Samuelson's Mistake

How to Correct it and Maintain Prosperity for All

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What This Talk is About

- In my book *How the Economy Works* I argued that there are three important ideas in *The General Theory*.
    - Confidence a.k.a. animal spirits, is an independent driver of business cycles
    - The unemployment rate has no tendency to converge back to the social optimum
    - Government can and should do something about this
- These ideas can be, and should be, reconciled with Walrasian equilibrium theory
- The right way to do this is with a new version of Temporary Equilibrium Theory

Two Visions of Macroeconomics

- Orthodox macroeconomics is based on Wicksell's rocking horse metaphor
  - Shocks are a child with a club
  - The rocker is the economic system
  - In the absence of shocks the system always returns to the natural rate of unemployment
- In *How the Economy Works* I argue that a better metaphor for macroeconomics is a sailboat with a broken rudder
  - Shocks are winds that blow the boat
  - The sailboat is the economic system
  - In the absence of shocks the boat may become becalmed anywhere

Reconciling Keynes with Walras

- In orthodox macroeconomics, the world is Keynesian in the short run and classical in the long-run
- The short-run is the period when prices have not yet adjusted to clear markets
- The long-run is the period when all prices have adjusted and the economy is back at full employment
- In this vision, the unique rest point of the system is the natural rate of unemployment
- This is the wrong way to reconcile Keynes with Walras

Temporary Equilibrium Theory is the Right Approach

- In *Value and Capital*, the world proceeds in a series of weeks
- Each week:
  - People bring commodities and assets to market
  - They form expectations of future prices
  - A fictitious auctioneer calls out current prices
  - When all demands and supplies are equal; trade takes place
- After reading the general theory Hicks changed the equilibrium concept
  - Some markets are flex-price
  - Some markets are fix-price
- In 1955: Samuelson cemented this idea in the third edition of his Principles Textbook

Samuelson was Wrong

- The idea that recessions are caused by sticky prices is wrong
- It is closer to David Hume's essay *Of Money* than *The General Theory*
- Reconciling Keynes with Walras by assuming sticky prices is a mistake

- **It should be resisted**

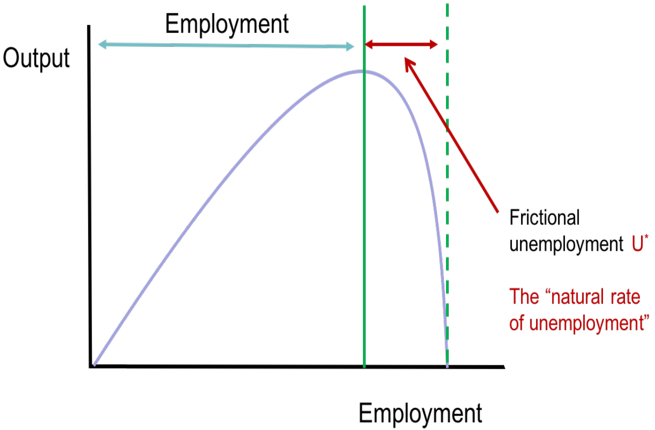
We Need a Different Kind of Temporary Equilibrium Theory

- In Samuelson/Hicks: markets do not clear
  - The auctioneer does not finish his job
  - People trade each week at ‘false prices’
  - Benassy/Malivuad/Barro-Grossman formalized this idea

- In My works, most recently the book *Prosperity for All*
  - The labor market is a Keynesian search market
  - There are two inputs to the job-funding process
  - There are not enough prices to allocate search inputs
  - There is a continuum of labor market equilibria
  - In all of these equilibria: no firm has an incentive to change wages or prices

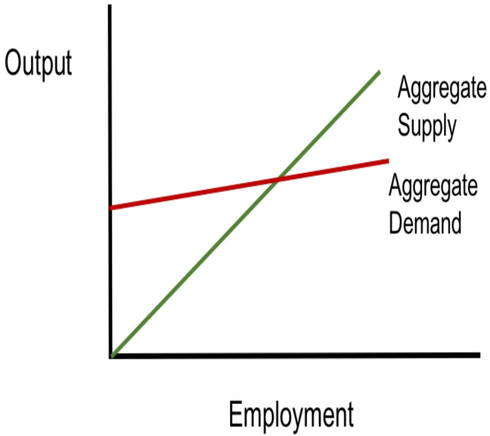
The Natural Rate

- Search theory leads to a definition of full unemployment
- If unemployment is too low, people spend too long searching for trading partners
- The ‘natural rate’ of unemployment is the rate that maximizes steady-state output (measured in wage units)

