<u>Another (Macro) Defence of Economics 101</u>

Christopher Ragan
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Six weeks ago I wrote a column defending economists against the allegation that we fill our students' minds with useless theories. I argued that the content of Economics 101 is invaluable to organizing their thinking and helping them sort through the many economic phenomena they encounter, either in their daily lives or in the news. But my arguments were all about "micro" economics; today I focus on "macro" economics.

Microeconomics is the study of individual markets and the players in those markets. Macroeconomics focuses not on the detail within any specific market but on how all markets come together to create the aggregate level of economic activity, usually measured as GDP. It examines why GDP ebbs and flows over periods of a few years, and also why it tends to grow gradually but inexorably over the longer term.

The causes of the economy's business cycles – those ebbs and flows – are central to most macroeconomic discussions. And we get pretty quickly to a related discussion: whether government should attempt to dampen or stabilize these cycles and, if so, how best to do so.

The first main stabilization tool is fiscal policy, the government's changes in spending or taxation designed to influence the economy. Students learn early in Economics 101 how, during recessionary times, when there is elevated unemployment and excess productive capacity, "fiscal stimulus" can be effective in increasing GDP – and the "multiplier" shows how the final change can actually exceed the size of the government's policy action. There is no better recent example than the Canadian government's 2009 budget, which contains a considerable discussion of the size of the fiscal multipliers the government assumed when designing its two-year stimulus program.

The second major tool for stabilization is the central bank's monetary policy, which works through interest rates and financial markets to influence the overall level of economic activity. Since very few people actually understand the workings of financial markets, an aura of mystique has developed around central banks – complete with plenty of wacko, conspiracy-type theories. Yet the essence of central banking is actually pretty straightforward, once you come to understand the central bank's balance sheet, how the bank "prints money", and how it injects that money into the commercial banking system. A good course in Economics 101 addresses it all, including why the U.S. Federal Reserve's unprecedented four-fold expansion of its balance sheet was necessary in the aftermath of the 2008 financial crisis.

Another major macro lesson that comes from Economics 101 is to understand the *limitations* of both fiscal and monetary policy. Faced with a deep recession, fiscal stimulus may be very effective over a period of a few years, but for very sound reasons we should not expect its effects to last beyond that. And while central banks can have a profound influence over GDP, employment, and investment over a few years, most of these "real" effects of monetary policy get unwound over the longer term; its legacy applies mostly to the price level and the rate of inflation. The crucial distinction between the short run and the long run in macroeconomics, including the different effects of various macro policy instruments, is one of the most difficult things for students to really grasp. But that understanding starts in Economics 101.

Many other important topics are covered. The social cost of unemployment is there, as is the types of policies that can be used to reduce (but not eliminate) unemployment. The dangers of high and volatile inflation are discussed, as is the operation of the inflation-targeting regimes now used in many countries, including Canada. The nature of government debt is addressed, as is the sensible case for using debt to finance genuine public investments – but also the dangers associated with having too much public debt. And no Canadian course in Economics 101 would be complete without a discussion of the exchange rate, the causes of its fluctuations, and why any given change likely creates as many winners as it does losers.

Macroeconomics as taught in Economics 101 is certainly not perfect. There remains plenty of debate about how the economy *really* works, how various policy instruments *really* influence the economy, and which policy is *really* the best for addressing any given problem. But this is as it should be: over time, our experience and knowledge improve, and the debates narrow. Economics 101 lives on – and will for many years to come.

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Christopher Ragan is an associate professor of economics at McGill University and a research fellow at the C.D. Howe Institute.