Farrokh K. Langdana

Macroeconomic Policy

Demystifying Monetary and Fiscal Policy

Second Edition

Springer

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Macroeconomic Policy is a lively and informative introduction to the diverse doctrines of macroeconomic theory.

Prof. Robert E. Lucas, Jr., Recipient of the 1995 Nobel Prize in Economics

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Dr. W. Michael Cox, Senior Vice President and Chief Economist, Federal Reserve Bank of Dallas, and co-author of Myths of Rich and Poor

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Foreword by W. Michael Cox

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To my wife, Mary

Foreword

Macroeconomic policy analysis has been in a state of flux since the early 1970s. Although the casual student of macroeconomics might expect that economists would have come to some agreement in our quest to model the so-called real world, the analysis of macroeconomic policy has perhaps never been so confounding as it is today. Each monetary or fiscal policy event is almost inevitably followed by at least two completely different and conflicting sets of analyses.

Consider, for example, the question of whether government spending affects GDP growth. One can find just about any answer to this question possible—some say it increases GDP, some that it decreases GDP, and some claim no effect. Others go on to claim that the answer depends on whether the economy is a developed one, such as the US, or an emerging one, like China.

Another central source of confusion is the proverbial Phillips Curve, which, as originally conceived, related the unemployment rate to wage inflation. Some researchers have found an inverse relationship between these variables; others have found no link at all. What's more, the economics profession has introduced new and improved variants on Phillips' tradeoff theme—inflation versus unemployment rates, inflation versus GDP growth, inflation versus capacity utilization, and so on. For each of these postulated relationships, virtually any conclusion can be found. And to confound things even more, the conclusions appear able to change over time as the economy changes. The statistical evidence from the much-heralded "New Economy" of the late 1990s seems to suggest that rapid GDP is linked more to *low* than high inflation. Will the real Phillips curve relationship please stand up?

Conceivably, there are as many interpretations of economic phenomenon as there are economists to interpret them. All this may be well and good from the standpoint of the passionate researcher, who makes a living in an endless search for the Holy Grail. But for the typical student, less interested in contrast and more interested in conclusions, the result can be a state of confusion as he or she moves from class to class, from book to book, or from publication to publication. Finding the truth for economics students has become a bit of a mystery.

Enter Farrokh Langdana's book, aptly titled *Macroeconomic Policy: Demystifying Monetary and Fiscal Policy*. Not only does the book shine a bright light through the dense fog surrounding economists' centrist position on macroeconomic thought, it does so with a set of tools virtually all readers can handle. The cumbersome mathematics that most modern economists love but most students loathe, are put aside in favor of teaching tools with wider appeal.

Even economists have recognized that as our profession has aged, our language—both verbal and quantitative—has become more convenient and precise for us, but less accessible and attractive to the general audience. So, what should the economics professor do? Economist Francis Edgeworth, writing nearly a century ago about Alfred Marshall, one of economics' original and first-class mathematicians, said that "Marshall, who desired above all things to be useful, *deferred to the prejudices of those that he wished to persuade* (emphasis added)." In other words, we should speak in the language of our audience, not our profession. Increasingly, the economics profession shuns this communication principle in favor of "rigor," all the while knowing that, as economist Robert Heilbroner said, "Mathematics has given economics rigor, but alas, also mortis."

The Bureau of Labor Statistics estimates that there are roughly 135,000 economists in the US out of a population of roughly 287 million. This figures out to be 1 economist for every 2,126 people. Must not it be important to speak to the other 2,125, not just to the one? Of course, and thus this book is written for you, not for economists.

When Richard Alm and I wrote Myths of Rich and Poor, we set out to debunk a series of widely accepted myths that the US was lagging behind economically, and that its citizens were getting progressively worse off. We accomplished the complete dismantling of such myths by presenting systematic overwhelming evidence that the US has been prospering splendidly in recent decades, and we did so using the only tool possible for such a large audience—common sense. The reaction to our book has been tremendous because we spoke eye to eye with folks, not above their heads.

Macroeconomic Policy: Demystifying Monetary and Fiscal Policy takes on an equally important task—to show the reader that modern macroeconomic analysis is systematic, with logical frameworks within which economies can be successfully analyzed, and to do this without the use of overly fancy techniques. The applied and intuitive approach to the theory centers on diagrammatic derivations, using only the minimal techniques necessary to prove its points. While the book approaches analysis primarily via applications and analysis, the vital theoretical underpinnings have not been sacrificed.

