Recent Macroeconomic Thought as an Interrupted Three-Cornered Cage Match: Greenspanists, Producerists, Punchbowlers—and Nihilists

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The Collapse of Old Keynesianism

Let me start my story in the 1970s. The 1970s saw the collapse of *Old Keynesianism*, which was the belief that government had the tools—fiscal policy expansion via deficit spending, monetary policy expansion via lowering interest rates and price policy via guidelines and what was called "jawboning"[1]—to maintain a stable economy at something we could call "full employment."

Old Keynesianism in America did not survive the stagflation of the 1970s.

[1] Which consisted mostly of pointing out to labor unions with pricing power on the wage side and large oligopolistic firms with pricing power on the product side that full employment was inconsistent with an inflationary spiral—and that if they would not moderate their wage demands and cut back their margins, then somebody would eventually do it for them via high unemployment and great excess capacity, and they would be sorry. Eventually Paul Volcker did do it for them (or rather to them) over 1979-1983, and they were sorry.

What succeeded it, as far as theories of macroeconomics that had application to economic policy were concerned, were more measured and cautious doctrines:

- The government could not maintain full employment and should not try.

- The government could, however, achieve some success at stabilizing employment and capacity utilization around "normal" levels and avoid deep recessions.

- The government did not, moreover, dare try to push the envelope of demand: That risked a repeat of the 1970s in which everyone began to expect that the Federal Reserve would let inflation rise just a bit above what people expected. That expectation had set off a spiral that eventually reached double-digit inflation. Such a spiral was too dangerous to risk.

These doctrines became a new, chastened conventional wisdom. They seemed to work well—for a time.

The Great Moderation

As the 1990s progressed, and even more so as the 1990s turned into the 2000s, macroeconomists began to breathe sighs of relief: finally, it seemed they and the world's central bankers had gotten it about right. They labeled the age in which we all lived the "Great Moderation," an era of low inflation, adequate growth (especially after 1994), and very small recessions. The economic catastrophes on the employment, production, and capacity utilization side of 1982 or 1975 (let alone those of 1933 or 1938) seemed to have been banished.

The global community of policy-oriented macroeconomists did not reach a smug worry-free consensus. There were grave worries about "global imbalances"—why was the U.S., the richest country in the world, a

country that ought to be lending to others and so helping them accumulate capital and grow richer, running the world's largest trade deficits ever?

Figure 1: The U.S. Civilian Employment-to-Population Ratio, 1950-2009

Why were the princes of Wall Street so well-compensated? Why was finance consuming such a large share of corporate profits? Stability in unemployment and capacity utilization seemed to imply instability in interest rates, especially on the downside when the Federal Reserve reduced its flagship "federal funds" interest rate to 1% per year in the

early 2000s: did not such instability in interest rate policy generate risks of its own? 1987, 1991, 1998, 2000—weren't the relatively-frequent near-financial crises in America telling us something? But these worries were for the most part whispers in the back of people's minds, as year after year production grew, prices remained stable, and large nationwide labor-market collapses were avoided—until now.

The Expected Three Sides in the Macroeconomists' Forthcoming Cage Match

Then came 2007-2009—or what I hope in the future we will call 2007-2009 rather than 2007-2010 or 2007-2012 or even worse—and the "Great Moderation" bubble was itself pricked. The Federal Reserve acted swiftly and aggressively in the wake of the subprime mortgage crisis to lower interest rates and encourage spending, and soon found it had lowered its flagship interest rates as far as they could go and the biggest recession since World War II still loomed. At the level of macroeconomic theory, there were two big questions:

- What should we do to try to fix the situation?
- What went wrong?

And the debate began.

I expected that the debate about policy-relevant macroeconomic theory in the wake of the financial crisis would involve three sides, which I will call:

- The Greenspanists.
- The Punchbowlers
- And the Producerists

I expected the *Greenspanists* to say that macroeconomic policy before the crisis had been just fine. The problem, I expected them to say, was that we were freakishly unlucky.

