

“Is the Fundamental Science of Macroeconomics Sound?” by David Colander

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We All Share an Interest in Macro Doctrine, but. . .

- David's paper is a slim 7 pages, and of these pages an excessive number are devoted to unhelpful analogies
 - Searching for the keys under the streetlight or in the dark
 - Building cathedrals in the middle ages
- I lost count of the numbers of statements of this character: “Let me be clear about what I am saying.”
 - Just be clear in the first place, don't keep announcing “let me be clear.”

Where Are the Specifics of the Critique?

- The paper's predominant quality is vagueness. The main exception is the list of authors who should be cited but have allegedly been forgotten:
- Keynes, Minsky, Hicks, Clower, Leijonhufvud [repeated twice], Gurley, Davidson, Goodhart, Clower, or "even Friedman"
- That's a good beginning of a list, but let me put in a plug for adding the names of Modigliani, Tobin, Okun, and Jorgenson, among others

The Critique of DSGE Models

- I am no defender of DSGE models, and indeed I have my own critique
- But DSGE models are an elusive beast
 - Anytime you criticize them for neglecting something, up pops another one like mushrooms after a rainstorm
 - No investment, no fiscal policy, no financial frictions? DSGE articles incorporating all these previously missing elements and much more have been written in the last half-decade

A Specific Critique of DSGE

- The core of DSGE is the Euler consumption equation
 - This assumes that all consumers have sufficient assets to reallocate consumption over time
 - Neglects liquidity constraints, dependence of consumption on current income
 - Has no explicit channel for real net wealth effects coming from asset bubbles or high household debt
 - Predicts implausible and unrealistic wealth effects on labor supply
 - Disutility of work – jobs and employment are bad and to be avoided. Let's envy the unemployed for all the leisure they are enjoying.

But Most Economics Taught to Students is Not DSGE

- We need to recognize the stark dichotomy in the teaching of macroeconomics in American universities
- DSGE models are taught only in graduate school. I recently looked up DSGE models in the indexes of leading intermediate ugrad macro texts, and they are barely mentioned (in less than half a paragraph) by Mankiw and Chad Jones

What Is Taught to American Undergraduates?

- With virtually no exceptions, intermediate undergraduate texts teach what I call “traditional macro.”
- The only difference among leading macro texts is whether they place long-term growth first (Mankiw, Abel-Bernanke, Jones) or business cycles first (Blanchard, Gordon)

A Definition of “Traditional Macro”

- It is all there, in the 1978 first editions of the intermediate undergrad texts published simultaneously by Dornbusch-Fischer and Gordon
- Business cycle macro in 2011 retains all the 1978 elements, with a few new applications but no change in the underlying theory
- Traditional macro can explain the crisis and slow recovery with virtually no alterations from its original 1978 incarnation.
 - Part of the 1978 version was a theoretical analysis of the Great Depression and problems of policy in coping with it

What Are the Core Elements of Traditional Macro?

- Dynamic AD-AS model as a second-order difference equation. It combines
 - Natural rate hypothesis and adaptive expectations
 - Demand shocks change output and inflation in the same direction in the short-run, no change in output in the medium to long-run
 - Explicit supply shocks (oil, food, exchange rate, productivity trend) that change output and inflation in the opposite direction in the short run
- This model explains the late 1960s inflation, the twin peaks of unemployment and inflation in the 1970s, the “valley” of low unemployment and inflation in the late 1990s, and even the 2007-09 crisis via analysis of similarities/differences with 1927-33.
 - In contrast DSGE has no explicit treatment of supply shocks and thus no explanation for the twin peaks of the 70s & valley of the late 90s.

Where Do the Demand Shocks Come From?

- Their causes are sorted via the IS-LM model, which is still in virtually every intermediate macro textbook
- Consumption: current and permanent income, expectations, interest rates, real net wealth, quantitative credit conditions
- Investment: profit expectations, output accelerator, cost of capital, overbuilding
- Government (tax vs. spending multipliers)
- Net exports (exchange rate, domestic vs. foreign income)

Monetary and Fiscal Policy in Traditional Macro

- Impediments to monetary policy were all in the first edition and give us a good headstart on monetary policy problems in 2008-10
 - Vertical IS, horizontal LM, liquidity trap, zero lower bound and excess reserves in 1935-40
 - Newer editions have applications to Japan in 1990s, to U.S. today
- Impediments to fiscal policy
 - Vertical LM, interest rate crowding out, capacity constraint crowding out (WWII, Korea, Vietnam)
- Impediments to any policy: adverse supply shocks

Application: 1927-33 vs. 2002-10

■ Bubbles

- 1927-29, stock market bubble on top of overbuilding 1924-28
- 2002-06 housing bubble with overbuilding in nonresidential structures

■ Overleveraging

- 1927-29 (construction debt, stock market 10% margin)
- 2002-06 (leverage, securitization)

■ Why wasn't the 1996-2000 stock market bubble as harmful? Lack of leverage (50% margin, much buying with 100% equity through mutual funds)

Policy: Differences and Similarities

■ Monetary policy

- 1930-32: Bank failures, no deposit insurance
 - Fed allowed declining GDP and bank failures to drag down money supply passively (vs. actively in Friedman-Schwartz)
- 2008-10 very different: Bank bail-outs, QE1 and QE2
- Similarity: ZLB 1935-40 and 2009+

■ Fiscal Policy

- 1933-39 Stimulus too small to raise share of govt spending in potential GDP
- 2008-10 Obama stimulus failed to raise govt spending share or offset ongoing decline in total government employment

What Version of Old Macro Does David Critique?

- According to David on p. 1: “I do not blame academic macroeconomics for abandoning the neoclassical / neoKeynesian synthesis that preceded them; I agree with modern macroeconomists that synthesis had serious problems and had to be abandoned.”
- David stops there. What era of traditional macro does he recommend abandoning? Keynes 1936? Samuelson’s 1948 textbook? 1960? 1968? 1978? Traditional macro was reconstructed in the 1970s by merging the dynamic AD-AS model with traditional Keynesian demand-side macro.

A Word About Paul Davidson's Paper

- Where David is vague, Paul is specific
- He ranges over a wide set of issues, most of which are treated explicitly in traditional macro
 - Example #1: Liquidity constraints
 - Example #2: The possibility of an underemployment equilibrium even with flexible wages and prices
 - Tobin's elegant analysis of the offsetting stabilizing and destabilizing effects of declining prices, real balance effect fights the expectations and redistribution effects

Paul's Last Point is Important But Not Related to Macro Doctrine

- Once we're convinced by Paul (or by traditional macro) that a fiscal stimulus is needed, on what should the federal government spend the money?
- That's not a matter of theory or doctrine, but rather
 - Econometric estimates of multipliers
 - Practical issues in speed and effectiveness, e.g., whether projects are “shovel-ready”
- Alan Krueger's elegant summary of fiscal policy from the inside: the multiple dimensions of politics and practicality