

## **2. Macroeconomic Theories that Rule the World**

**Vincent Amanor-Boadu**

**<vincent@agecon.ksu.edu>**

*Dr. Vincent Amanor-Boadu is the director of the Kansas Ag Innovation Center and an assistant professor in the Department of Agricultural Economics, Kansas State University. Vincent received his PhD from the University of Guelph in Ontario, Canada and directed research at the George Morris Center, an agri-food think-tank, for almost a decade after graduation. Vincent joined K-State in 2002. He teaches at both the undergraduate and graduate levels and conducts research in business development and strategy with a focus on understanding consumer decision-making. Vincent also maintains an active outreach program centered on entrepreneurial economic development and wealth creation in small towns and rural communities. He is a member of the board of directors of Farms.com, LLC and the Kansas Agriculture and Rural Leadership, Inc.*

### **Abstract/Summary**

*A few major theories rule national and international economies and the lenses through which policymakers view economic problems define the theories dominating their policies. Increasing globalization ensures that no country and its citizens are protected from the dominant theories in operation in any other major country. This paper provides an overview of the major macroeconomic theories competing for attention and argues that business leaders have to develop sound appreciation of their effects and develop coherent strategies to minimize any adverse effects or maximize any beneficial effects they may present.*

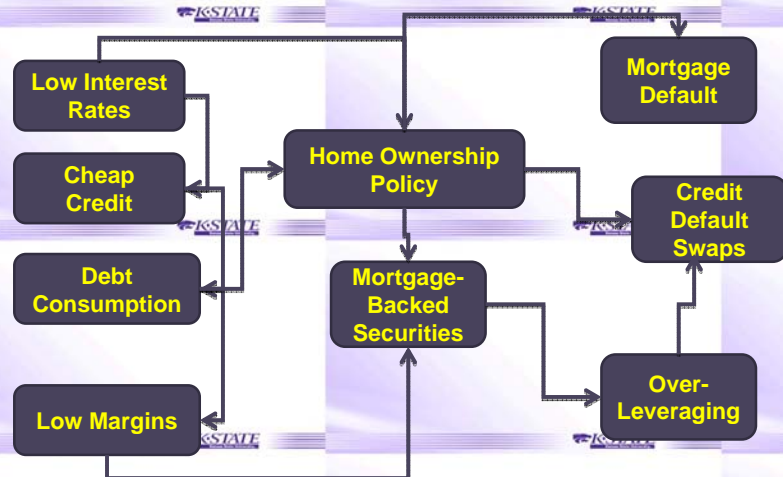
# Macroeconomic Theories that Rule the World: Knowing Them and Getting Ahead of Them

**Vincent Amanor-Boadu, PhD**  
Department of Agricultural Economics  
Kansas State University  
Manhattan, KS 66506  
Email: [vincent@ksu.edu](mailto:vincent@ksu.edu)

## Conversation Outline

- Behavioral Assumptions Driving the Economy
- Overview of Recent Events
- How the Economy Works
- What to Do

## Explaining the Recent Economic Crisis



## Assumption # 1: Incentives Work

- All economic agents respond to incentives
- Their response will always be driven by their self-interest
- This is true regardless of the benevolence of the agent in any economic action
  - While we might not gain any pecuniary benefits from our neighbor winning the lottery, we can be happy for her because we get good feelings from being happy for our neighbor
  - Those good feelings are our non-pecuniary benefits that cause us to be happy for the neighbor

## Assumption # 2: Opportunism is a Rational Response

- Opportunism is self-interest with guile
- When incentives reward opportunism, people with the means to be opportunistic will behave accordingly
- There is no natural law that prevents this rational behavior

## Assumption # 2: Opportunism is a Rational Response

- The only barrier to opportunism is fear
  - Fear of retaliation
  - Fear of punishment
- But fear is a rational response to estimation of expected costs and benefits
  - If the expected cost of retaliation is higher than the perceived benefits from the opportunistic action, the agent will avoid opportunism
  - If the expected cost of punishment is lower than the expected benefits, the agent will act opportunistically

## Assumption # 3: Signals are Important

- Signals are the information pieces economic agents receive from the market or from their transactions
- These signals influence the adjustments agents make in their decisions
  - Adjustments in costs and benefits
  - Adjustments in time value of money (discount rate) for costs and benefits

