Samuelson’s Mistake
How to Correct it and Maintain Prosperity for All

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FMM Conference Presentation

20th October 2016
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 diagram shows two lines representing the S&P 500 in Wage Units (left axis) and the Unemployment Rate (right axis) over the years 1929 to 1940. The shaded areas indicate NBER recessions.
The Great Recession

Shaded areas are NBER recessions

- S&P 500 in Wage Units (left axis)
- Unemployment Rate (right axis)
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.