The Greenspanists had been riding high while Alan Greenspan held his eighteen-year tenure from 1987 to 2005 as head of the Federal Reserve. His three major policy principles were:

- The Federal Reserve should focus on pumping up demand to keep employment as high as possible without running any significant risk of running an inflationary spiral.
- The government should by and large keep its nose out of financial regulation—it should rely on investor self-interest and due diligence to minimize fraud and excessive leverage. Financial innovation promised benefits, and tight regulation of financial markets would kill a goose that promised to lay occasional golden eggs, even if it also laid eggs of another kind.
- If it turned out that such *Greenspanist* expansionary monetary and hands-off regulatory policies led to a bubble which then collapsed, the Federal Reserve would then step in to handle the situation and use its tools to contain the damage. It would keep disruption in financial markets from spilling over to the real economy and causing mass unemployment.

The problem in 2007-2009, I expected the *Greenspanists* to say, was that the system was struck by a perfect storm—a once-in-a-lifetime combination of errors and bad luck that exceeded the Federal Reserve's normal powers. The unfortunate consequence was a deep recession and a necessary resort to emergency policy measures of all sorts as the Federal Reserve's conventional monetary measures reached their limit and lost their virtue. But, they would say, this did not mean that there was *ex ante* reason to have made policy any different than it was. And there was no *ex post* reason to change the way the Federal Reserve and the other regulators acted.

I expected those who I call the *Punchbowlers* to take a different tack. I expected them to agree with the Greenspanists on regulatory issues—that under normal circumstances investor self-interest and due diligence would minimize fraud and excessive leverage; that financial innovation did

promise benefits, and tight regulation of financial markets would kill a goose that promised to lay occasional golden eggs, even if it also laid eggs of another kind.

But, I expected the Punchbowlers to say, there are some circumstances that are not normal and that subject financial markets to temptations that they cannot withstand. Excessively-easy monetary policy and excessively-low interest rates push asset prices up to unsustainable levels. Once asset prices reach unsustainable levels they keep on going. The pessimists who are short will have lost their money; the optimists who were long will have gained—and will now have larger stakes with which to be optimistic. Others who had been on the sidelines will see the profits to be earned by taking on more and more risk. Financial markets can stand many things, the Punchbowlers would say, but not a federal funds rate at one percent.

Thus I expected the Punchbowlers to say that the Federal Reserve committed an error in pushing interest rates as low as they could go without igniting an inflationary spiral. The Federal Reserve also needed to keep from pushing interest rates low enough to ignite a speculative bubble. And if the interest rate path high enough to avoid igniting overspeculation left a million or more workers who could have non-inflationary jobs jobless—well, that was unfortunate but that was karma. Attempts to push interest rates lower in the hope of boosting employment in 2004 and 2005 ran an unacceptable risk of in the end generating a 2009.

Thus I expected the Punchbowlers to say that monetary policy must not just keep interest rates high enough to avoid inflationary spirals, it must also keep interest rates high enough to avoid asset market bubbles—like the real estate bubble the collapse of which led to the subprime mortgage security losses that triggered the financial crisis that brought on the recession. The Punchbowlers follow former Federal Reserve Chair William McChesney Martin's dictum that the Federal Reserve needs to take the punchbowl away before the party really gets going: that's why I call them Punchbowlers. By contrast, the Greenspanists think that it is fine for the Federal Reserve to spike the party punchbowl with the grain

alcohol of a 1% federal funds rate so long as no inflationary spiral threatens.

The third faction I expected to see emerge was what I call the *Producerists* to agree with the Greenspanists on monetary policy. They disagree about financial regulation. Were he alive today, Henry George would be a producerist: the rewards to financial speculation today would arouse the same suspicion in him that the rewards to urban real estate speculation on the lands lapped by the waters east of the Golden Gate and north of the Verrazano Narrows aroused in the nineteenth century.

From the Producerist perspective, finance exists to (a) channel savings to firms undertaking investments; (b) allow those who have information about the long-term profitability of companies and industries to trade on that information, profit, and so push prices of assets closer to social marginal values; (c) provide a check on the unwarranted freedom-of-action of corporate executives; (d) spread risk; and (e) offer people convenience in handling their money. To perform these functions you need credit cards, checking accounts, savings accounts, plain-vanilla mortgages, stocks, and bonds. Everything else is pointless. It is a zero-sum casino at best. And it is in most cases an extraordinary dissipation of wealth, and a cruel hoax on many of the customers of the financial sector who are made to bear risks that they have no business bearing.

Therefore, the Producerists say, finance ought to be regulated within an inch of its life to minimize the prospects for bubbles, crashes, and crises while still preserving its abilities to provide convenience, to spread risk, to govern corporations, and to channel savings to investments.

