The Worst Macroeconomy since the Great Depression Itself

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Back to 1825!

- Sometimes things can be seen more clearly in their origins...
- We have been here before...
- So why are we here now?
E.M. Forster’s Great Aunt Marianne’s View

- E.M. Forster, *Marianne Thornton: A Domestic Biography*
- Marianne Thornton:
  - There is just now a great pressure in the mercantile world, in the consequence of the breaking of so many of these scheming stock company bubbles...
  - Saturday however—that dreadful Saturday I shall never forget—the run increased to a frightful degree, everybody came in to take out their balance, no one brought any in; one old steady customer, who had usually £30,000 there [think CA$300,000,000], drew it out without, as is usual, giving any warning, and in order to pay it the House was left literally empty...
  - Such a moment of peril completely turned Free's head; he insisted on proclaiming themselves bankrupts at once, and raved and self-accused himself...
  - Old Scott cried like a child of five years old, but could suggest nothing. Pole and Down were both out of town...
Twenty-Five Year Old Henry Thornton Goes Out into the Streets of London

• Marianne Thornton:
  – [25 year-old] Henry [Thornton] saw it all lay upon him...
  – [O]ne last resource... John Smith... if he could give his word of honour... that the House was solvent? Henry said he could. Well! then he said they should have everything they could spare.... Henry heard the door locked, and the shutters put up, he felt they would not open again....
  – John Smith declared if Henry would make a statement of the accounts and prove their solvency, he would apply to the Bank of England for them. Henry had little hope form this, for the Bank had never been known to do such a thing in the annals of Banking...
The Establishment Players: At Downing Street and at Threadneedle Street

Robert Banks Jenkinson, Second Earl of Liverpool, First Lord of the Treasury

Cornelius Buller, Governor of the Bank Of England
The Bank of England Comes to the Rescue

- Marianne Thornton:
  - [T]he next morning at 8 o'clock.... [A]ll the Bank of England directors who were in town.... John Smith began by saying that the failure of this House would occasion so much ruin that he should really regard it as a national misfortune....
  - The Governor turned to Henry and said, 'I think you give your word the House is solvent?' Henry said he could.... 'Well then', said the Governor and the Deputy Governor of the Bank, 'you shall have four hundred thousand pounds by eight tomorrow morning, which will I think float you'. Henry said he could scarcely believe what he had heard....
  - He was off again in the dark on Monday morning to the Bank of England, where he found the Governor and Deputy Governor who for the sake of secrecy had no clerks there, and they began counting out the Bills for him. 'I hope this won't overset you my young man', said one of them, 'to see the Governor and Deputy Governor of the Bank [of England] acting as your two clerks.
  - He went back to the banking house £400,000 richer than he left it on Saturday. For the first hour there was a little run, but the rumours that the Bank of England had taken them under its wing soon spread, and people brought back money as fast as they had taken it out on Saturday...
The Bank of England’s View

- From Walter Bagehot’s *Lombard Street: A View of the Money Market:*
  - 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.
  - 'We lent it,' said Mr. Harman, on behalf of the Bank of England,
    - by every possible means and in modes we had never adopted before; we took in stock on security, we purchased Exchequer bills, we made advances on Exchequer bills, we not only discounted outright, but we made advances on the deposit of bills of exchange to an immense amount, in short, by every possible means consistent with the safety of the Bank, and we were not on some occasions over-nice. Seeing the dreadful state in which the public were, we rendered every assistance in our power...
  - After a day or two of this treatment, the entire panic subsided, and the 'City' was quite calm.
What Is Going on Here?

• A recognition that there has been “irrational exuberance”: “the breaking of so many of these scheming stock company bubbles…”
• A corresponding sudden fall in the risk tolerance of the private market...
• Which produces a fall in asset prices because capital is now durable...
• A fear that banks that are not well-capitalized--like Pole, Thornton--will crash because of the fall in asset prices, and incur the further losses associated with bankruptcy...
• This would be of no concern to anybody (except Pole, Thornton and its customers) were it not for the systemic consequences of this fall in asset prices and fear of bank bankruptcies
  – The fall in safe interest rates...
  – The flight to quality and the demand for cash...
  – Excess demand for high-quality investment assets means excess supply of goods and services
  – Means unemployment
• Hence Robert Banks Jenkinson asks Cornelius Buller to step in
  – The market wants more high-quality investment assets? Give it what it wants
Did It Work Back in 1825?

