Lecture 3: The night they reread Minsky

Paul Krugman
Securities, commodity contracts, and investments (% of GDP)
FINANCIAL-INDUSTRY PROFITS AS A SHARE OF U.S. BUSINESS PROFITS

Source: Simon Johnson/James Kwak

PAY PER WORKER IN THE FINANCIAL SECTOR AS A PERCENTAGE OF AVERAGE U.S. COMPENSATION
What if we de-financialize?

US exports of financial services, 2007:

$43 billion = 0.3 \% \text{ of GDP}$

UK exports of financial services, 2007:

$69 billion = 2.5\% \text{ of GDP}$
BLOOM COUNTY by Berke Breathed

1. Y...you're from my anxiety closet?
   Yes, we're two expert economists. We'll be your nightmare tonight.

2. Two economists?! In the same room? Please... just don't discuss the economy! Oh, it's not improving!

3. The leading economic indicators show a sustained renoeration towards what of the deficit?
   Phooey! The deficit!

4. AAIGH! The key, of course, is my deficit. Fanny...
From the time of Say and Ricardo the classical economists have taught that supply creates its own demand;—meaning by this in some significant, but not clearly defined, sense that the whole of the costs of production must necessarily be spent in the aggregate, directly or indirectly, on purchasing the product.

... 

It is, then, the assumption of equality between the demand price of output as a whole and its supply price which is to be regarded as the classical theory's 'axiom of parallels'. Granted this, all the rest follows—the social advantages of private and national thrift, the traditional attitude towards the rate of interest, the classical theory of unemployment, the quantity theory of money, the unqualified advantages of *laissez-faire* in respect of foreign trade and much else which we shall have to question.
Let $Z$ be the aggregate supply price of the output from employing $N$ men, the relationship between $Z$ and $N$ being written $Z = \phi(N)$, which can be called the aggregate supply function. Similarly, let $D$ be the proceeds which entrepreneurs expect to receive from the employment of $N$ men, the relationship between $D$ and $N$ being written $D = f(N)$, which can be called the aggregate demand function.
Now if for a given value of $N$ the expected proceeds are greater than the aggregate supply price, i.e. if $D$ is greater than $Z$, there will be an incentive to entrepreneurs to increase employment beyond $N$ and, if necessary, to raise costs by competing with one another for the factors of production, up to the value of $N$ for which $Z$ has become equal to $D$. Thus the volume of employment is given by the point of intersection between the aggregate demand function and the aggregate supply function; for it is at this point that the entrepreneurs' expectation of profits will be maximised. The value of $D$ at the point of the aggregate demand function, where it is intersected by the aggregate supply function, will be called the effective demand. Since this is the substance of the General Theory of Employment, which it will be our object to expound, the succeeding chapters will be largely occupied with examining the various factors upon which these two functions depend.
Rationalizing macro, part 1:

The neoclassical synthesis (Samuelson)

Rational consumers (Ando-Modigliani, Friedman)

Natural rate hypothesis (Friedman, Phelps)
The Phillips curve, 1960-69
Friedman, 1967:

To state this conclusion differently, there is always a temporary trade-off between inflation and unemployment; there is no permanent trade-off. The temporary trade-off comes not from inflation per se, but from unanticipated inflation, which generally means, from a rising rate of inflation. The widespread belief that there is a permanent trade-off is a sophisticated version of the confusion between “high” and “rising” that we all recognize in simpler forms. A rising rate of inflation may reduce unemployment, a high rate will not.

Prediction: “Clockwise spirals” in unemployment-inflation
The Phillips curve, 1960-90
The Great Divide

Lucas / rational expectations

Too much information (circa 1979)

Real business cycle ("fresh water")

New Keynesian ("salt water")

In the background: efficient markets theory
For a long while after the explosion of macroeconomics in the 1970s, the field looked like a battlefield. Over time however, largely because facts do not go away, a largely shared vision both of fluctuations and of methodology has emerged. Not everything is fine. Like all revolutions, this one has come with the destruction of some knowledge, and suffers from extremism and herding. None of this deadly however. The state of macro is good.

Olivier Blanchard, August 2008
John Cochrane, a finance professor at the Booth School of Business at the University of Chicago, said that while Tobin made contributions to investing theory, the idea that spending can spur the economy was discredited decades ago.

“It’s not part of what anybody has taught graduate students since the 1960s,” Cochrane said. “They are fairy tales that have been proved false. It is very comforting in times of stress to go back to the fairy tales we heard as children but it doesn’t make them less false.”

To borrow money to pay for the spending, the government will issue bonds, which means investors will be buying U.S. Treasuries instead of investing in equities or products, negating the stimulative effect, Cochrane said. It also will do nothing to unlock frozen credit, he said.

From Bloomberg: Yale’s Tobin Guides Obama From Grave as Friedman Is Eclipsed
What even salt-water schools lost:

_Fiscal policy:_ only 5 NBER working papers mentioned fp in title or abstract between 1985 and 2000 (out of about 7000)

_Causes of demand fluctuations_
THE NIGHT THEY RAIDED MINSKY'S

JASON ROBARDS
BRITT EKLAND
NORMAN WISDOM
BERT LAHR

OFTEN TIMES,
BEING A NICE GIRL
IS TOO MUCH TO BARE!