I confess that I did not know which of the three sides in this cage match I looked forward to I would join. Up until the start of 2007 I had been a Greenspanist. I was not a Producerist. It is true that most of sophisticated finance is a hoax on many of the customers of the financial sector who are made to bear risks that they do not want to bear. It is true that allowing innovation in finance and corporate funding had led to great financial instability and near crises in 1987, 1991, 1998, and 2000 as well as 2007-

2009. But it did not seem to be such a bad thing to raise the market's risk tolerance—the behavioral financiers like Richard Thaler and Matthew Rabin tell me that investors are, by and large, much too fearful of many risks. The economists who study consumption behavior like Chris Carroll and David Laibson tell me that consumers are much too impatient. To pull a little wool over their eyes by financial legerdemain in the interest of getting them to save more and be less cautious in portfolio choice seemed to me to be an allowable deception—and it seemed to me that there had been at least some benefits from (some of) the waves of financial innovation.

Moreover, up until the current crisis, it seemed to me that there had been little costs. At the level of the economy as a whole, financial turmoil in 1987, 1991, 1998, and 2000 had little impact It was true some of the greedy, rash, and wealthy had lost some of their money in ill-judged investments and lost some more to the even-richer cardsharps of Midtown Manhattan. But had the rich who invested in the dot-com bubble decided instead to give $1 trillion to universities that promised to spend it rapidly on research into applied computing and communications technology we would have applauded—and that's what they did during the dot-com bubble. And had the rich who invested in subprime mortgage securities instead given $500 billion to charities to upgrade America's housing stock we would have applauded—and that's what they did during the real estate bubble. Admittedly, charities seeking to improve America's housing stock would have built three-story multi-unit buildings near shopping and transit rather than five-bedroom houses with swimming pools hours from everywhere in the desert between Los Angeles and Albuquerque, but you cannot have everything.

And I was not a Punchbowlist because it seemed to me that to have had had higher interest rates and higher unemployment just to make the financial markets quieter and more placid places would have been a bad bargain.

Today, of course, I am undergoing an agonizing reappraisal. We confident former Greenspanists can no longer be Greenspanists—can no longer be

confident Greenspanists at least. And the Producerists and Punchbowlers are both pushing their agendas, and they have powerful arguments on their sides.

Thus I looked forward to the debate, and I had little sense of how policy-relevant thought about macroeconomics was going to develop. But then I was surprised.

Enter the Nihilists…

But for the past nine months or so this three-cornered cage match has been suspended. I was very surprised when, in late 2008 and 2009, the rhetorical heat in macroeconomics was generated by a fourth position that seemed to me to come out of nowhere. For there appeared a group of economists saying that there was, at some level, either no problem or no problem that was fixable. They said that Greenspanists, Producerists, and Punchbowlers were all wrong in believing that their was an extraordinary situation that required extraordinary policy measures. They said that normal monetary policy should suffice—or if it didn't suffice then it was still the best that we could do. They said that they "did not get" the concern with propping up the banking sector: let the banks fail as long as the money stock did not fall, they said. They said that the belief that expansionary fiscal policy had a role to play was a "childish fantasy."

(An aside: In that claim, it seemed to me at least that they were being extraordinarily anti-market. 2008 saw a collapse in the price of private bonds and a large increase in the value of government bonds. The market tells us that when something falls in price you should make less of it and when something rises in price you should make more of it. The way you make more government bonds is by having the government spend more and run a deficit. But I digress.)

These—I can only call them Nihilists—said that the Producerists were wrong in thinking that finance needed tighter regulation. They said that the Punchbowlers were wrong in thinking that irrational exuberance and other market failures were so large as to require the government to exert either

sporadic or constant downward pressure on asset prices to curb animal spirits. They seemed most in agreement with Greenspanists—and their criticisms of Greenspan were overwhelmingly that he had not been pro-market enough, that he had not deregulated finance enough, that if only the government had been less interventionist in financial markets and in monetary policy everything would have been fine.

They seemed to me to treat Alan Greenspan much as Job of the Bible was treated by his three “friends”: Eliphaz, Bildad, and Zophar. You remember Job: a guy whom God himself calleth “an honest and an upright man, who feareth God and escheweth evil.” Job winds up weeping on a dungheap, covered with boils, starving, penniless, with all his family dead—and Eliphaz, Bildad, and Zophar come up to him and say “Boy! You must be a huge sinner! Or none of this would have happened to you!”

