Lecture 13 - Theoretical Controversies

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13 Theoretical Controversies

My lecture notes give a partial assessment of the field of macroeconomics, and leave out important theoretical controversies which I would like to talk about today.[1] As *The Economist Magazine* reported in a recent article on the teaching of macroeconomics titled "Why is macroeconomics so hard to teach?":

> Macroeconomics is difficult to teach partly because its theorists (classical, Keynesian, monetarist, New Classical and New Keynesian, among others) disagree about so much. It is difficult also because the textbooks disagree about so little. To reach the widest possible audience, most cover similar material: a miscellany of models that are not always consistent with each other or even with themselves. The result is that many professors must teach things they do not believe.

During this lecture, I would like to clarify what the main theoretical controversies in the field of macroeconomics are. Such controversies often revolve around even the most basic questions, such as what the cause of unemployment is, whether we should have fiscal stimulus when a recession comes, whether the trade deficit is a problem or whether public debt is too high. Macroeconomic experts and policy wonks are far from knowing everything, even though some of them sometimes tend to talk very assertively.[2] Inevitably, this lecture will therefore be a patchwork of different approaches, and I will be asking more questions than I can answer. I will try to give you a "map of the land" of what the theoretical controversies are. I think it should be useful for you to read the *Wall Street Journal*, *The Economist*, *The New York Times*, and also hopefully for you to become more informed citizens.

13.1 Austrian VS Keynesian Economics

Figure **??** is an educational video to give you the main debate between the "Keynesian" and the "Austrian" school of macroeconomics, between impersonations of John Maynard Keynes and Friedrich Hayek (the lyrics are here). For the Austrian school of thought, with a rather pro-market leaning, the problem with recessions is not the bust but the preceding boom. Therefore, according to these economists, doing a fiscal stimulus, or making monetary policy more accomodative during a crisis, can only making macroeconomic problems worse. According to Austrian economists, business cycles are caused by malinvestments, and too low interest rates

[1] This is one reason why I have chosen to not use a textbook, and write my own lecture notes. Another reason is cost. The inflation rate for college textbooks has been $(914.9/315.9)^{1/16} - 1 \approx 6.9\%$ on average between 2000 and 2016 (a 16-year period), according to this data. At the same time, CPI inflation between 2000 and 2016 has been $(244.5/178.8)^{1/16} - 1 \approx 2\%$ on average (see here).

[2] According to Joan Robinson: "The purpose of studying economics is not to acquire a set of ready-made answers to economic questions, but to learn how to avoid being deceived by economists."

during the boom phase. This view is opposite to Keynesian economics. This view is very influential in some policy circles.

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You should also note that the Keynesian view is represented in this video as the view that unemployment is related to "sticky wages". Although I briefly alluded to this during lecture **??** when we studied the labor market, and the cause of unemployment, we never mentioned this issue in lectures **??**, **??**, **??**, **??**. This is the issue we take up now.

13.2 Short-run Keynes: The Neoclassical Synthesis

Many Keynesian economists, though not all, have come to adopt a vision of Keynesian economics based on what is called the "neoclassical synthesis", sometimes also called "American Keynesianism", or new-Keynesian economics. To quote from the third edition of his *Economics* textbook, Paul Samuelson, a major proponent of that approach, was writing in 1955 that:

> In recent years 90 percent of American economists have stopped being 'Keynesian economists' or 'anti-Keynesian economists.' Instead they have worked towards a synthesis of whatever is valuable in older economics and in modern theories of income determination. The result might be called neo-classical synthesis and is accepted in its broad outlines by all but about 5 per cent of extreme left wing and right wing writers. (Samuelson 1955: 212)

This school of thought holds that the economy is Keynesian in the short-run, and Neoclassical in the long run. This approach is often taught in *Intermediate Macro courses*, including Olivier Blanchard's *Macroeconomics* textbook, in the form of what is called the AS-AD approach. What I would then have taught you is that in the long run, output is determined by technology; while in the short-run, it is determined by aggregate demand (government spending, disposable income, etc.). According to this view of the macroeconomy, aggregate demand may determine output in the short run because prices are sticky.[3]

One key prediction of this approach to Keynesian macroeconomics is that there is then a trade-off between output (or equivalently, unemployment and aggregate demand) and inflation. This trade-off is called the *Phillips Curve* (after William Phillips who first documented the correlation), and corresponds to a negative relationship between unemployment and inflation in the time series: when unemployment is high, inflation is low, while when unemployment is low, inflation is high. Paul Samuelson and Robert Solow documented the same statistical fact for the United States. For proponents of the neoclassical synthesis, this can be explained by the fact that increases in aggregate demand both decrease unemployment in the short run and lead to inflation in the longer run. Therefore, lower unemployment can only be achieved at the expense of lower future unemployment.

In the 1970s, the Phillips Curve, or the negative relationship between unemployment and inflation, started to break down. Keynesian economists who had embraced the neoclassical synthesis were caught off guard. Keynesian economics started to lose its appeal, even though the version of Keynesian economics which was then rejected had very little resemblance to J.M. Keynes' original vision. As we saw during this class, Jonn Maynard Keynes was actually much more worried about the issue of too much capital accumulation, or an excess of saving over investment, than about sticky wages. To J.M. Keynes, if wages were lowered (the way that neoclassical economics would say they should be, following a labor demand shock), then aggregate demand problems would be even more severe, and as a result even more unemployment would follow.