As a long-time professor of economics, a practicing economist and an author, the teaching approach that I find most compelling is the "applications method." Begin with an important issue (such as supply side economics) at least vaguely familiar to just about anybody, set out the central opposing views with the intuition behind each side, then examine the evidence and thrash out the conclusion. That's the best teaching approach because that's the way people think and work.

And thus it is with Professor Langdana's book, we have a text that is first and foremost applications oriented. That's why MBA and Executive MBA students will find this book indispensable, financial analysts may like to have it on hand as an essential reference, and even a general audience can find it useful.

The overview chapter clearly and concisely states the book's position regarding its focus on intuition and applicability. The notion of allowing the reader the freedom of choice between the Keynesian or the Supply-Side paradigm for developed economies is fresh and radically different from most conventional macroeconomics texts. In addition, it is an honest approach, given that both monetary and fiscal policy makers in Washington D.C. still make policy based on assumptions behind each paradigm.

The author states that he has taken care not to influence the reader towards either paradigm and he has faithfully managed to keep the promise throughout the text. The coverage is carefully balanced, with the excellent chapter on the New Economy (Chapter 10) being especially pertinent to the two-model approach. In the chapter on monetary policy (Chapter 11), Farrokh Langdana and Giles Mellon actually discuss the fact that reserve requirements are not binding any more in the United States. This is one of very few texts that have managed to cogently explain how the conventional textbook explanation of open market operations and the "money multiplier" has substantially changed in several major economies.

The simulated "media articles" following each chapter are vital to this text and to truly analyzing macroeconomic policy in general. It rapidly becomes evident through the clarity of exposition why the author has been consistently rated so highly as a teacher.

Federal Reserve Bank of Dallas W. Michael Cox
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Dr. W. Michael Cox is Senior Vice President and Chief Economist at the Federal Reserve Bank of Dallas, Professor of Economics at Southern Methodist University, and co-author (with Richard Alm) of the highly acclaimed *Myths of Rich and Poor: Why We're Better Off Than We Think* (nominated for a Pulitzer Prize). He is a regular contributing columnist for *Investor's Business Daily*. In addition to being a frequent guest on CNN, Voice of America and National Public Radio, Dr. Cox is past President of the Association of Private Enterprise Education, a CATO Institute Adjunct Scholar, senior fellow at the National Center for Policy Analysis, and senior fellow at the Dallas Fed's Globalization and Monetary Policy Institute.

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This book would, quite simply, not have been possible without the assistance and encouragement of many people.

I begin by thanking Prof. Robert E. Lucas of the University of Chicago, the recipient of the 1995 Nobel Prize in Economics, for his comments and suggestions pertaining to my experimental testing of his paradigm-busting "islands" model (Chapter 10). Prof. Lucas' work has been a source of encouragement and inspiration to me as well as to generations of macroeconomists over the last three decades.

Dr. Michael Cox, Chief Economist and Senior Vice President of the Federal Reserve Bank of Dallas, and co-author of *Myths of Rich and Poor: Why We Are Better Off Than We Think,* took time off from his busy schedule to write the foreword for this book, and for that I am most grateful. Dr. Cox, who is also Professor of Economics at Southern Methodist University, has drawn upon his experience as economist, professor, and author to eloquently describe the challenges faced in analyzing as well as teaching macroeconomic policy today. In a few short pages, he has deftly managed to home-in on the very essence of the book.

I remain extremely grateful to my former colleague Professor Giles Mellon at Rutgers Business School with whom I co-authored most recently, "Monetary Policy in a World of Non-Binding Reserve Requirements." I thank Giles for his invaluable assistance with Chapter 11 in which we "blow the whistle" on the fact that, in reality, central bank open market operations in most developed economies have very little in common with conventional textbook discussions on the subject.

I am indebted to my co-author of two books (and a well-received paper on Confederate financing in the US Civil War), Prof. Richard C.K. Burdekin of Claremont McKenna College and Claremont Graduate School, for his comments, suggestions, and detailed structural advice related to the draft of the first proposal. Thanks also to Professors Mark Castelino, Leonard Goodman, and Menahem Spiegel for their extremely valuable comments that enabled the proposal to evolve into the first draft.

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