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.
  - John Hicks (1937), "Mr. Keynes and the 'Classics': A Suggested Interpretation", Econometrica http://web.econ.unito.it/bagliano/macro3/hicks_econ37.pdf
  - 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 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 (he changed his mind)
- John Stuart Mill
- Bastiat and, surprise, 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... [money] 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... 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.... [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... some other trade is understocked. But where, I would ask, is there any considerable trade... where high profits have been long pleading in vain for additional capital?... [W]e... [must not neglect] how much profits depend upon... prices... and upon... supply compared with the demand...

Jean-Baptiste Say After 1825

- *Cours Complet d'Economie Politique Pratique*: The Bank [of England]... regarded itself as obliged to buy gold back... and to coin money at a loss.... To limit its losses, it forced the return of its banknotes... cease[d] to discount commercial bills. Provincial banks... follow[ed]... commerce found itself deprived at a stroke of the advances on which it had counted.... 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... sold goods for half what they had cost... assets could not be sold... 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... could no longer find guarantees to cover their issues beyond the undertakings of individuals... themselves... 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... sellers and the buyers... must, by the metaphysical necessity of the case, be an exact equipoise.... This argument is evidently founded on... barter.... If, however, we suppose that money is used.... [H]e who sells, really sells only to buy, [but] he needs not buy at the same moment.... [I]t may very well occur, that... a very general inclination to sell with as little delay as possible, [is] accompanied with an equally general inclination to defer all purchases.... This is always actually the case.... 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... a superabundance of all commodities relatively to money...

Frederic Bastiat and Jean-Baptiste Say on Expansionary Fiscal Policy

- Frederic Bastiat: [T]he Constitution... states: "Society assists and encourages the development of labor.... through... appropriate public works to employ idle hands." As a temporary measure in a time of crisis... this intervention... could have good effects... as insurance. 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 administration can... [employ] supplanted or inactive labor in the construction of works of public utility at public expense... canals, roads, churches, or the like...

Walter Bagehot, Lombard Street

- Any sudden event which creates a great demand for actual cash may cause... a panic.... [Y]ou must not starve it. The holders of the cash reserve must... 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.... An 'alarm' is an opinion that the money of certain persons will not pay their 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... is... many banks keeping their own cash reserve, with the penalty of failure before them.... I have shown that our system... a single bank... whole reserve... no effectual penalty of failure. And yet I propose to retain that system.... 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... slowly grown up... has suited itself to the course of business... 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: $MV = PY$
- Knut Wicksell: $S = I$

Irving Fisher and Knut Wicksell

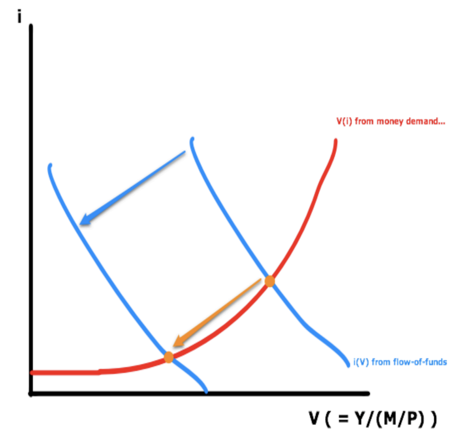
- Irving Fisher: MV = PY
  - Money market: excess demand for “money” produces excess supply of goods
  - Plus nominal inertia
    - But nominal inertia on the downside not a problem but an opportunity: the debt-deflation theory of great depressions
  - Shocks to the money stock (and to velocity) are the problem
- Knut Wicksell: S = I
  - Flow-of-funds: excess demand for high-quality investment assets (“market” interest rate higher 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 down during recessions and up during booms—a self-reinforcing cumulative process, for a while
    - Disturbances to the flow-of-funds (S or I) are the problem
      - “Austrians”
      - “NBER school”

Shortage of Liquid Cash v. Shortage of High-Quality Investment Assets

- Note that Fisher and Wicksell are not talking about the same thing
- An excess demand for liquid cash money on the one hand
- An excess demand for safe high-quality investment assets on the other
- Which gets us to Keynes and Hicks

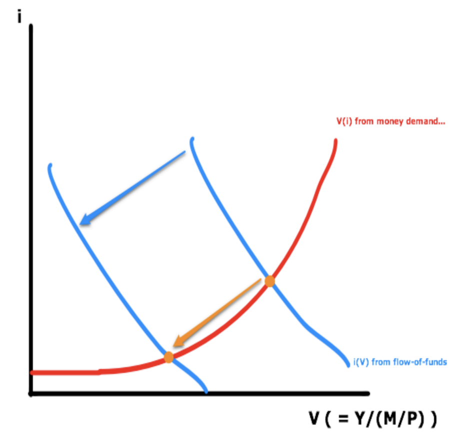
John Hicks I

- 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 supply of goods can be caused by
    - Excess demand for cash money
    - Excess demand for high-quality investment assets
- Hence the IS-LM diagram



John Hicks II

- 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
- 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"
- Always 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
  - What do you do when conventional monetary policy is tapped out?

Application to the Situation Today

- What do you do when conventional open-market operation monetary policy is tapped out?
- Four possibilities:
  - Monetary policy that alters expected inflation in the future—and by taxing long-duration high-quality investment assets reduces the excess demand for them (as long as it does not diminish the quality of such assets!)
    - Hard for a respected central bank to credibly commit to hire inflation in the future
    - Role of exchange-rate targeting?
  - Banking policy that makes low-quality investment assets into high-quality ones
  - Recapitalization policy that reduces private banking-sector demand for high-quality investment assets
    - Loans
    - Equity stakes
    - Nationalization (temporary or other ways)
  - Fiscal policy that makes more high-quality investment assets by prnting more government bonds (as long as it does not diminish the quality of such assets!)