Thus we have David K. Levine of Washington University in St. Louis saying that all extaordinary stimulative policies should be cut off right now—“we are recovering… isn't that evidence it isn't needed?”—never mind that extraordinary policy measures are appropriate not just while capacity utilization is falling but as long as it is low. We have John Cochrane of the University of Chicago saying that it is logically impossible for government spending to boost employment—for that “requires that people make logically inconsistent plans to consume more, invest more, and pay more taxes with the same income”—never mind that Milton Friedman’s Chicago monetarism was based on models in which changes in the money stock made people in aggregate to make such inconsistent plans. We have Edward Prescott of Arizona State say that there is no danger of a depression now, and in fact there would not have been a depression in the 1930s if not for “Herbert Hoover's anti-market, anti-globalization, anti-immigration, pro- cartelization policies… [that] created a great depression..."—never mind that Hoover thought he was a right-wing pro-market laissez-faire president. We have Michele Boldrin from Washington University writing that “[p]eople are worried about the future and are sensibly reducing their spending. Does this imply the government should step in and do the spending for them? Put that way, the idea seems like a non-starter..."—never mind that while people are less

willing to hold the bonds that fund private investment spending they are more willing to hold the bonds that fund government spending, and the first principle of markets that you should make more of something when people find it more valuable applies to government bonds just as well as it applies to everything else.

They do so in a manner that seems somewhat less than polite. David Levine—about whom I do not believe Paul Krugman has everwritten an unkind word—writes an open letter to Paul in which he claims it is “a daunting task to bring you [Paul Krugman] up to date on the developments in economics in the last quarter century. I know that John Cochrane has tried to educate you about what we've learned about fiscal stimulae [sic] in that period...”[2]

It is John Cochrane who falsely writes “[that spending can spur the economy] is not part of what anybody has taught graduate students since the 1960s. They are fairy tales that have been proved false. It is very comforting in times of stress to go back to the fairy tales we heard as children but it doesn’t make them less false." It is Robert Lucas of the University of Chicago who says that President Obama’s Council of Economic Advisers Chair Christy Romer does not believe the arguments she makes to support her conclusion that the stimulus boosted second-quarter growth measured as an annual by 2.3%: “somebody says, you've got to come up with a solution to this--in defense of this fiscal stimulus, which no one told her what it was going to be, and have it by Monday morning.... [I]t's a very naked rationalization for policies that were already, you know, decided on for other reasons...”—and let me assure Robert Lucas that Christy Romer, and Ben Bernanke, and Tim Geithner, and Peter Orszag, and Larry Summers within the administration believe what they are saying. So does Doug Elmendorf at the Congressional Budget Office. So do outside forecasters who make their living getting

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[2] The boy in me who took Latin in high school winces: female nouns that end in –a change to –ae to mark a plural, male nouns like stimulus that end in –us change to –i to mark a plural

people to actually pay for their forecasts like Larry Meyer, Joel Prakken, and former McCain advisor Mark Zandi.

It is Edward Prescott who says: “If you go down to the third-tier schools, yes,” you find economists approving of emergency policy actions, “but they're not the people advancing the science..." And it is Eugene Fama of the University of Chicago who claims to have never read the best book ever on financial crises and their macroeconomic impact: my old teacher Charlie Kindleberger’s *Manias, Panics, and Crises*.

Now the Nihilists I just quoted include two past Nobel laureates—and, I would have said before this year, three future ones as well. These are not people at the fringes of the economics profession.

Why Did the Nihilists Gain Influence?

Nevertheless, I would be ignoring the Nihilists right now were it not for the fact that they have gained political traction in the form of becoming the house economists of the Republican Party. That in itself is very odd. Last fall, you see, the divides were not Republican-Democratic divides. Ben Bernanke and Hank Paulson and Phil Swagel (Republicans) were on the same page with respect to the need for emergency policy actions above and beyond normal monetary policy as were Larry Summers and Tim Geithner (Democrats). McCain advisors Doug Holtz-Eakin and Mark Zandi were on the same page as Obama advisors. Talk to any of them today, and they have criticisms of how the extraordinary banking, monetary, and fiscal policies we have seen this year have been implemented and think that in many cases they have long-run costs that make them not worthwhile, but as Phil Swagel says, “anyone who tells you [the fiscal stimulus] has had no impact,” as the nihilists do, of them “you should be skeptical of” for “[I]t is a gigantic amount of fiscal stimulus” and is “starting to play a role, helping us to have slightly positive rather than slightly negative GDP growth…”

