# Economists Think Productively About Macroeconomics, 1803-2007

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# Readings: Macroeconomics from 1825-2007

- Five things to read:
  - Walter Bagehot (1873), Lombard Street http://www.gutenberg.org/etext/4359, entire.
  - Ben Bernanke (1983), "Nonmonetary Effects of the Financial Crisis in the Propagation of the Great Depression" American Economic Review 73, pp. 257-276, http://www.jstor.org/view/00028282/di950033/95p00602/0
  - John Hicks (1937), "Mr. Keynes and the 'Classics': A Suggested Interpretation", Econometrica http://web.econ.unito.it/bagliano/macro3/hicks_econ37.pdf
  - John B. Taylor (2000), "Reassessing Discretionary Fiscal Policy," Journal of Economic Perspectives Vol. 14, No. 3 (Summer, 2000), pp. 21-36 http://www.jstor.org/stable/2646917
  - Alan Auerbach and William Gale (2009), "Activist Fiscal Policy to Stabilize Economic Activity" http://www.nber.org/papers/w15407.pdf
- Tyler Cowen: "Useful macroeconomics is common sense plus accounting identities"

# At the Start: Macroeconomics Before 1890

- Say
- Malthus
- Say again
- John Stuart Mill
- Bastiat and Say
- Walter Bagehot

# Jean-Baptiste Say

- Say: A Treatise on Political Economy, Book I, Chapter XV: [T]o say that sales are dull, owing to the scarcity of money, is to mistake the means for the cause; an error that proceeds from the circumstance, that almost all produce is in the first instance exchanged for money, before it is ultimately converted into other produce: and the commodity, which recurs so repeatedly in use, appears to vulgar apprehensions the most important of commodities, and the end and object of all transactions, whereas it is only the medium. Sales cannot be said to be dull because money is scarce, but because other products are so. There is always money enough to conduct the circulation and mutual interchange of other values, when those values really exist. Should the increase of traffic require more money to facilitate it, the want is easily supplied, and is a strong indication of prosperity—a proof that a great abundance of values has been created, which it is wished to exchange for other values. In such cases, merchants know well enough how to find substitutes for the product serving as the medium of exchange or money...

# Thomas Robert Malthus

- [W]e hear of glutted markets, falling prices, and cotton goods selling at Kamschatka lower than the costs of production. It may be said, perhaps, that the cotton trade happens to be glutted; and it is a tenet of the new doctrine on profits and demand, that if one trade be overstocked with capital, it is a certain sign that some other trade is understocked. But where, I would ask, is there any considerable trade that is confessedly under-stocked, and where high profits have been long pleading in vain for additional capital?... [W]e only take a view of half the question if we... [neglect] how much profits depend upon... prices... and upon the cause which determines these prices... supply compared with the demand...

# Jean-Baptiste Say After 1825

- *Cours Complet d'Economie Politique Pratique*: The Bank [of England], legally obliged to redeem its banknotes in specie, regarded itself as obliged to buy gold back at any price, and to coin money at a loss and at considerable expense. To limit its losses, it forced the return of its banknotes, and ceased to put new notes into circulation. It was then obliged to cease to discount commercial bills. Provincial banks were in consequence obliged to follow the same course, and commerce found itself deprived at a stroke of the advances on which it had counted, be it to create new businesses, or to give a lease of life to the old. As the bills that businessmen had discounted came to maturity, they were obliged to meet them, and finding no more advances from the bankers, each was forced to use up all the resources at his disposal. They sold goods for half what they had cost. Business assets could not be sold at any price. As every type of merchandise had sunk below its costs of production, a multitude of workers were without work. Many bankruptcies were declared among merchants and among bankers, who having placed more bills in circulation than their personal wealth could cover, could no longer find guarantees to cover their issues beyond the undertakings of individuals, many of whom had themselves become bankrupt...

# John Stuart Mill

- There can never, it is said, be a want of buyers for all commodities; because whoever offers a commodity for sale, desires to obtain a commodity in exchange for it.... The sellers and the buyers... must, by the metaphysical necessity of the case, be an exact equipoise.... This argument is evidently founded on the supposition of a state of barter.... If, however, we suppose that money is used.... Although he who sells, really sells only to buy, he needs not buy at the same moment.... [I]t may very well occur, that there may be, at some given time, a very general inclination to sell with as little delay as possible, accompanied with an equally general inclination to defer all purchases.... This is always actually the case, in those periods which are described as periods of general excess. And no one, after sufficient explanation, will contest the possibility of general excess, in this sense of the word.... What they called a general superabundance, was not a superabundance of commodities relatively to commodities, but a superabundance of all commodities relatively to money...

# Frederic Bastiat and Jean-Baptiste Say

- Frederic Bastiat: There is an article in the Constitution which states: "Society assists and encourages the development of labor.... through the establishment by the state, the departments, and the municipalities, of appropriate public works to employ idle hands." As a temporary measure in a time of crisis, during a severe winter, this intervention on the part of the taxpayer could have good effects... as insurance. It adds nothing to the number of jobs nor to total wages, but it takes labor and wages from ordinary times and doles them out, at a loss it is true, in difficult times. As a permanent, general, systematic measure, it is nothing but a ruinous hoax...
- Jean-Baptiste Say: [A] benevolent administrationcan appropriately make provision for the employment of supplanted or inactive labor in the construction of works of public utility at public expense, as in construction of canals, roads, churches, or the like...

