

**Economics 448W – Current Macroeconomic Issues
Midterm Essays**

**Prof. Steven Fazzari
Spring, 2019**

Due: Thursday, April 4

This assignment consists of three independent essays, equally weighted for grading. As usual, please e-mail your answers to Professor Fazzari (fazz@wustl.edu). Send three files, a separate file with the answer to each question, labeled with your last name followed by -MT1-2, -MT2, and -MT3. While there is no strict length limit, make sure that every aspect of your answer relates directly to the question. It is unlikely that you will need more than 1,500 words for any of the three essays (and possibly much less) to provide focused and complete answers.

You will submit your first draft for question 1 before spring break and you will receive feedback helpful for the revision. Submit your final version of question 1 along with questions 2 and 3 on the due date above.

As always, pay careful attention to the sentence structure, clarity, precision, and logical coherence of your writing. Make sure you write a first draft of all your answers and then revise them after some time has passed. (There will be no revision grades for questions 2 and 3). Polish your writing carefully before you hand in your assignment. Redundancy or discussion of irrelevant details will affect your grades on these essays.

Again the target audience is other students in the class. Therefore, you may use common terms or notation from our class discussions without detailed definitions. Make sure, however, that you present the logic of your analysis in enough detail that your peers could fully understand what you write.

Your primary source for material to complete this assignment comes from our class meetings. I also encourage you to use readings on the course web site as well. Parts of all of these articles are directly relevant to the questions. A few choice quotations from readings could surely provide good support for arguments in your answers. Also, the questions ask you to refer to blog or news articles available on the assignment page of the course web site. Make an effort to link your answers to these discussions of “current macroeconomic issues.”

Question 1

Assigned earlier. Turn in your revised essay on the due date.

Question 2

In the aftermath of the Great Recession, journalists and some economists have paid more attention to the Keynesian “paradox of thrift” idea. Read the *New York Times* blog post from Paul Krugman that lays out a paradox of thrift argument (August 26, 2010, posted on the assignments page) and answer the questions below.

- a) Define the paradox of thrift as it is described in this post. Explain why it is labeled a “paradox.”
- b) Critics of the paradox of thrift have said things like “money that is not consumed will be invested, so what’s the problem?” Provide a critique of this logic from the perspective of the Keynesian macroeconomic model. (Hint: consider the different mechanisms in the loanable funds market between the classical and Keynesian models.) How does your critique motivate the basic logic of Keynesian theory?
- c) Krugman writes in “normal times” a rise in saving allows “the Fed to cut interest rates, making capital cheaper.” Explain why this perspective is different from the effect of higher saving in the basic classical model. What kind of macroeconomic model would be consistent with Krugman’s description?
- d) Explain Krugman’s claim that higher saving can actually *reduce* investment, rather than just leave investment at the initial level. Identify the structure of a macroeconomic model that would lead to this result. (Hint: think about how investment demand might depend on the strength of the economy overall.) In such a model, how does an increase in the desire to save affect the equilibrium level of saving?

Question 3

News coverage of labor productivity over the past several years has created a debate. Almost all economists believe that growth in labor productivity is the key to rising standards of living, at least over long horizons. When slow job growth occurs, however, it is common to read that if workers become more productive the economy will need fewer workers and therefore create fewer jobs. One example is an Associated Press article from the immediate aftermath of the Great Recession: “Productivity Gains may be Bad News for Job Seekers” by Crutsinger and Manning. More recently arguments over immigration policy spilled over to the productivity issue: we don’t need more immigrants because “the robots are coming for our jobs” as summarized in a *Washington Post* article by Heather Long. (Links to both articles are posted on the course assignments page.).

This question asks you to compare the logic that links labor productivity and the job market according to the major macroeconomic models we have developed in class. Begin by analyzing the effects of higher labor productivity on the macroeconomic equilibrium in the classical model. Draw the relevant diagrams (use the “four-quadrant” approach we developed in recent classes based on the 1998 Fazzari-Ferri-Greenberg paper) and briefly explain classical predictions about the effect of higher productivity on employment, output, the price level, the nominal wage,¹ and the real wage. Then consider how the results would change in the two Keynesian models: the “conventional” model with a downward sloping AD curve and downward sticky nominal wages and the “intrinsic” Keynesian approach with a flat AD curve.

Which side of the productivity debate is right, according to each of the models? Link your analysis back to the arguments in the articles.

Note: For this question, I encourage you to assume that the marginal productivity of labor and the negative inverse elasticity of demand (“ ϵ ”) are both constant. These two assumptions make the FM curve flat. This approach can be used for *all* models (including the classical) without changing the substance of the answer, and the flat FM will make drawing the diagrams and finding the general equilibrium points much easier.

Also, you do not need to go to great lengths to make electronic diagrams. You may attach scans or photos of clear and legible hand-drawn diagrams to your answer, or you may hand in hard-copy diagrams in class.

¹ Here’s a helpful hint. The effect on the nominal wage in the classical model is ambiguous, depending (among other things) on the slope of the AD curve. Think about which direction of nominal wage movement following the productivity shock makes the analysis most interesting and proceed from there.