

## Why Macroeconomic Theory is Not Enough,

for Business Students and General Readers

*by Anne Emerson*

Macroeconomic Theory, as it was taught in my day - and I don't think it has changed much - talks about "Aggregate Supply" and "Aggregate Demand". As discussed elsewhere on this website, aggregates and averages can be misleading. They can convey the idea that all is well, or at least comfortable, when in fact it may not be.

Consider a basket of apples. Three of them are very small, say about one inch in diameter. Two are a little larger, say about two inches in diameter. And one is very large, say about five inches in diameter. When we average over these six apples, we add up the diameters of them all, and divide by six, to get an average size of apple. (Now, don't bother me about Pi and volume or any of that stuff. They're apples, not pies. And I'm giving a simple example.)

$$1 + 1 + 1 + 2 + 2 + 5 = 12$$

And my math teacher said, don't put a dividing line under that 12 as you proceed. Go to the next line and make the next step another equality (the abstract idea of a total diameter of 12, divided by six apples). It's less confusing that way.

$$12/6 = 2.$$

So, we might think, if we weren't being careful, that each apple is about two inches in diameter. That's not very big, but probably big enough that we think it's ok. But how might the people feel who get the one-inch apples, especially when they compare their situation against the person with the five-inch apple? The latter would make a bigger pie, right?

So, macroeconomists talk about the "economic pie." That is, in some sense, everything the economy produces. How we divide up the economic pie is someone else's job. Macroeconomists just want to make the pie bigger. So, let's think of a pie now. It can even be an apple pie! We make it bigger by throwing in more apples and other ingredients, including, say, currants. Then we bake it, but we are not done yet.

Now we have to serve it! In my house, growing up, the person who cut the pie was the last person to choose which piece he or she would eat. That was a pretty good way to ensure that the pie was cut evenly. But the economic pie is not so simple! Let's keep the pie analogy. If the family gangs up on little sister, then they can make sure she gets the last piece, every time. We explain to her that she is the youngest, and when she grows up it will be different. Or, if Dad makes the rules, he can make sure he gets the biggest piece, every time. He explains that he is the breadwinner and he deserves it. Perhaps he forgot that Mom baked the pie, which took time and effort too. And that children need to learn how to behave when they are older. (Maybe none of the above is true anymore; but that's how it worked in many people's lives when I was growing up.)

It is fairly easy to see how an apple pie gets divided up among a family; and fairly easy to decide whether or not we agree with the explanations given for the behaviors described above. If we are little sister we might disagree. If we are a conventional 1950s Dad, we are probably okay with getting

the biggest piece. I will add, complicating the matter, that a Dad who is big and tall and does a lot of hard manual work probably does need a bigger piece. It's biology!

But back to the economic pie – it is not so easy to decide how to divide up the pie. Who “deserves” a bigger piece? Who “needs” a bigger piece? Who makes the rules, who enforces them, and do we trust that person, or those persons? Around the time of Adam Smith, people were talking about a system which ran itself – which did not need king and subjects; which operated automatically, for everyone's benefit, if everyone did what they thought was best.

That is a fantastic idea, if it works! Well, the world was less complicated then, but I was chatting with a reenactor the other day, and he said no-one can know everything. In his world, he trusted his tailor to know how to make his clothes, his housekeeper to know how to run his house, etc., and he, himself, knew about the law. (He was a law professor, back in the day. And he had some excellent thoughts on how to build a system of just laws.)

Yet, once you have made the laws and institutions, clever people learn how to get around them, if they aren't convenient! It's human nature, but if you start out with more money, you probably have more options for doing that. So, the problem with macroeconomists who just want to make the pie bigger is that they don't consider the possibility that something about the tilt of the shelf in the oven makes the currants in the pie flock to one side of the plate or the other. So, if you like currants and you get a piece that doesn't have many, the macroeconomists aren't looking at how to fix the tilt of the shelf.

If you see what I mean...

Now, if any math-happier people (or expert pie-bakers) have been reading this and rolling their eyes, here's my best way to explain, briefly, what that means in more-technical, but still intuitive, terms:

Aggregate Supply and Aggregate Demand, for products and services, as well as for money, are abstract, theoretical concepts. Equilibrium, where supplies and demands are equal, is an ideal that is not always met in the real world. IF something is going on under the radar that moves money into one part of the system and out of another part of the system, in a way that does not self-correct, our macroeconomic models will not see it. That is not their job, actually, if we think their job is to make the pie bigger.

So, if we can change the narrative and suggest that macroeconomic advisors need to worry about how the pie is distributed, as well as how to make it bigger, we will have a challenge on our hands! I think that is where we are, today. Policy needs to be informed by economic reality; it should not be an arbitrary choice made by politicians who don't understand the full impact of their well-intentioned ideas. That is to say, that's how I see it. And, if you are not an economist, there will be some other realities that you think our leaders need to consider. But I think I have made a persuasive case that many of those other inequities can be mitigated by a change in the macroeconomic worldview.