What appears to have happened, I think, is that the Congressional Republican Party has made a decision that if they oppose everything

President Obama proposes—no matter if it is exactly what Treasury Secretary Paulson or General Petraeus was doing last year—then they stand a good chance of making Obama's presidency appear a failure, and then of taking seats back in the next congressional election. But in order to oppose extraordinary policy measures to fight the recession, they need an argument. They cannot get the argument from the economists who were advising Bush or McCain last year: they are as much in favor of monetary, banking, and fiscal policy measures as anybody. Yet the nihilists are hear at hand.

Now let me be clear: I don't mind people working for politicians who advocate policies in which they believe. And I don't mind the vitriol—these are important issues, and people should care a lot about important issues, and they will and should express that: I can take Edward Prescott telling me that the University of California at Berkeley is a third-tier university and that we are not "advancing the science"—indeed, I would be somewhat worried if someone who really does appear to think that Herbert Hoover's anti-market policies brought on the Great Depression thought that we were. Maury Obstfeld—who in a better world than this one would have shared the international economic Nobel Prize Paul Krugman won—can take John Cochrane's sneering claim that the models in Obstfeld-Rogoff are "fairy tales" and that Obstfeld only imagines he teaches them to our graduate students.[3] The ghost of the late Charlie Kindleberger can take Eugene Fama's claim that he is not worth reading and Fama's further claim that he has never read Kindleberger's Minskyite *Manias, Panics, and Crashes*.[4]

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[3] I do want to make an exception for Robert Lucas and Richard Posner. They have no business saying what they are saying explicitly and implicitly about Bernanke, Romer, Summers, Geithner, Orszag, Elmendorf, and company, and there can be no excuse.

[4] Which he should have. It is the best book on financial crises, associated asset [rice movements, and their macroeconomic consequences ever written.

The Nihilists vs. Milton Friedman, Jacob Viner, and Irving Fisher

What I do mind is that I cannot make sense of the Nihilists' views. Consider Robert Lucas's claims that expansionary fiscal policy cannot boost output and that there is no reason for special banking sector recapitalization policy:

> I avoided this bank bailout issue in my 15 minutes and there's a reason for it. I don't really get it. Some of the problems you're talking about deciding who gets paid and who doesn't, that's the whole function of bankruptcy law…. Now, it may be that the kind of neighborhood effects of the bankrupt banks are sufficiently different from the neighborhood effects of a bankrupt auto company—that they need some kind of special treatment. But then it seems like the right public policy is… some kind of accelerated bankruptcy proceedings. Just to say make them well on all the money they've lost over this thing, I just—I do not get it...

And:

> Would a fiscal stimulus… add another weapon that would help in this problem?… If the government builds a bridge, and then the Fed prints up some money to pay the bridge builders, that's just a monetary policy…. We can print up the same amount of money and buy anything with it… the only part of the stimulus package that's stimulating is the monetary part…