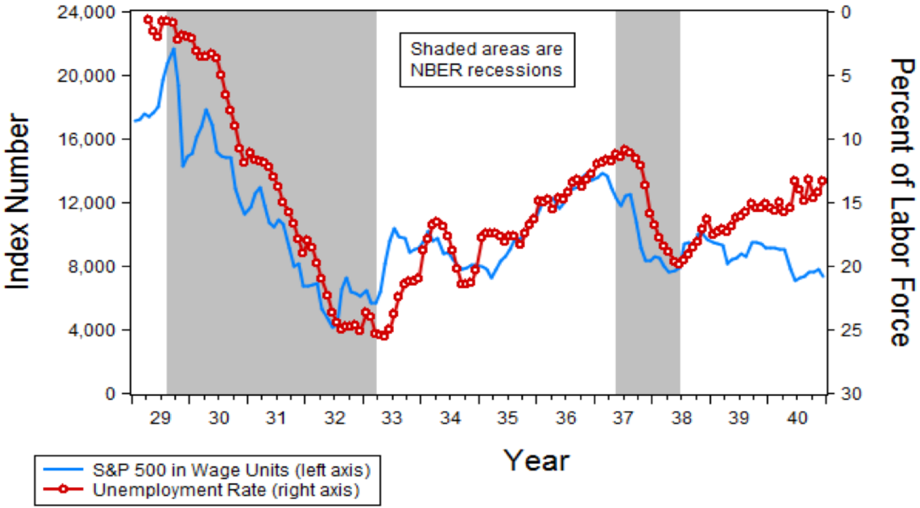


Back To Basics

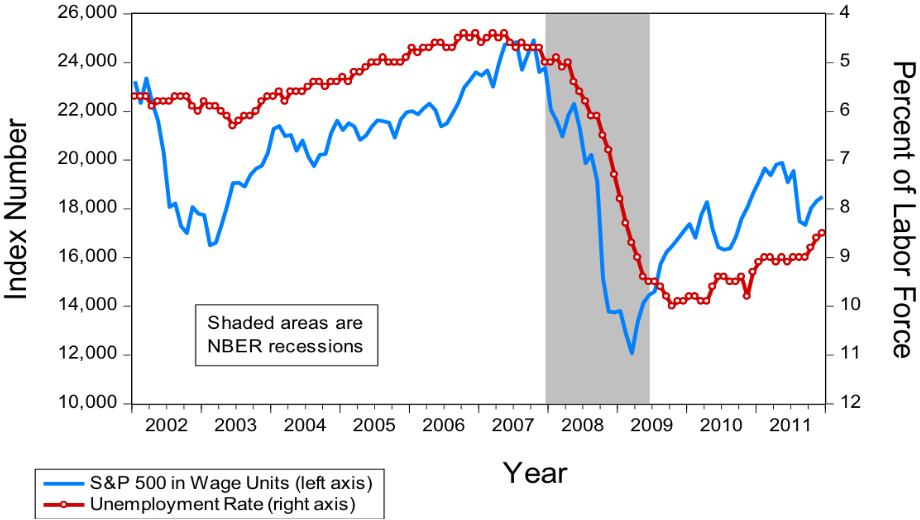
- The most important hole in *The General Theory* is the lack of a theory of aggregate supply
- Why do firms not offer to employ unemployed workers at lower wages?
- My explanation...
- ...Incomplete labor markets
- Animal Spirits is a fundamental that shifts the aggregate demand curve up and down
- For every value of animal spirits there is a different long-run steady-state equilibrium



The Great Depression

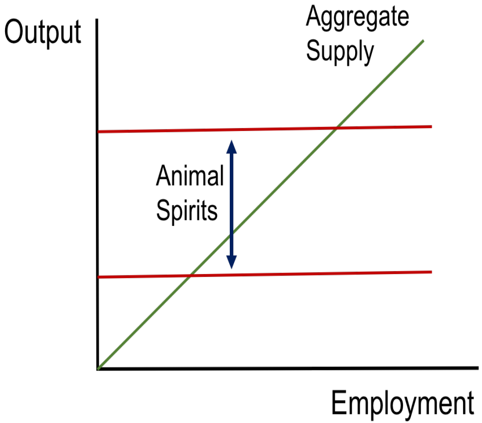


The Great Recession



Financial Recessions

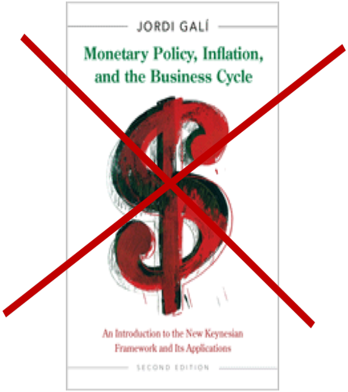
- What causes business/financial cycles?
- In my work recessions are a self-fulfilling prophecy
  - Self-fulfilling movements in animal spirits cause shifts in aggregate demand
  - As people spend more firms hire more workers
  - Wages and prices adjust to implement a zero profit equilibrium
  - For every value of animal spirits there is a different long-run steady-state equilibrium



Summary

- New-Keynesian DSGE theory assumes
  - Rational Expectations
  - Convergence to a unique steady state equilibrium unemployment rate
  - (Approximate) Pareto optimality of the equilibrium
  - No involuntary unemployment
  - Complete financial markets

- None of these properties are necessary features of a DSGE model



Summary

- In contrast to New-Keynesian DSGE models: I build DSGE models where:
    - Expectations are fundamental
    - There is a continuum of steady state equilibrium unemployment rates
    - Unemployment is involuntary in the sense of Keynes
    - Financial markets are incomplete
    - The equilibria are NOT Pareto Optimal
- I incorporate essential elements from *The General Theory* into a DSGE model without compromising the basic message
- Unregulated market economies are NOT self-stabilizing