Annual Change in British Cotton Consumption

Date

- War of 1812
- U.S. Civil War
Did It Work Back Then?

- Cotton textiles the leading sector of the Industrial Revolution.
- We expect an 8% per year increase in cotton consumption in Britain in this period.
- We only have a 3% increase in 1825 over 1824
  - We have an 11% decrease in 1826 over 1825
  - Cotton consumption in 1826 was thus some 24% below trend.
  - But followed by a 30% increase in 1827 over 1826.
- It does not look like it worked as well as we would have hoped.
  - Of course, we tend to say that this only shows that the Bank of England did not do enough to stabilize the situation.
  - Jenkinson, however, did not end under the guillotine.
- Oh, Henry Thornton lied.
On the Possibility of a “General Glut”

- Jean-Baptiste Say:
  - [In general,] sales cannot be said to be dull because money is scarce, but because other products are so...
  - There is always money enough... when... values really exist....
  - [M]erchants 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....
  - [T]he 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?...
Cutting Edge Macroeconomic Theory—as of 1844

• Jean-Baptiste Say, 1829:
  – The Bank [of England]... cease[d] to discount... bills. Provincial banks... follow [ed]... commerce found itself deprived at a stroke of... advances...
  – As the bills that businessmen had discounted came to maturity, they were obliged to meet them... use up all the resources at his disposal. They sold goods for half what they had cost. Business assets could not be sold...
  – [A] multitude of workers were without work... bankruptcies were declared... merchants and among bankers... having placed more bills in circulation than their personal wealth could cover could no longer find guarantees... beyond the undertakings of individuals many of whom had themselves become bankrupt...

• John Stuart Mill, 1844:
  – Persons... from a general expectation of being called upon to meet sudden demands, liked better to possess money than any other commodity... all other commodities were in comparative disrepute... [T]he result is, that all commodities fall in price, or become unsaleable... [T]here would seem to be in the nature of the case no particular impropriety in saying that there is a superabundance of all or most commodities, when all or most of them are in this predicament...
Only Two Significant Differences Between Then and Now

- Say’s and Mill’s “commercial crises” involved a fifteen-percent decline in a fifth of the economy—call it a 3% fall in real GDP relative to trend...
- Our demand and production shortfall from potential today is approaching 10% of our entire volume of production and spending...
- Say and Mill knew that commercial crises were a new and unmanaged disease of industrial market economies...
- Our economists only a little while ago were very confident that we understood the process and “won’t let it happen again...”
Classical Economics: What to Do

• The problem:
  – The market has an enormous excess demand for liquid, high-quality investment assets
  – This excess demand for liquid, high-quality investment assets is mirrored by a large excess supply in the markets for goods and for labor
  – Firms seeing inventories rise are shutting down, or cutting back on hours, or firing people
  – But firing people reduces incomes—and further reduces demand for goods and for labor, thus increasing the excess supply...
  – And shutting down makes assets that were regarded as high-quality investment assets clearly no longer so—and further increases the excess demand for liquid high-quality investment assets

• The solution?
  – The market wants more high-quality, liquid investment assets
  – So give the market what it wants
  – Or wait for the situation to shake itself out by itself—which will take yrs
The Scale Today Is Unimaginably Greater, But the Pattern Is the Same

- Why have I spent so much time back in 1825?
- Here we see in its first appearance what the central bankers of the world are trying to do right now:
  - Monetary expansion.
  - Banking support.
- We don't see the other two branches of macroeconomic stabilization policy that are being tried today:
  - Fiscal policy.
  - Quantitative easing.
- But what is going on today is a continuation of a tradition of policy from the past, and how and where and why this tradition of policy first got established.
The Other Point of View: The Hayek-Hoover-Marx-Mellon Axis
Karl Marx’s Critique

• Those trying to fix depressions via strategic government interventions are misguided:
  – It is not a financial but rather a real-side problem
  – Something is very wrong with the structure of production
  – You can’t solve a real-side problem—with financial manipulation
  – “Peel himself has been apotheosized in the most exaggerated fashion... a massive accumulation of commonplaces, skillfully interspersed with a large amount of statistical data...”

