

Economics 1: Fall 2010

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cast of thousands...

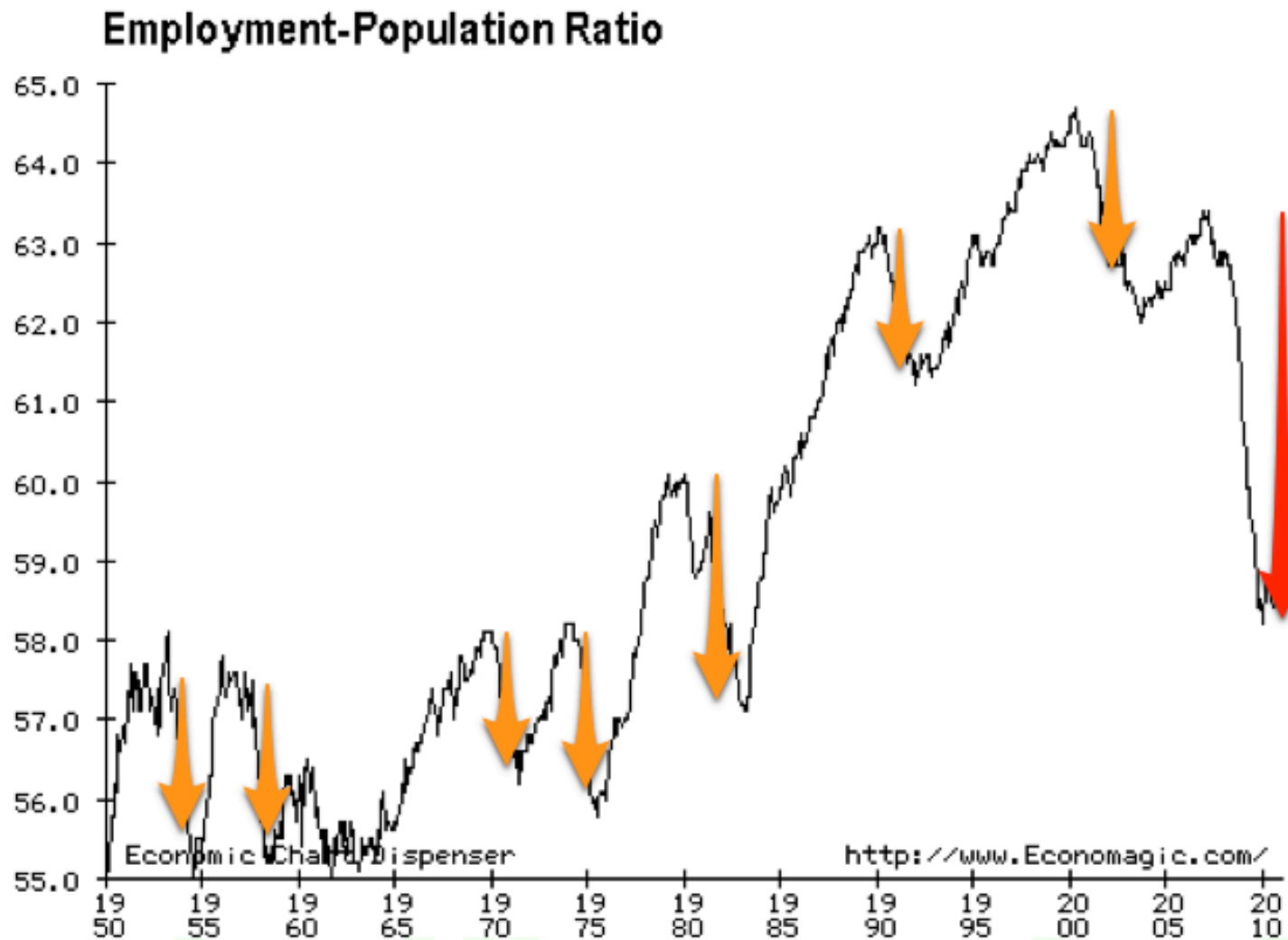
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Economics 1: Fall 2010: Inflation Economics

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The Employment-to-Population Ratio, Seasonally Adjusted



Depression Economics Review I

- The crash of the employment-to-population ratio
- Why should this happen?
 - Say's Law
 - Nobody makes except to use or sell, nobody sells except to buy
 - Thus while there can be particular shortages of demand, they are balanced by shortages of supply elsewhere
 - Overall excess demand is a self-contradictory notion
 - The circular flow principle:
 - Everybody's spending is someone else's income

Depression Economics Review II

- But demand does not have to be for currently-produced goods and services
- Excess demand for financial assets implies deficient demand for currently-produced goods and services
 - This suggests that even a big downturn should have a strategic, financial cure: fix the excess demand in financial markets and you fix the economy
- Historically, three types of excess demand for finance
 - Excess demand for bonds, planned savings > investment (Keynesian)
 - Master equation: $Y = (c_0 + NX + I + G)/(1 - c_y)$
 - Fixed by reducing demand for or increasing supply of bonds
 - Excess demand for liquid cash money (monetarist)
 - Master equation $Y = (M/P) \cdot V$
 - Fixed by having the Federal Reserve buy short-term government bonds for cash to increase the money stock
 - Excess demand for safety, for high-quality AAA assets (Minskyite)

Depression Economics Review III

- We have a Minskyite crisis: an excess demand for safe assets
 - Inducing a fall in spending on currently-produced goods and services
 - And thus a steep economic downturn
- Where did it come from?
 - Deregulation
 - Securitization of mortgages
 - A housing bubble—and crash
 - Overleverage: failure of the originate-and-distribute model
 - Panic: not just MBS are no longer regarded as safe, but every asset that might be backed by MBS, or was issued by people like the people who assured us that MBS were safe
- What to do?
 - Theory tells us we fix the downturn by fixing the excess financial-market demand for safe assets
 - Doing that successfully would be a neat trick
 - How to keep it from happening again