## Assumption # 4: Interventions Distort Signals

- Any intervention by administrative fiat in transactions among economic agents distort the signals they receive
  - They alter the true costs and benefits
  - They allow for aversion of costs and/or benefits through positive and negative externalities
- These distortions feed into the agent's decision algorithm and may lead to "wrong" decisions causing unexpected consequences

## Assumption # 5: People Make All the Decisions

- Outcomes in every dimension of the economy are based on decisions made by people . . .
  - Who are responding to incentives (#1)
  - To achieve defined (conscious or unconscious) objectives (#2)
  - Given the signals that are coming to them (#3)
  - And accounting for the distortions created by interventions (#4)

## Assumption # 5: People Make All the Decisions

- Because they are human (and rational), they learn from their previous decisions and their outcomes
  - Using the lessons to make adjustments in their decisions in the hope that they lead them to their objectives
  - They may make changes in the content of their objectives but its essence never changes

## The Components of the Economy: The Actors

Households

Businesses

Governments

## The Components of the Economy: The Markets

Labor  
Market

Goods &  
Services  
Market

Financial  
Markets

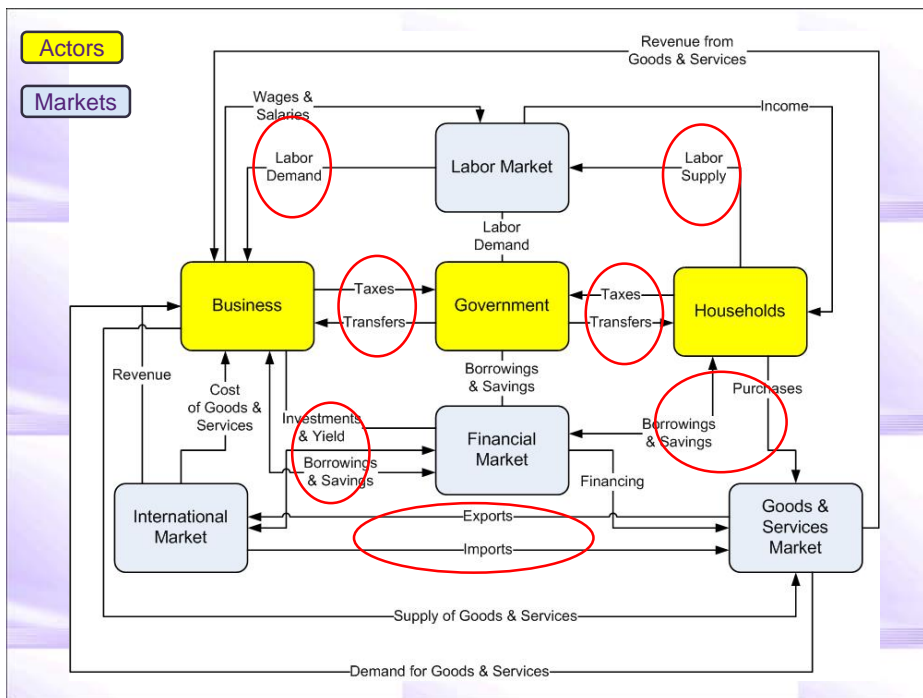
International  
Markets

## The Economy, Its Actors and Markets

- The actors' decisions and their interactions in the various markets determine the economy's performance
- The signals they receive from the markets modulate their behavior
- And the interventions always affect the strength of the signals, and thus the actors' responses

## The Signals in the Economy

- Prices and interest rates (businesses)
  - Influence supply and demand for goods and services
  - Influence supply and demand for money
- Taxes and Transfers (government)
  - Influence infrastructure and business and household well-being
- Wages and salaries (household incomes)
  - Influence consumption and investment decisions



## The Relationships

- The relationships among the actors and the markets are complex—non-linear, spatially and chronologically separated
  - Action and reaction have lags between them
  - They behave like system where the objects with the specific attributes interact with each other
  - And then, just like the sand pile, one more grain causes the whole thing to unravel

## The Economists' Problem

- What are the principal forces that influence the economy's behavior?
  - Why does it expand and contract?
  - Why are some of the contractions so severe— e.g., the 1929 depression?
- How can we predict when these contractions will occur and how do we prevent them?
- And if we can't prevent them, how do we get the economy back to "normal" when it unravels? Quickly!