• Marx’s three part plan:
  – Nationalize private ownership of the means of production
  – Eliminate the capitalist mode of production
  – Create a free society of associated produceres
Leave-It-Alone Liquidationism

- Hoover in retrospect:
  - The “leave it alone liquidationists” headed by… Mellon… felt that government must keep its hands off and let the slump liquidate itself…
  - “Liquidate labor, liquidate stocks, liquidate the farmers, liquidate real estate.” [Mellon] insisted that, when the people get an inflation brainstorm, the only way to get it out of their blood is to let it collapse…
  - [E]ven a panic was not altogether a bad thing. [Mellon] said: “It will purge the rottenness out of the system. High costs of living and high living will come down. People will work harder, live a more moral life. Values will be adjusted, and enterprising people will pick up the wrecks from less competent people”…

Avoiding moral hazard

“Beware the descent of the conservative principles will not go though.”

I love The New Yorker — for the wonderful writing, the reporting, the poetry — oh, who am I kidding? Like everyone, I start with the cartoons.
Some Examples

- **Casey Mulligan:**
  - “Are Employers Unwilling to Hire, or Are Some Workers Unwilling to Work?” New York Times:
    Employment has been falling over the past year… [Today] some employees face financial incentives that encourage them not to work… [The] decreased employment is explained more by reductions in the supply of labor (the willingness of people to work) and less by the demand for labor (the number of workers that employers need to hire)...

- **John Cochrane:**
  - We should have a recession. People who spend their lives pounding nails in Nevada need something else to do.
  - John Lippert: “John Cochrane was steaming as word of U.S. Treasury Secretary Henry Paulson’s plan to buy $700 billion in troubled mortgage assets rippled across the University of Chicago in September… ‘We all wandered the hallway thinking, How could this possibly make sense?’ says Cochrane, 51, recalling his incredulity at Paulson’s attempt to prop up the mortgage industry and the banks that had precipitated the housing market’s boom and bust…

- **Chari, Christiano, and Kehoe:**
  - One view of the current situation that might justify intervention is that projects that are well understood not to be risky cannot get funding… because the weak balance sheets of the bank force them to pass on what otherwise would be very profitable loans… [Documenting this view will be an uphill battle because many versions of this view would imply large profit opportunities for the subset of banks with relatively healthy balance sheets…

- **All of these people are very clever:**
  - If perhaps not so wise…
I Want to Argue Against Those Who Are Arguing Against Stabilization Policy

• Martin Wolf characterizes them:
  – Austrians… argued [in the 1930s] that a purging of… excesses… was required. Socialists argued that socialism needed to replace failed capitalism… both views… grounded in alternative secular religions…
  – This same moralistic debate is with us, once again. Contemporary “liquidationists” insist that a collapse would lead to rebirth of a purified economy. Their leftwing opponents argue that the era of markets is over. And even I wish to see the punishment of financial alchemists…
• And dismisses them as engaged in the wrong project:
  – Keynes’s genius – a very English one – was to insist we should approach an economic system not as a morality play but as a technical challenge…. Keynes would have insisted that such approaches are foolish…
• Summing up:
  – [O]ne should not treat the economy as a morality tale…. Markets are neither infallible nor dispensable. They are indeed the underpinnings of a productive economy and individual freedom. But they can also go seriously awry and so must be managed with care…
The Sheer Size of This Recession
The Problem Is Exactly What J.S. Mill and J.-B. Say Would Have Said

- Excess demand for high-quality investment assets: cash (and safe bonds):
  - Reinforced by the collapse of the supply of safe assets
  - Or at least of assets that are perceived to be safe...
- Thus deficient demand for other things:
  - Risky bonds and loans to finance investment spending...
  - Goods and services...
- Reinforced by a vicious downward spiral...
Today’s Crisis