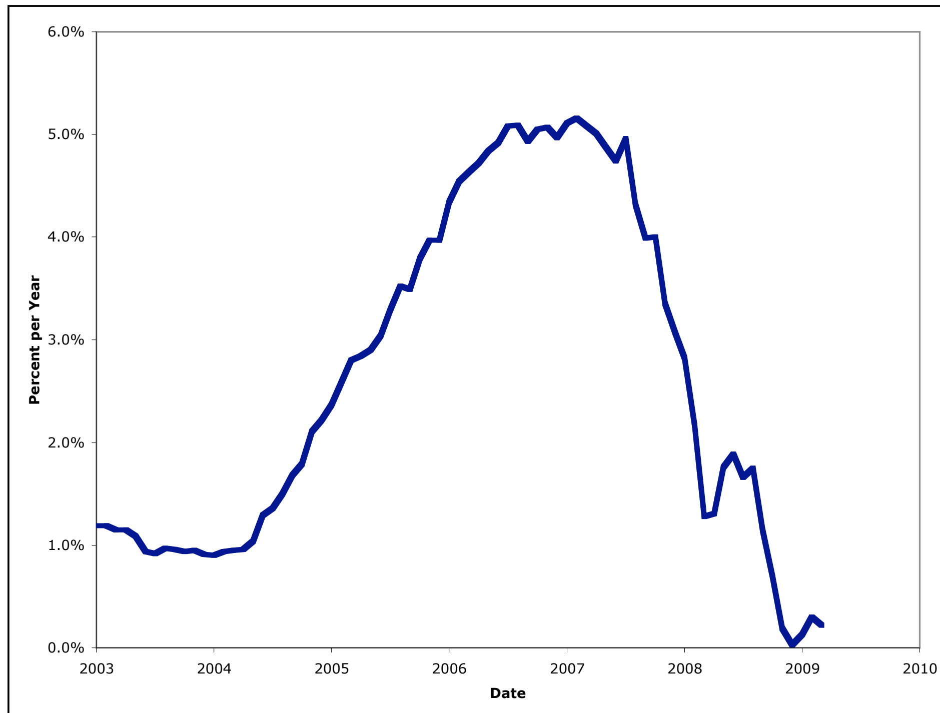
Let me give the responses that Milton Friedman would have given—that Milton Friedman's teacher Jacob Viner did give during the Great Depression—for extraordinary stimulative policies over and above monetary policy.

Start with the quantity theory of money—as far as I know nobody denies the quantity theory of money. It says:

$$MV = PY$$

Total spending in the economy—PY—depends on the quantity of money M in the economy and that quantity's velocity of circulation V. Money, you see, is valued because it id liquid: holding money provides you with the ability to buy goods and services quickly and easily. If you have money, therefore, you tend to want to spend it. Your wealth that you don't want to spend you keep in other forms that promise higher returns. Money burns a hole in your pocket.

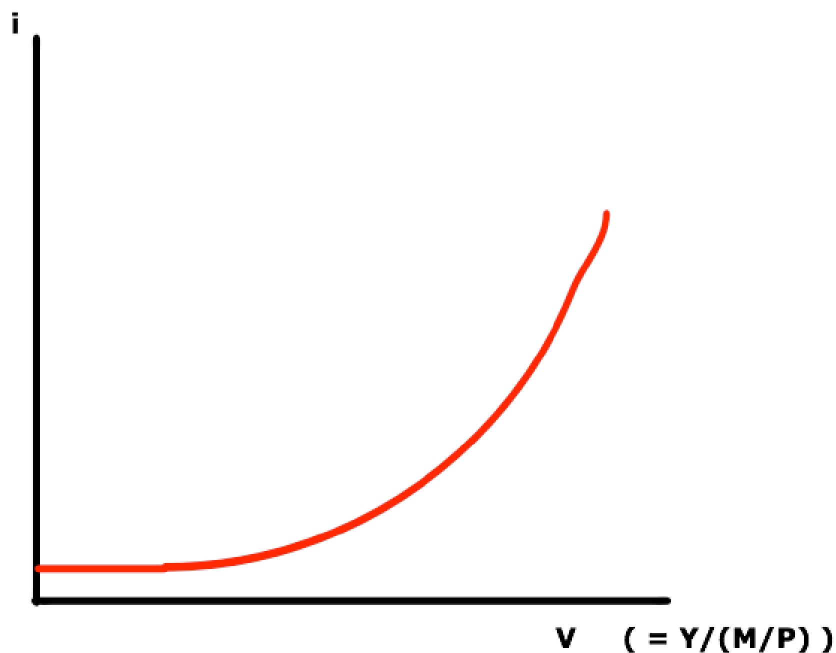
Figure 3: Nominal Interest Rate on Three-Month Treasury Bills



The Federal Reserve, therefore, can affect the flow of spending PY by altering the quantity of money. It can buy government bonds for cash. After it does so, there is more money in the economy—and people up their spending. It can sell bonds for cash. After it does so, there is less money in the economy—and people cut back on their spending. If you want to boost

spending—as the Federal Reserve has ever since it became clear in the summer of 2008 that the economy was falling into recession—Federal Reserve open-market operations of buying bonds for cash is the natural thing to do.

