THE BIRTH OF MACROECONOMICS

The 1930s marked the first stirrings of the science of macroeconomics, founded by John Maynard Keynes as he tried to understand the economic mechanism that produced the Great Depression.

After World War II, reflecting both the increasing influence of Keynesian views and the fear of another depression, the U. S. Congress formally proclaimed federal responsibility for macroeconomic performance. It stated: "... (It) is the continuing policy and responsibility of the federal government to use all practicable means consistent with its needs and obligations to promote maximum employment, production, and purchasing power.

"For the first time, Congress affirmed the government's role in promoting output growth, promoting employment, and maintaining price stability.

Since the 1946 Employment Act, the nation's priorities among these three goals have shifted; but in the United States, as in all market economies, these goals still frame the central macroeconomic questions:

Why do output and employment sometimes fall, and how can unemployment be reduced?

All market economies show patterns of expansion and contraction known as business cycles. The last major business-cycle downturn in the United States came in 1990-1991, when production of goods and services fell and millions of people lost their jobs. For much of the postwar period, one key goal of macroeconomic policy has been to use monetary and fiscal policy to reduce the severity of business-cycle downturns and unemployment.

From time to time countries experience high unemployment that persists for long periods, sometimes as long as a decade. Such a period occurred in the United States during the Great Depression, which began in 1929. In the next few years, unemployment rose to almost one-quarter of the work force, while industrial production fell by one-half. European countries in the 1990s had a mild depression, with persistent unemployment of over 10 percent in many countries.

Macroeconomics examines the sources of such persistent and painful unemployment. Having considered the possible diagnoses, economics can also suggest possible remedies, such as adopting stimulative demand policies or reforming labor market institutions by reducing the incentives not to work or increasing wage flexibility. The lives and fortunes of millions of people depend upon whether macroeconomists can find the right answers to these questions.

What are the sources of price inflation, and how can it be kept under control?

Economists have learned that high rates of price inflation have a corrosive effect on market economies. A market economy uses prices as a yardstick to measure economic values and as a way to conduct business. During periods of rapidly rising

prices, the yardstick loses its value: People become confused, make mistakes, and spend much of their time worrying about inflation eating away at their incomes.

Rapid price changes lead to economic inefficiency. As a result, macroeconomic policy has increasingly emphasized price stability as a key goal. In the United States the overall rate of inflation has fallen from more than 10 percent per year in the late 1970s to less than 3 percent per year in the mid- and late 1990s.

How was the United States able to put the inflationary tiger in the cage? Macroeconomics can suggest the proper role of monetary and fiscal policies, of exchange-rate systems, and of an independent central bank in containing inflation.

How can a nation increase its rate of economic growth?

Above all, macroeconomics is concerned with the long-run prosperity of a country. Over a period of decades and more, the growth of a nation's productive potential is the central factor in determining the growth in its real wages and living standards.

During the last 25 years, rapid economic growth in Asian countries such as Japan, South Korea, and China produced dramatic gains in living standards for their peoples. A few countries, particularly those of sub-Saharan Africa, have suffered declining per capita output and living standards over the last two decades. Nations want to know the ingredients in a successful growth recipe. They want to understand why high rates of investment and saving usually have a big payoff in promoting economic growth.

They want to understand the role of budget deficits and industrial policies in promoting growing living standards. They ask about the role of investment in research and development and in human capital. A final complication in considering the three central issues is that there are inevitable tradeoffs among these goals.

Increasing the rate of growth of output over the long run may require greater investment in knowledge and capital; to increase investment requires lower current consumption of items like food, clothing, and recreation. Of all the macroeconomic dilemmas, the most agonizing is the tradeoff between unemployment and inflation.

High unemployment and high inflation produce economic distress and political unrest. But when output rises too rapidly and unemployment falls, the situation tends to drive up prices and wages. Policymakers are forced to rein in the economy through macroeconomic policies when it grows too fast, or when unemployment falls too low, in order to prevent rising inflation.

There are no simple formulas for resolving these dilemmas, and macroeconomists differ greatly on the proper approach to take when confronted with high inflation, rising unemployment, or stagnant growth. But with sound macroeconomic understanding, the inevitable pain that comes from choosing the best route can be minimized.

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