# Walter Bagehot, Lombard Street

- Any sudden event which creates a great demand for actual cash may cause, and will tend to cause, a panic.... A panic, in a word, is a species of neuralgia, and according to the rules of science you must not starve it. The holders of the cash reserve must be ready not only to keep it for their own liabilities, but to advance it most freely for the liabilities of others.... In wild periods of alarm, one failure makes many, and the best way to prevent the derivative failures is to arrest the primary failure.... The way in which the panic of 1825 was stopped by advancing money has been described in so broad and graphic a way that the passage has become classical.... When reduced to abstract principle, the subject comes to this. An 'alarm' is an opinion that the money of certain persons will not pay their creditors when those creditors... that alarm is best met by enabling those persons to pay their creditors to the very moment. For this purpose only a little money is wanted. If that alarm is not so met, it aggravates into a panic.... I know it will be said that in this work I have pointed out a deep malady, and only suggested a superficial remedy. I have tediously insisted that the natural system of banking is that of many banks keeping their own cash reserve, with the penalty of failure before them if they neglect it. I have shown that our system is that of a single bank keeping the whole reserve under no effectual penalty of failure. And yet I propose to retain that system, and only attempt to mend and palliate it. I can only reply that I propose to retain this system because I am quite sure that it is of no manner of use proposing to alter it. A system of credit which has slowly grown up as years went on, which has suited itself to the course of business, which has forced itself on the habits of men, will not be altered because theorists disapprove of it...

# State of Macroeconomics in 1890

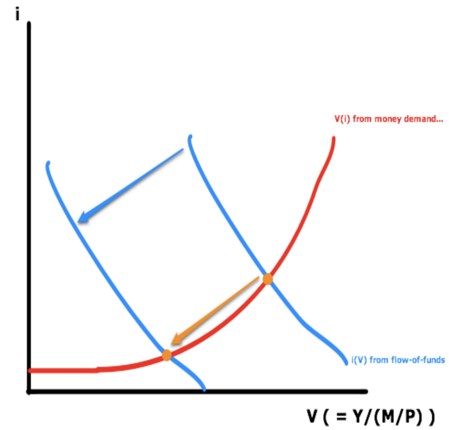
- A panic is:
  - –Excess demand for “cash”
  - –Excess supply of goods and labor
    - Slow adjustment in goods and labor markets
- A panic is fixed by:
  - –Having the central bank increase the supply of “cash”
  - –Having the government increase the demand for goods and labor
- A panic is temporary

# Macroeconomics From 1890-1940

- How are we to understand events that are not full panics?
- Why does this happen over and over again?
- Irving Fisher: MV = PY
  - Money market: excess demand for “money” produces excess supply of goods
  - Plus nominal inertia
    - But nominal inertia on the downside not a problem but an opportunity: the debt-deflation theory of great depressions
  - Shocks to the money stock (and to velocity) are the problem
- Knut Wicksell: S = I
  - Flow-of-funds: excess demand for high-quality investment assets (“market” interest rate lower than “natural” interest rate) produces excess supply of goods (including risky new plant and equipment)
  - Plus nominal inertia
    - But expected price rises push the “natural” interest rate up during booms and down during recessions
  - Disturbances to the flow-of-funds (S or I) are the problem
- Note that Fisher and Wicksell are not talking about the same thing:
  - Liquid cash money on the one hand
  - Safe high-quality investment assets on the other
- Which gets us to Keynes and Hicks

# John Hicks

- The Great Depression: no excess demand for liquid "cash", but huge excess supply of goods—so what is going on?
- John Hicks (1937), "Mr. Keynes and the 'Classics': A Suggested Interpretation", Econometrica http://web.econ.unito.it/bagliano/macro3/hicks_econ37.pdf
  - Three commodities: goods, money, and (high-quality) investment assets
    - Excess demand for high-quality investment assets
  - An "IS" curve for the Wicksellian flow-of-funds investment market (high-quality investment assets on the one hand and goods (including risky new plant and equipment): S=I)
  - An "LM" curve for the Fisherian money market (money and goods: MV=PY)
    - An "LM" curve that becomes flat at low nominal interest rates as open market operations no longer affect the quantity of high-quality assets
    - An "LM" curve that becomes vertical at high interest rates as money demand becomes interest-inelastic
- This is the "neoclassical macroeconomic synthesis"
- Dissents:
  - Friedman-Lucas
  - Keynes-Minsky



# Useful Macroeconomics From 1940-2007

- Ben Bernanke (1983), "Nonmonetary Effects of the Financial Crisis in the Propagation of the Great Depression" American Economic Review 73, pp. 257-276, http://www.jstor.org/view/00028282/di950033/95p00602/0
  - Monetary policy cannot just analyze the money-goods margin
  - Bank failures affect not just supply of (inside) cash but also, via the credit channel, the supply of high-quality investment assets as well
- John B. Taylor (2000), "Reassessing Discretionary Fiscal Policy," Journal of Economic Perspectives Vol. 14, No. 3 (Summer, 2000), pp. 21-36 http://www.jstor.org/stable/2646917
  - Fiscal policy a way of increasing the supply of high-quality investment assets—government buys stuff and uses its taxing power to finance it by issuing high-quality investment assets
  - Discretionary fiscal policy (relatively) ineffective and also unnecessary
- Alan Auerbach and William Gale (2009), "Activist Fiscal Policy to Stabilize Economic Activity" http://www.nber.org/papers/w15407.pdf
  - But what do you do when conventional monetary policy is tapped out?
  - Four things:
    - Monetary policy that alters expected inflation in the future—and by taxing long-duration high-quality investment assets reduces the excess demand for them (without diminishing the quality of such assets!)
    - Banking policy that makes low-quality investment assets into high-quality ones
    - Recapitalization policy that reduces banking-sector demand for high-quality investment assets
    - Fiscal policy that makes more high-quality investment assets