2009 Henry George Lectures II

Macroeconomic Policy When Bubbles Matter

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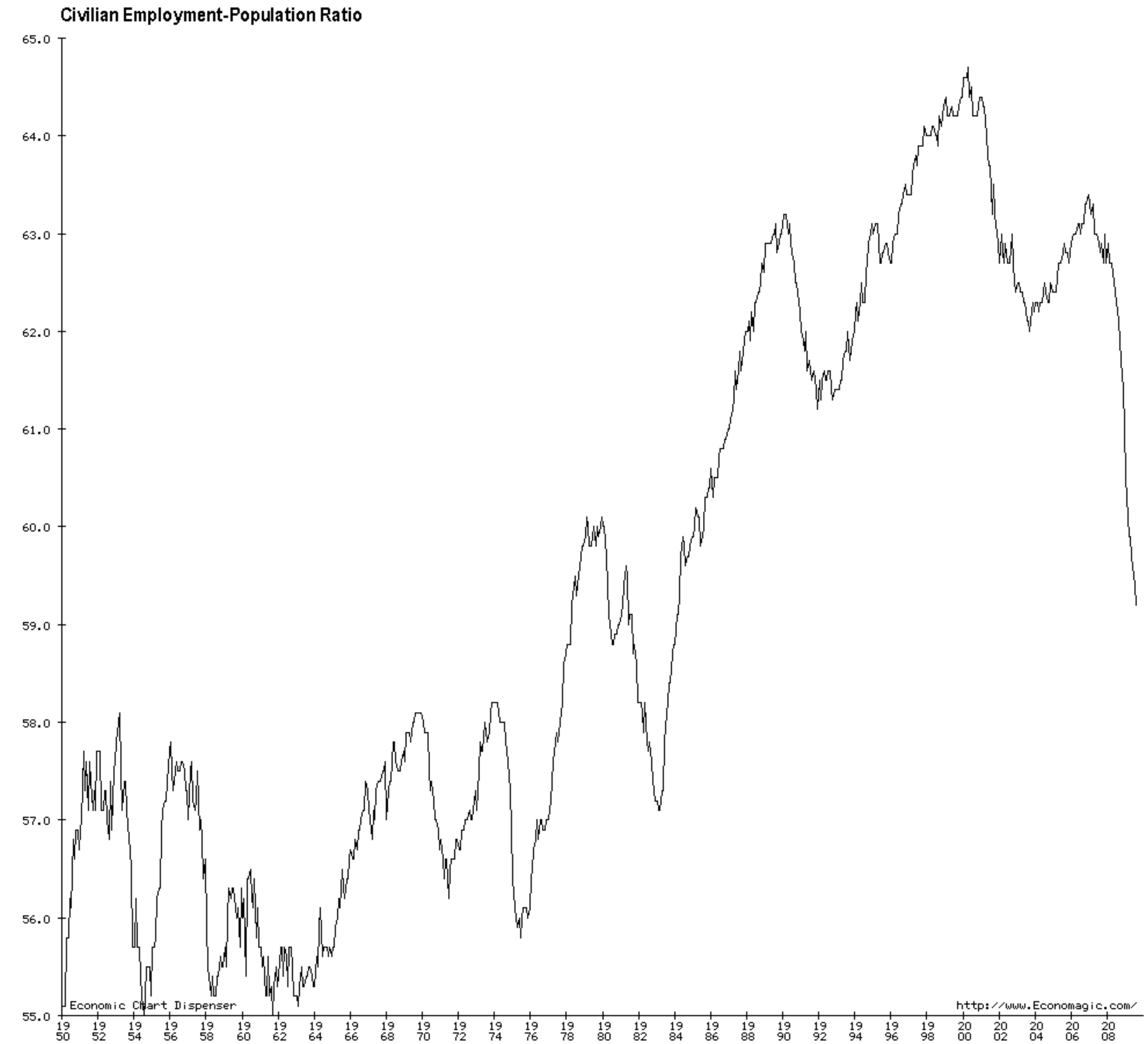
Where We Are Today



Old Keynesianism's Collapse and the Great Moderation

- Maximalism
  - Fiscal
  - Monetary
  - Jawboning
- Caution
  - The government cannot maintain "full employment" and should not try
  - The government can stabilize
  - The government cannot push the envelope of demand
- The Great Moderation
  - Substantial financial turmoil and innovation
  - Little pass-through to the overall economy
    - Key indicators: unemployment rate and capacity utilization

The Crisis of 2007-2010

- The Great Moderation vanishes
- Standard monetary policy not enough
  - Call for extraordinary stimulative policies
    - What kinds, in what mix, and how implemented?
- What to do now?
- What to do afterwards?
- Four factions:
    - Greenspanists
    - Punchbowlers
    - Producerists
    - Nihilists

Schools of Thought

- Greenspanists
  - Avoid inflationary spirals
  - Avoid financial regulation
  - Otherwise, push the envelope getting as close to full employment as you can
  - If necessary, clean up the mess afterwards
- Punchbowlers
  - Financial markets are very vulnerable to irrational exuberance
  - Job of the Federal Reserve: take away the punchbowl before the party gets going
- Producerists
  - Fear of finance
  - Needs to be tightly regulated--because most of high finance is really a cruel hoax

Enter the Nihilists…

- Not anything I expected to see…
- Now the official economists of the Republican Party
- But not people who played any sort of role in the discussions of policy-relevant macroeconomics over the past two decades
- They seem largely negative:
  - They say producerists are wrong to want financial regulation
  - They say punchbowlers are wrong to fear bubbles excessively
  - They "do not get" banking policy
  - They do not get fiscal policy either: "nothing to apply a multiplier to…"
- We have a political explanation for their appearance
- An explanation at the level of economic theory is harder to arrive at…