• Cheap money from abroad:
  – The “global savings glut”...
• Financial engineering:
  – “Inventing” new ways to turn risky lead into safe well-hedged gold...
• The corporate form and investment banking:
  – In a partnership every thirty-something is a risk manager...
  – Today everyone is seeking large bonuses paid in cash on the basis of mark-to-model valuations at the end of the fiscal year...
• The collapse of lending standards in housing...
• The belief that the risks were well-spread:
  – 4 million homes x $150K per home...
  – Only $600 billion of losses in mortgage-backed securities...
  – In a $80 trillion global asset value economy...
  – But the risks weren’t well-spread:
    • They were concentrated...
    • Originate-and-distribute turns into originate-and-mark-to-model-and-collect-your-year-end-bonus...
In 2007-2008 Things Fall Apart

• Finance:
  – Originate and not distribute...
  – Neglect the first lesson of risk: in a panic all correlations go to one...
    • Hence you have to be duration-matched...
  – AIG turns out not to be in the insurance business...

• Lehman Brothers:
  – “No legal authority”...
  – Bernanke, Paulson, Geithner hammered for a year as enablers of “moral hazard”...
  – Run on the shadow banking system...

• And all of a sudden the Federal Reserve proves to be much less powerful than it had thought...
Some Numbers…

- $80 trillion of global financial assets three years ago.
- $60 trillion of global financial assets today.
- Default, duration, risk, and information discounts.
- Default discounts:
  - A $3 trillion increase from mortgages.
  - A $6 trillion increase from other forecast recession losses.
- Duration discounts:
  - A -$4 trillion move by central banks.
  - What monetarist theories said you should do.
- Risk and information:
  - A +$15 trillion increase in the discount on low-quality financial assets
- That is a gauge of the magnitude of the imbalance in the market for high-quality investment assets
From Subprime to Bear-Stearns
From Bear-Stearns to Lehman and AIG
Collapse of perceived supply of high-quality assets
- 40% fall in S&P composite...
- The Federal Reserve swings into action
The Banking System on the Edge of Collapse...
Where We Stood in 2007

- Federal Reserve trying to maintain full employment
  - Without inflation
- Needs investment, demand for another leading sector with the housing collapse
- Fears of Japan in the 1990s (let alone U.S. in the 1930s)
- Also fears of overreacting:
  - An inflationary liquidity tsunami
Confident Central Bankers on the Hot Seat

• The Fed in 2007:
  – Recognition in 2005-2007 of “overbuilding” in the housing market...
  – Reluctance to be a national nanny: what would congress think if we stopped letting people do deals?
  – Confidence in its ability to keep the supply of high-quality assets in balance with demand
How Did We Get Here?: Economists’ Hubris

· Four times in the past century and a half prominent economists have assured us that:
  - “The central problem of depression-prevention has been solved” —Robert Lucas...
  - Earlier we had:
    · Walter Heller: “new dimensions of political economy”...
    · Irving Fisher: “permanent and high plateau”...
    · Walter Bagehot: the Bank of England knows how to manage Lombard Street...

· When a prominent economist says that the problem of depression-prevention has been solved...
  - ...hold on to your wallet!
What Happened When We Did Not Try to Give the Market What It Wanted: “New Deals” and Recovery

**Figure 5. Indices of industrial production, 1929-1937 (1929 = 100)**

*Sources: League of Nations, World production and prices, 1933/6, p. 44.*
Fixing It: How Are We Doing?

• Four ways to give the market more high-quality investment assets to hold:
  – Federal Reserve open-market operations—buy (high-quality) government bonds for (higher-quality) cash
  – Loan guarantees to turn low-quality into high-quality investment assets
  – Expansion of Federal Reserve balance sheet: turn low-quality assets into high-quality Federal Reserve obligations
  – Fiscal policy: print up a huge honking extra tranche of government bonds (but not too much!)
• Two ways to diminish the market’s appetite for high-quality investment assets
  – Recapitalize the banks
    • Giveaways
    • Equity stakes
    • Nationalizations
  – Quantitative easing to impose the inflation tax on high-quality bonds (but not too much!)
• Put people to work directly
  – The flip side of fiscal policy
Not as Well as We Could Be Doing