[3] To be more precise, according to the neoclassical approach, this is why output can be determined by demand. Firms have market power so that they set a price at a markup over marginal cost. In the short-run, when they face higher demand, they cannot increase their price. However, they are willing to supply the corresponding quantity at the old price, because their marginal costs are still lower than the price they charge (since they had market power).

13.3 Neoclassical Economics

Given this failure of the neoclassical synthesis, neoclassical economists, and particularly the Chicago school, started to question the very appeal of Keynesian Economics. In a provocative article titled "After Keynesian Macroeconomics", Thomas Sargent and Robert Lucas famously asserted:

> That these predictions were wildly incorrect and that the doctrine on which they were based is fundamentally flawed are now simple matters of fact involving no novelties in economic theory. The task now facing contemporary students of the business cycle is to sort through the wreckage, determining which features of that remarkable intellectual event called the Keynesian Revolution can be salvaged and put to good use and which others must be discarded.

This revival of neoclassical economics, noting the failure of the Phillips curve in particular, consisted in rejecting all views of the economy based on aggregate demand. This approach to macroeconomics culminated in the Real Business Cycle approach, according to which all fluctuations in output were caused by technological "supply" shocks. This approach is in turn based on a strong view of agents' rationality, and in particular of the "Ricardian equivalence view", according to which decreases in taxes have no effects on consumption because consumers rationally anticipate future taxes to come (as we have seen, in the overlapping generations model, such taxes never come, since public debt is always rolled over).

13.4 Long-run Keynes: Secular stagnation

As much as the neoclassicals were right about the failure of sticky price Keynesian economics, I believe that it is very hard to et the same time deny that aggregate demand does have effects on the economy. We shall see a lot of evidence in the next lecture suggesting that output is not determined only by supply forces, but also by marginal propensities to consume and disposable income. An alternative approach to Keynesian economics, and one which is not based on sticky prices, revolved around ideas related to the issue of "secular stagnation." According to this view, output may be determined by demand, even in the longer run.

Before he left academia for the policy world, after an exceptionally rapid career which led him to become a tenured professor at Harvard University at age 28, Lawrence Summers wrote a piece called "Should Keynesian Economics Dispense with the Phillips curve" (you can read the first pages of this paper on Google Books), in which he was already criticizing the sticky price approach to macroeconomics, as well as proposing a vision of Keynesian economics based on long-run aggregate demand effects.

Larry Summers has recently debated with Olivier Blanchard, a proponent of the New-Keynesian approach to macroeconomics, in December 2017, at the Peterson Institute of International Economics. Their debate very much reflects the short-run versus long-run approach to Keynesian economics which I just alluded to. In the video debating Olivier Blanchard, Larry Summers expresses some of the ideas that we have been exposed to in this class:

> I believe that rather than excessive demand yielding to temptation, the larger issue will be insufficient demand produced by a variety of forces that lead to a chronic excess of saving over investment. I would cite as evidence for that concern three types of evidence. First, we have been below target inflation for a long time. Second, the behavior or real interest rates is close to zero over the next 10 years, is substantially suggestive of excess saving over investment. Third, the difficulty now over a long period of time in seeing strong and adequate growth consistent with stable financial conditions.

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Larry Summers' remark is based on the observation that aggregate demand has recently often been boosted by either credit or equity financial bubbles. The 2007-2009 financial crisis was indeed caused by the inability to repay of many homeowners who had taken on too much credit. Coming back to the Keynes vs. Hayek debate, one view could have been the Hayekian, malinvestment, view. Another could simply be that with "too much savings", or an excess of saving over investment, investors were just investing in these very risky securities because they could not find profitable investment opportunities elsewhere.

Finally, note that the Keynesian view of macroeconomics leads one to have a balanced approach to lenders / creditors relationship. One view is that homeowners were too irresponsible in taking out loans which they would not be able to repay. The same argument has been made about Greece. But if one has the view that saving is plentiful, then investors are actually pushing borrowers to borrow because they need some "parking spaces" for their money. According to this view, it is also the reason why financial assets are subject to so frequent booms and busts: investors buy overvalued assets, because they have no better option in a world of scarce investment opportunities.

Next lecture will be devoted to trying to sort out some of these issues using data. Although we shall not be able to conclude definitely, I will show you empirical macroeconomics research as it is currently being done; and show you that data is consistently coming in, which unambiguously points to a view of the economy where aggregate demand have long lasting effects, just as the models studied in this class suggest they would.

Readings - To go further

Robert E. Lucas and Thomas J. Sargent, "After Keynesian Macroeconomics," Federal Reserve Bank Minneapolis Quarterly Review, no. Spr (1979).

"Secular Stagnation, Coalmines, Bubbles, and Larry Summers", Paul Krugman, *New York Times* Blog Post, November 16, 2013.

"The Economic Hokum of 'Secular Stagnation' ", John B. Taylor, *Wall Street Journal*, January 2, 2014.

"The Age of Secular Stagnation", Larry Summers, *Foreign Affairs*, February 15, 2016.

(Gated) Why is macroeconomics so hard to teach? *The Economist*, August 9, 2018.