares Samuelson, "is that the little picture is the big picture." Economic success, he argues, is simply a matter of getting the incentives right. And he goes on to deride macroeconomics for its "illusion that it could make the whole system run smoothly almost regardless of how the economy's underlying sectors functioned. ... It's as if a car could run at breakneck speed even if the engine was corroded and missing some parts."

One wonders why the usually judicious Samuelson found it necessary to invent this straw man. Who is supposed to have had that illusion? Even when Keynesian macroeconomists were at their most hubristic, none of them claimed that macroeconomic "fine-tuning" could make an economic jalopy into a Porsche. But they did claim that even a Porsche won't perform very well if you don't give it enough gas--that using three workers very efficiently is not much help if the fourth is unemployed because consumers don't spend enough. And this is not an abstract point: Just look at the economic storms ravaging quite a lot of today's world.

For example, Japan's economy has been shrinking at an alarming pace the last few quarters. Is this because Japanese workers have become lazy or because the country's factories have fallen into disrepair? Or to take a more extreme case, has Indonesia become a 15 percent less productive society than it was a year ago? Of course not: Whatever the ultimate sources of the crisis in Asia, the immediate cause of these slumps is a collapse in that good old-fashioned macroeconomic variable, aggregate demand.

I don't know what provoked Samuelson's outburst. But if one of our most well informed economic journalists has come to disdain macroeconomics, this may be because he has been listening to economists themselves. Over the past 30 years, macroeconomics--and especially that part of macroeconomics that concerns itself with recessions and depressions, in which the economy as a whole is less than the sum of its parts--has fallen steadily into disfavor within the economics profession. As late as the mid-1970s, many textbooks still followed the lead of Paul (no relation to Robert) Samuelson's classic 1948 Economics, beginning with the macroeconomics of booms and slumps and turning to microeconomics only in their second half. Nowadays, however, every textbook (yes, even the one I'm writing) relegates macro to the second half. Even within the macroeconomics half, more and more books (like the much-hyped new text by Harvard's N. Gregory Mankiw) dwell on "safe" issues like growth and inflation as long as possible, introducing the question of recessions and what to do about them almost as a footnote.

In graduate education the situation has become even more extreme. While most Ph.D. programs continue to require that students take a year of macroeconomics, more and more of that year is devoted to long-run issues, less and less to that part of the subject that might tell you who Alan Greenspan is and why he might matter. (When I gave an honorific lecture at one prominent department, students there told me that their macroeconomics course did not even mention money until the last two weeks, and never so much as suggested that monetary policy might have anything to do with business cycles.)

The reasons for this aversion to macroeconomics are a little hard to explain to a lay person. It's not that the business cycle has become less relevant--the U.S. economy has lately had a smooth few years, but macroeconomics was already in retreat during the anything but tranquil '70s and '80s. (I remember one famous anti-Keynesian, challenged during an early '80s conference to explain how his model could be reconciled with the savage recession then gripping the United States, snapping "I'm not interested in the latest residual"--i.e., the latest statistical blip.) Nor did macroeconomics fail the test of empirical relevance. Though it is widely believed that events such as the combination of inflation and unemployment in the 1970s, or the noninflationary growth from 1982 to 1989, baffled and astounded macroeconomists, this turns out to be another of those oddly popular anti-economist legends--similar to the legend that economists refused to believe in increasing returns. The truth is that stagflation was predicted as a possibility long before it emerged as a reality and that the disinflation of the 1980s played out just the way the (old) textbooks said it should.

The real problem with macroeconomics, from a professor's point of view, is the shakiness of its "microfoundations." Most economic theorizing is based on the assumption that individuals behave rationally--that companies set prices to maximize their profits, that workers choose to accept or reject jobs based on a rational calculation of their interests, and so on. You don't have to believe in the literal truth of this assumption to recognize how powerful it is as a working hypothesis. But while macroeconomists generally try to put as much rationality into their models as they can, useful business cycle models--the kind in which Greenspan does matter--always depend crucially on the ad hoc assumption of "sticky prices." In other words, they assume that at least in the short run, companies do not immediately reduce their prices when they cannot sell all their production, and workers do not immediately accept lower wages even when they have trouble finding jobs. This assumption works; that is, it transforms the otherwise incomprehensible reality of the business cycle into something that is not only understandable but, to some extent, controllable. But it

makes many economists uncomfortable; it is the classic case of something that works in practice but not in theory.

And so economists have, more and more, simply avoided the subject; and being human, have tended to rationalize that avoidance by asserting that the subject isn't really important anyway.

The trouble with this evasion is, of course, that macroeconomics is important. Paul Samuelson had good reasons for beginning his textbook with Keynesian analysis. He knew that students would not find microeconomics, with its emphasis on efficiency, interesting unless they were first convinced that the economy could achieve more or less full employment, that it need not relapse into depression. He also knew what too many latter-day economists have forgotten: Macroeconomics is crucial to the public credibility of economics as a whole. Analytical, model-oriented thinking came to dominate American economics mainly because supernerds like Samuelson had something useful to say about the Great Depression, and their pompous, windy rivals did not. By abandoning macroeconomics the profession not only leaves the world without guidance it desperately needs; it also risks letting the fuzzy-minded literati reclaim the ground they so deservedly lost 60 years ago.

Of course the little things matter. But the big things matter too, and if economists try to pretend that they don't, one of these days they are going to get stomped on.