## The Economists' Problem

**"On this question, various and contradictory opinions have been formed; and if the notorious fact of the public distress has united the sentiments of all parties on this single point, they seem to differ as widely as ever in their judgments as to the causes of it."**

[Anonymous, 1816, p. 375]

## Business Cycle Theorists

- Schumpeter popularized the idea of business cycles in his 1939 tome (1,095 pages)
- The work involved attempts to explain the cycles in the economies of U.S., Germany and the UK
  - Clement Juglar (1860) is credited with being the first to identify economic cycles, arguing that they were 8-11 years long
  - Kuznets infrastructural investment cycle of 15-25 years
  - Kondratieff wave was based on long technological cycle of 45-60 years
- Empirical evidence debunked the idea of business cycles of regular periodicity

## Business Cycle Theorists

- Yet, the NBER provides "official" dates on the peaks and troughs of the economy, marking the beginning and end of recessions
  - Recessions are significant declines in economic activity spread across the economy, lasting more than a few months, normally visible in real GDP, real income, employment, industrial production and wholesale-retail sales for their estimation
  - The NBER argues that expansions are the normal state of the economy



## Business Cycle Theorists

- Schumpeter's work was cumbersome and unconvincing for the most part
- Causing it to fail in the face of Keynes' *General Theory of Employment, Interest and Money*, which was prescriptive, exactly what the world was looking for in 1936
- And the birth of Keynesianism
  - Which Schumpeter criticized for discarding the capitalist process of change

## Keynesian Theorists

- Keynes' provided a plausible diagnosis of the Great Depression and a prescription for its cure
- Keynes' diagnosis of the declines in the economy was that private sector (households and businesses) sometimes make decisions that lead to inefficient macroeconomic outcomes
- And his prescription was that government must intervene actively to correct and arrest declines
  - Monetary policies by Central Banks
  - Fiscal policy actions by government



## Keynesian Theorists

- For Keynesians, there is a strong role for government and the public sector
- Contrasts with Schumpeterian positions of focusing on the private sector as the basic engine of the economy
- Their simple prescription was for government to spend during recessions and tax to pay for its spending during expansions

## Friedman and the Monetarists

- Monetarists believe that fluctuations in the money supply are principal causes of fluctuations in national output and price level
  - Milton Friedman saw the role of the Central Bank as that of keeping money supply and demand in equilibrium
  - Because for Friedman, “inflation is always and everywhere a monetary phenomenon”
  - But Keynes suggested that “money does not matter”



## Friedman and the Monetarists

- While Keynes explained the Great Depression as lack of investment by the private sector, Friedman [and Schwartz] attributed it to acute shortage in money supply
- They also argued that post-war inflation resulted from over-supply of money

## Friedman and the Monetarists

- Monetarism's popularity accelerated when unemployment and inflation were rising at the same time in the early 1970s
  - Higher unemployment called for fiscal spending
  - But higher inflation called for fiscal restrictions (and taxation)
  - This marked the beginning of the end of Keynesianism as a serious policy tool
- The Fed Chair at this time was a monetarist – Paul Volcker – and his sole aim was to fight inflation
  - A similar focus seen in the last two Fed Chairs

## Which One?

- But Joseph Stiglitz has pointed out that when inflation is low (as we have seen in recent years), the relationship between it and money supply is weak
- We know there is a risk of inflation with over spending to arrest a recession
- But the economic system will continue to expand and decline in response to the cumulative decisions of its agents



## What to Do

- The fight for dominance will continue because academics have vested interests in these theories and policymakers need something to depend on
- So let's get back to the assumptions we started with
  - The economy is made up of individuals economic agents—consumers and business owners
  - Who respond to incentives and react to signals
  - Any interventions attempting to correct certain behavioral outcomes distort the quality of the signals economic agents receive
  - Leading to unexpected consequences—e.g., inflation, unemployment, credit crisis, etc.

## What to Do

- As households (consumers) and business owners (businesses), our objective is clear
  - To maximize the returns to our most-limiting investments – money, time and effort *ad infinitum*
- Which means we need to *insulate* ourselves from the adverse effects of the system even as we take full advantage of its beneficial effects

## What to Do

- Think strategically about your business
- Define your purpose as incessantly creating innovative value for your customers
  - Understand what customers truly value in your industry
  - Find out how you may redefine the boundaries of your market and expand demand
  - Look for tangible and intangible points of value differentiation
  - Move into uncontested markets and make competitors irrelevant
  - While influencing policy and simultaneously insulating yourself adverse policies

## Thank You

Contact Information  
Dr. Vincent  
785-532-3520  
Email: [vincent@ksu.edu](mailto:vincent@ksu.edu)