Digression: Modern "Cutting-Edge" Theory vs. Economic History

- Ask an economic historian what is going on right now, and he or she will tell you:
  - Another case of a fever that has periodically hit industrial economies since the very start of the Industrial Revolution in Britain
  - At least since the Panic of 1825
  - Refer to Charles Kindleberger's Minskyan account: *Manias, Panics, and Crashes*
- Ask a modern economic theorist--and he can't tell you:
  - "Why do we have business cycles? Why do asset prices move around so much?... [M]acroeconomics has little to offer by way of answer to these questions..."
  - Eugene Fama: "I'm not familiar" with Minsky…
  - The very sharp Narayana Kocherlakota's take:
    - Modern macro models have business cycles driven by one of three things:
      - Great forgetting, great vacation, great rusting
      - But these are not plausible--they are just ways of getting a DSGE model of the economy to move so then you can analyze how it moves…

So What Do You Do When You Feel You Have to Opine on Economic Policy?

- You cannot use your cutting-edge models
  - Actually, some people do…
- And here the profession divides into two:
  - People who know some history and history of thought and are able to apply older, earlier models…
  - People who don't--and who try to roll their own earlier-generation models on the fly…
- When you try to roll your own earlier-generation models on the fly…
  - …without reading the literature
  - …without even knowing that there is a literature to be read
  - You are going to make mistakes
- I don't think this is an adequate explanation:
  - Why these mistakes?
  - Why the certainty?
  - Why the venom?
- But it is the best I can do right now…

The Current State of Play

- I don’t understand the Nihilists
  - I really don’t…
- I think they will vanish
- They have placed too many bad reputational bets
  - And they are, now, crapping out…
  - Too many of them with predictions a year ago summer that the Federal Reserve was panicking unnecessarily
  - Too many of them with predictions six months ago that the stimulative policies--and their cousins around the world--would not work out
- And then the real three-cornered cage match will begin: what do we know, and what should we do later?
  - I don’t know who will win--Greenspanists, producerists, or punchbowlers
  - I have sympathies on all three sides…

Robert Lucas and Company vs. Milton Friedman, Jacob Viner, Irving Fisher and Company

- Why will the Nihilists' reputational bets fail? Because they are wrong…
- The quantity theory of money
  - MV = PY
  - In normal times, control PY by controlling M
  - Standard open-market operations
    - Expand M by buying bonds for cash
    - Contract M by selling bonds for cash
    - Cash burns a hole in your pocket--it's an asset that you want to hold only to spend
      - Hence change M and you change spending
- V, however, depends on the interest rate on Treasury bonds
- And when you buy bonds you decrease their supply
  - Lower supply means higher price
  - Higher price of bonds means lower interest rate on Treasury bonds
- Almost all of the time--in normal times--this dependence-of-V-on-i is an unimportant second-order annoyance

These Times Are Not Normal, Are They

- Interest rates on Treasury bonds very, very low
- Holding cash doesn't lose you anything in foregone interest
- Holding cash gains you something in safety
  - Should interest rates go up your bonds will lose value; your cash won't
- So where is the hole being burned in your pocket?
- Hence Jacob Viner's advice in the Great Depression
  - Monetary policy and fiscal policy
  - Expand the money supply and take steps to try to boost or at least avoid further reductions in interest rates on Treasury securities

How Do You Deal with This Crisis?

- Government guarantees
  - Create more safe assets, and so push down their price and push up interest rates on them
- Banking recapitalization
  - Push up demand for risky assets and push down demand for safe ones
- Eliminate expectations of future deflation
  - Increase demand for real property and diminish demand for cash in your asset mix
- Expansionary fiscal policy
  - Have the government print up a huge honking additional tranche of bonds
  - But what does the government then spend the money on?
  - Needs to spend it on something or you have shrunk the money supply…
  - Have to make sure the newly-printed bonds have an impact…
- These are all what the government has been doing--however imperfectly and ineptly--for a year now.

Risks of All These Policies

- Government guarantees
  - Moral hazard
- Banking recapitalization
  - Rewarding the bad actors
- Eliminate expectations of future deflation
  - Inflationary overhang
- Expansionary fiscal policy
  - The government over the long run needs to be taxing more relative to its spending, not less
  - In the short run, however…
- Given these risks--and given uncertainties--how much of each of these extraordinary stimulative policies should we be doing?
  - More…
  - Unemployment rate nationwide likely to be stuck around 10% for the next fifteen months, and then only gradually decline
  - It should be around 5%…

Arguments Against the Three Live Positions

- Arguments against Producerism
  - Voluntary transactions between consenting adults
    - The Federal Reserve was supposed to tell venture capitalists they couldn't invest in dot-coms?
    - The Federal Reserve was supposed to tell people who wanted to lend that they couldn't lend to people who wanted to borrow and buy houses?
  - High finance: a cruel hoax or a more-or-less benevolent hoax?
    - Attitudes toward risk…
    - Attitudes toward savings…
- Arguments against Punchbowlism
  - It creates extra unemployment
    - For no obvious reason--stable consumer prices mean that aggregate demand is not out of whack with aggregate supply
  - There has to be a better way to defend against financial bubbles than by attacking American workers
  - "In a world of scarcity, it is worse to cause unemployment than to disappoint the rentier…"
- Arguments against Greenspanism
  - Shutting your eyes and saying "it didn't really happen" is not an attractive posture…