Figure 3: Velocity and the Interest Rate



However, the flow of spending depends not just on M but also on V. V—how fast people spend the money that is burning a hold in their pockets or in their checking accounts—depends on how big a hole it is burning. If you hold your wealth in money rather than short-term government bonds, you give up interest. When the interest rate on short-term government bonds is relatively high, like the 5% per year it was only a few short years ago, people have an incentive not to forget to spend the money that is in their pockets or in their checking accounts.

What, however, happens when the interest rate on government bonds gets very low—so low that you cannot imagine it can go any further? In that case, the opportunity cost of holding money rather than government bonds is zero. Bonds are at least somewhat risky: the interest rate might go up and then bond prices would drop. And if the current interest rate is very low, you aren't gaining anything by holding bonds to offset that risk. So when interest rates on short-term government bonds are very low, the velocity of money is very low too.[5]

As long as the short-term nominal interest rate is at "normal" levels—high enough that money and short-term Treasury bonds are not good substitutes—and does not vary much, then the Federal Reserve can keep the flow of nominal spending PY near where it wants that flow to be by normal open-market operations that alter the money stock M, raising the flow by buying bonds for cash when it wants to increase spending, and selling bonds for cash when it wants the flow of spending to decrease. If someone asks whether one should use other tools than open-market operations to attempt to manage the flow of nominal spending, the natural response is—as long as the short-term safe nominal interest rate is at some normal level—"for God's sake, why?"

In this quantity theory framework, fiscal policies—government deficits—work because a larger deficit raises the supply of bonds that households must hold, lowers their price, so increases interest rates, and increases the velocity of money. Why not just increase the quantity of money instead? Fiscal and banking-sector stabilization policies are roundabout ways of altering spending by altering velocity, and are subject

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[5] As John Hicks wrote back in 1937: "On grounds of pure value theory, it is evident that the direct sacrifice made by a person who holds a stock of money is a sacrifice of interest; and it is hard to believe that the nominal principle does not operate at all in this field…. Lavington… 'The quantity of resources… [held] in the form of money will be such that the unit of money which is just and only just worth holding… yields… a return of convenience and security equal… to the net [nominal, safe, short-term] rate of interest…" John Hicks (1937), "Mr. Keynes and the 'Classics': A Suggested Interpretation," *Econometrica* 5:2 (April), pp. 147-59.

to corruption, to rent-seeking, to very long and very variable lags, and have limited potential for effectiveness. Monetary policy seems much the preferred choice—for normal times.

Policies for Extraordinary Times

But what if times aren't normal? What if there has been for some reason or other a collapse in the risk tolerance of the private market such that the prices of risky private assets have collapsed, short-term Treasury bonds have gone to par, and the collapse in the opportunity cost of holding money has produced a class on velocity? You buy safe bonds for cash and you shrink the supply of safe bonds—raising their price and pushing safe interest rates and thus the velocity of money down even more. Even a big monetary impetus may have only a small effect.

Policies to do something that doesn't involve shrinking the money stock but yet raises safe interest rates and thus raises velocity appear more attractive. What are such policies? Four things come to mind:

1. Have the government issue a huge honking tranche of more bonds. If you expand the supply of safe government bonds, you lower their price—and thus raise the short-term safe nominal interest rate and so potentially boost velocity.[6]

2. Have the government guarantee private debts. The big reason that the short-term safe nominal interest rate is now low is that spreads are so high—that there has been a flight to quality. Having the government guarantee private debt reduces spreads as there is now effectively more public and guaranteed and less private debt out there, and that should bring asset values back to their normal configuration.

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[6] But what does the government do with the money? If it returns it to the public via tax cuts then they might save it leaving no net impact on the supply-demand balance. If it spends it on goods that are substitutes for private consumption they might cut back on their own consumption spending and save more, thus leaving no net impact on the supply-demand balance. The government needs to spend the money on something, and that something had better be something that is not a close substitute for private consumption spending.

3. Have the government forcibly recapitalize the banking system: if they have more of a net worth cushion, their tolerance for holding risk should increase and their demand for safe assets should fall because they are no longer so near the edge.
4. Have the government create expectations of future inflation: businesses will be willing to invest more if they are comparing their current nominal cost of funds to returns that include nominal inflation appreciations in the value of their capital in the future.

These are all the things that the government has been trying to do for a year and a half now. These are all the extraordinary policies that we have been trying. None of them are guaranteed to work well. But the judgment of the economists in the late Bush administration, of the economists in the Obama administration, and of the Greenspanists, Punchbowlers, and Producerists is that all are at least worth trying if they can be implemented well. Only the Nihilists stand in opposition: that's why I call them Nihilists.