• Federal Reserve open-market operations TAPPED OUT
• Loan guarantees NO APPETITE FOR ANY MORE
• Expansion of Federal Reserve balance sheet NO APPETITE FOR ANY MORE
• Fiscal policy: print up a huge honking extra tranche of government bonds (but not too much!) NO APPETITE FOR ANY MORE
• Two ways to diminish the market’s appetite for high-quality investment assets
  – Recapitalize the banks NO APPETITE FOR ANY MORE
  – Quantitative easing to impose the inflation tax on high-quality bonds (but not too much!) NO APPETITE FOR ANY MORE
• Put people to work directly NO APPETITE FOR ANY MORE
• Why no appetite?
White House: Government Deficit Large Enough to Scare, too Small to Fix Economy...
### Infinite-Horizon Auerbach-Gale-Orszag Fiscal Gaps

<table>
<thead>
<tr>
<th>Description</th>
<th>Percentage</th>
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<tr>
<td>CBO Adjusted Baseline Fiscal Gap:</td>
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<tr>
<td>EGTRRA, IGTRRA, ARRA, AMT Tax Provision Extension:</td>
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<td>Other Baseline Adjustments:</td>
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<td>Medicare Part D:</td>
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<td>Amortizing Bush-Era Deficits:</td>
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<td>Gore-PAYGO Baseline Fiscal Gap:</td>
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<tr>
<td>Sustainable Deficit (6% annual growth; D/Y=60%):</td>
<td>3.6%</td>
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<tr>
<td>Each Percentage Point of Excess Federal Health Spending Growth:</td>
<td>1.3%</td>
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<tr>
<td>Social Security:</td>
<td>1.5%</td>
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Sources of Political Paralysis

- Revolt of the politicians: the House and Senate Republican caucuses, “just say do nothing”...
- Revolt of the institutions: Council on Foreign Relations, American Enterprise Institute, Heritage Foundation...
- Revolt of the “Austrian” academics:
  - Not just the fringe, but people who are classified as Nobel Prize-caliber: Fama, Cochrane, Lucas, Boldrin, Zingales, Prescott, a whole bunch of pseudo-Austrians, others, all claiming not just that fiscal expansion is a bad idea because of its costs but that fiscal expansion cannot work in principle...
- Revolt of the deficit hawks...
- Revolt of the voters...
  - Cranky because of high unemployment
  - Cranky because of perceived unfairness
    - Henry Paulson and Don Kohn’s misjudgements
- Implication: Obama isn’t even grasping for the low-hanging fruit...
Unfortunately...

– John Stuart Mill, 1844, once again:
  • What was affirmed by Cicero of all things with which philosophy is conversant, may be asserted without scruple of the subject... there is no opinion so absurd as not to have been maintained by some person of reputation. There even appears to be on this subject a peculiar tenacity of error—a perpetual principle of resuscitation in slain absurdity...

– There are lots of people out there who are still saying that we “need” a depression...
  • ...or at least that we should not do anything out-of-the-ordinary to try to cut it short
  • Perhaps not important were it not for political backing from the Republican Party:
    – Very odd: Obama’s anti-recession policies are quite close to what John McCain’s would have been...
    – But Republicans in congress are following the Gingrich strategy (Republican governors are very, very different...)
Indeed...

NEWS IN PHOTOS

Hulking Strongman Now Only Voice Of Reason In Republican Party
Where We Are Now

• Nobel Prize-caliber economists making assertions about what can be deduced from the NIPA identity that are simply not true...
  – Justifications:
    • For example, NYU’s MARIO RIZZO: [The] argument does not appear in a journal article but... [is] directed to non-specialists... It is true that he simplifies the process. But you will note that, as a statement about the long run, it is not bad...
    • And here I protest: long-run full-employment crowding-out, when it occurs, is the result of changing real wages, prices, and interest rates—it is not a consequence of the NIPA identity, and these are not statements about the long run but about the ARRA...
  – Authorities:
    • When citations are made, and they are rarely made, they are made to Say, or Bastiat, or at best to Rueff...
• Perhaps related: an academic research community with nothing relevant to say:
  – NARAYANA KOCHERLAKOTA: Why do we have business cycles? Why do asset prices move around so much? At this stage, macroeconomics has little to offer by way of answer to these questions.... The sources of disturbances in macroeconomic models are [to my taste] patently unrealistic... large quarterly movements in the technological frontier... collective shocks to the marginal utility of leisure... quarterly shocks to the depreciation rate.... None of these disturbances seem compelling, to put it mildly...
The Claim that We “Need” a Depression Is Incoherent