It is unclear where in the above chain of reasoning—which is a cleaned-up version of Milton Friedman's teacher Jacob Viner's argument for expansionary monetary policy financed by large government deficits—the Nihilists diverge from the rest of us. And I am far from being alone, UNC Chapel Hill economist Karl Smith laments:

> Beginning with Eugene Fama's… arguing that the stimulus could not work… I have been deeply puzzled. The probability that I understand macro on a deeper level than Fama or Cochrane is low. Yet, it seems to me that basic error is being made… [by] assuming that… increases in the demand for money do not reduce the total quantity of transactions… naive assumptions…. [G]iven our premise that it is unlikely I understand something Fama and Cochrane do not, the logical conclusion is that I am missing something...

Yet, Karl Smith says, his understanding of macro has worked well over the past three years while the Nihilists' understanding has worked extraordinarily poorly as a guide to events:

> [W]hen I look at how the crisis unfolded I am struck by how well the basic model I was working with performed. In the spring of 2008, I told my graduate seminar class that if we had not already had the Great Depression that it would be starting now. Luckily I noted, we had learned many of the lessons and Ben Bernanke would not allow a general failure of the financial system….
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> In the days after Lehman's fail, just over one year ago, I wrote a letter to my colleagues… telling them we were walking a fine line. The money market appeared to be shutting down and there was a non-trivial chance that Western Capitalism was about to collapse. This, I felt, could almost certainly be avoided but we should not delude ourselves about the risks…. In October of 2008 I advised North Carolina officials that they were about to see an unprecedented drop in retail sales and that this would lead to massive losses in sales tax revenue….
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> All of these things seemed to be confirmed by events and they were all based on a vulgar New Keynesian model…. I didn't think any of these forecasts were particularly prescient. Indeed, I thought I was simply translating the conventional wisdom.
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> Apparently not...

Rejecting the Nihilists

I think that in the end we can reject the Nihilists, even though we cannot claim to fully understand them. We reject them for the reasons that Karl Smith gave above: that the alternative theories—whether put forward by Greenspanists, Punchbowlers, or Producerists—worked while the Nihilists' theories did not. That there was nothing especial to be alarmed at in the summer of 2008 was the point of the Christiano, Eichenbaum, and Kehoe "Four Myths About the Financial Crisis" paper of August 2008. Christiano, Eichenbaum, and Kehoe drew from the stabilization of monetary aggregates the conclusion that the Federal Reserve was irrationally panicking. They were wrong. Nihilists claimed that the Obama economic stimulus—and its cousins all around the world—could not work. It really looks like they were wrong.

Edward Prescott and company claim that the problem with Herbert Hoover and Alan Greenspan is that their policies were too interventionist—"anti-market, anti-globalization, anti-immigration, pro-cartelization policies." Hoover strove as much as he could to keep the social-democratic and socialist wolf from the door, to follow the rules of the gold standard game, and to limit government regulation of the economy. Greenspan sought to push the American political envelope: there have been lots of presidents, Treasury secretaries, and Federal Reserve chairman who were more open to regulation and more interventionist as temperament. There have been none who sought to do less. The offenses of Hoover and of Greenspan and Bush against the jealous gods of the market were not extravagant by comparison with other countries and other eras. Indeed, their sins were rather less. But their punishment was severe.

Here I think we need to read the end of the Boo of Job. Neither Herbert Hoover on the one hand nor Alan Greenspan on the other thought that they were following an anti-market social-democratic pro-regulation economic policy. They all saw themselves as on the pro-market libertarian as opposed to the pro-regulation social-democratic end of the American spectrum. They had the faith. But the Nihilists' answer appears to be that they were too interventionist.

Eliphaz, Bildad, and Zophar—come to help Job by telling him that he was not a good man, that it is because of his many grevious sins that all these horrible things have happened—that they are wrong. Job does not think that this is terribly helpful. At the end of the Book of Job, a voice speaks out of the whirlwind to tell Eliphaz, Bildad, and Zophar that He does not think they are particularly helpful either.

So now I am looking forward to the three-cornered cage match between Greenspanists, Punchbowlers, and Producerists that was interrupted some nine months ago.

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