• We don’t have any overhang of mal-investment...
• We don’t have any excess employment in sectors where bosses need to be pushed by losses to shut factories and drive out workers...
• John Maynard Keynes, 1932:
  – Doubtless... the rate of growth of some individual commodities... could not always be in just the appropriate relation.... But, on the whole, I see little sign of any serious want of balance.... It seems an extraordinary imbecility that this wonderful outburst of productive energy [over 1924-1929] should be the prelude to impoverishment and depression. Some... regard it both as an inevitable and a desirable nemesis,... It would, they feel, be a victory for the Mammon of Unrighteousness if so much prosperity was not subsequently balanced by universal bankruptcy. We need, they say, what they politely call a 'prolonged liquidation' to put us right.... And when sufficient time has elapsed for the completion of the liquidation, all will be well with us again...
Not So Cutting-Edge Macroeconomic Theory
—as in Academia Today

• Three examples:
  
  — Nobel Prize-winning University of Chicago Professor Robert Lucas:
    • [When a large number of people are unemployed, it is because they] expect... a return to normal [wage] levels. With these expectations, it is to a [worker’s] advantage to [decrease] his current supply of labor... when [wages fall]... [M]oney wages... fell noticeably below their ‘normal levels’ in 1930 [and] fell further below in subsequent years....
  
  — Nobel Prize-winning ex-Chicago (now ASU) Professor Edward Prescott:
    • The period of the ’20s was one of healthy growth, until Hoover’s anti-market, anti-globalization, anti-immigration, pro-cartelization policies were instituted, brought this expansion to an end, and created a great depression...
  
  — Nobel shortlist Chicago Professor Eugene Fama:
    • [P]rivate investment must equal the sum of private savings, corporate savings (retained earnings), and government savings.... Government bailouts and stimulus plans seem attractive when there are idle resources—unemployment.... The problem is simple: bailouts and stimulus plans are funded by issuing more government debt. (The money must come from somewhere!) The added debt absorbs savings that would otherwise go to private investment. In the end, despite the existence of idle resources, bailouts and stimulus plans do not add to current resources in use. They just move resources from one use to another...
Reactions to Today’s Not so Cutting-Edge Macroeconomic Theory

• A friendly critique: FRBM President Narayana Kocherlakota: a “great forgetting,” a “great vacation,” a “great rusting”:
  – Why do we have business cycles? Why do asset prices move around so much?... [Modern m] acroeconomics has little to offer by way of answer to these questions.... The sources of disturbances in macroeconomic models are (to my taste) patently unrealistic... large quarterly movements in the technological frontier... shocks to the marginal utility of leisure... shocks to the depreciation rate.... None of these disturbances seem compelling, to put it mildly...

• An unfriendly critique: Robert Solow:
  – Suppose someone sits down where you are sitting right now and announces to me that he is Napoleon Bonaparte. The last thing I want to do with him is to get involved in a technical discussion of cavalry tactics at the Battle of Austerlitz. If I do that, I'm getting tacitly drawn into the game that he is Napoleon Bonaparte...

• A “not so cutting-edge” rebuttal: Robert Lucas on Christy Romer:
  – The Moody's model that Christina Romer — here's what I think happened.... [S]omebody says, "you've got to come up with a... defense of this fiscal stimulus." So she scrambled and came up with these multipliers... [that] I don't think anyone really believes. These models have never been discussed or debated.... These are kind of schlock economics.... I think it's a very naked rationalization for policies that were already, you know, decided on for other reasons...
Does It Matter that the Economics Profession Is Divided?

• It would be nice if people adopted what I think of as the sound analyses of Say (1829) and Mill (1844)...
  — They are not exactly new ideas...
• But many people are not: and they recommend policies:
  — Lucas: easy money, but no banking policy, no fiscal policy...
  — Prescott: deregulate and cut taxes!...
  — Fama: ???
• And a whole bunch of others: NPR, the New York Times, National Review, the entire Republican congressional caucus:
  — All saying we should do nothing or we should do less than we are doing...
• I think that this does matter, because this is not going to be