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No Tears for Keynes

During the Great Depression, the central public-policy debate concerned the role that government should play in reviving a faltering economy, with some economists advocating an expanded government role and "classical" economists arguing against it. Today, in the wake of the worst recession since the Depression, we seem to have come full circle, with the revival of many of those earlier classical arguments.

In that Depression-era debate, classical economists argued that the role of government was very limited. Money, they claimed, was simply a "veil" over the real economic world, and thus could do little to stimulate real economic activity. An increase in the money supply would simply increase the price level. Indeed, they argued that workers could not be fooled into accepting lower real wages even when they were disguised as higher money wages, so that there was nothing that stimulative public policy could do in the long run to eliminate unemployment. On these grounds, public policy could alter real economic activity only if it could in some sense fool the public.

Enter Keynes

John Maynard Keynes, a highly skilled economist and statistician from Cambridge, was well-trained in this classical notion of the limitations of public economic policy. Throughout his early career, he had expressed the Cambridge view of the world—the classical quantity

theory, which stressed money's limited role as a policy tool. According to this theory, the money supply was the sole determinant of the absolute price level, but of little else.

Yet Keynes ultimately rejected his intellectual heritage when he published "The General Theory of Interest, Employment, and Money." The 'General Theory' emphasized that individuals desire money for other than transactions (spending) reasons; for example, they may desire to hold money because the risk of doing so is less than the risk of holding bonds if interest rates are expected to rise (and bond prices to fall). In modern Keynesian thinking, monetary policy was downgraded and fiscal policy instead was accepted as the primary tool of economic stabilization, with the Federal budget being used to manage aggregate demand. Another persistent thread running through the 'General Theory' was the argument that prices were "wage determined." This continual reliance on wages as the primary factor determining prices gave rise to the cost-push theory of inflation.

Enter econometrics

Twentieth-century aggregate economic theory—Keynesian and non-Keynesian—did not submit to hard scientific testing until economists discovered how to handle the mountains of available statistics through econometric model building. This new methodology involved the statistical estimation of

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interrelated equations describing private market behavior—for example, the response of consumption to a rise in income, or the sensitivity of savings to changes in interest rates. Most large-scale econometric models were built along Keynesian lines, emphasizing the inter-relationship between income and expenditures. Also, most of these early models yielded large fiscal-policy impacts and rather modest monetary-policy impacts, reflecting the model builders' preconceptions concerning policy's proper role.

In the late 1960's, however, economists at the Federal Reserve Bank of St. Louis reacted to this strong Keynesian bias by developing a model which emphasized the dominant role of the money supply in determining nominal and real output, especially in the short-run. In this model, fiscal variables displayed very little long-run ability to affect real output. Models of this type were scorned by textbook Keynesians, but still showed good results in interpreting reality.

Enter Friedman

The guiding spirit behind this anti-Keynesian sentiment was the University of Chicago's Milton Friedman, the 1976 Nobel laureate in economics. Friedman was not personally involved with the testing of "monetarist" econometric models of aggregate economic activity, but he had a great deal to do with them intellectually. In a seminal essay published in 1956, he said, "The quantity theorist not only regards

the demand function for money as stable; he also regards it as playing a vital role in determining variables that he regards as of great importance for the analysis of the economy as a whole, such as the level of money income or of prices."

Friedman threw down the gauntlet to Keynesians with his thesis regarding the "stability" of the demand for money. Over the years, students of Friedman have spent countless numbers of computer hours showing that the demand for money is dependent on only a few variables, and that this relationship shows a good deal of statistical stability over time. Indeed, the stable money-demand hypothesis was the rock upon which the St. Louis Fed economists built their model of the U.S. economy.

Yet, Keynesians disputed these money-demand studies. They often found an unstable demand for money over short-run periods, on the basis of quarterly or even monthly data. This difference was not merely a point of esoteric intellectual dispute, for if they could prove that the demand for money was actually unstable, Keynesians would win much of the debate over fiscal vs. monetary policy.

The stable money-demand debate still rages in the pages of economic journals, but the monetarists appear to have won some major battles in the twenty years since Friedman edited "Studies in the Quantity Theory of Money." Central banks around the world now pay a good

deal of attention to the impact of money on nominal output and prices. Money is no longer regarded simply as a veil over real economic activity. Indeed, Congress itself has been influenced to the extent that it passed a resolution in 1975 requiring the Federal Reserve to report periodically on its annual monetary targets.

New palace coup

In emphasizing the relationship between money and prices—an argument still in dispute—monetarists have raised the flag of the pre-Keynesian classical economists. Today, more flags are in the offing. In the most recent assault on the conventional wisdom, Robert Lucas, Jr., of the University of Chicago and Thomas Sargent and Neil Wallace of the University of Minnesota argue that public policy's impact on real economic activity has been grossly overstated.

Their basic point is that statistical economic models of the economy have misrepresented the way individuals and businessmen form their price expectations. In their view, economists have always assumed that the public could never learn the "policy rule"—that is, the manner in which policymakers respond to economic information in determining future policy. Lucas, Sargent and Wallace argue that this view is mistaken and that the private sector has "rational expectations"—people actually can, over a period of time, learn about the real structure of the economy and the policy rule by which policymakers behave.

This knowledge is enough for the private sector to offset whatever impact policymakers exert on the real economy.

This notion of rational expectations leads to what might be called "super-classical" economic results, for in effect neither fiscal nor monetary policy would have any impact on real economic growth. The only way policymakers could affect real output would be to fool the public as to their intended actions. All other policy effects on real output would be negligible. While this theory has received only moderate statistical testing, it has led to the revival of the classical argument that money is to some extent a veil over the real economy.

"Rational expectations" might help explain why some econometric models have shown monetary policy to be more stimulative than fiscal policy, because the public has had greater knowledge of fiscal policy (tax rates, government spending, etc.) and less knowledge, until recently, of the actions of the Federal Reserve. If this line of argument is believed, monetary policy henceforth might lose some of its power to affect real economic growth. This remains an hypothesis for future economists to test. In sum, however, it seems clear that a circle has been closed in economic theory, stretching from pre-Keynesian classicism, to Keynesianism, to the anti-Keynesian revolution of the 1960's and, finally, back to strict classical economics.

Joseph Bisignano

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT
(Dollar amounts in millions)

Selected Assets and Liabilities	Amount Outstanding 12/29/76	Change from 12/22/76	Change from year ago	
			Dollar	Percent
Large Commercial Banks				
Loans (gross, adjusted) and investments*	94,878	+ 1,171	+ 4,839	+ 5.37
Loans (gross, adjusted)—total	70,842	+ 527	+ 4,278	+ 6.43
Security loans	1,898	+ 236	+ 335	+ 21.43
Commercial and industrial	22,858	- 123	- 833	- 3.52
Real estate	21,464	+ 49	+ 1,867	+ 9.53
Consumer instalment	12,230	+ 122	+ 1,609	+ 15.15
U.S. Treasury securities	11,177	+ 760	+ 396	+ 3.67
Other securities	12,859	- 116	+ 165	+ 1.30
Deposits (less cash items)—total*	95,087	+ 1,934	+ 3,663	+ 4.01
Demand deposits (adjusted)	27,032	+ 755	+ 1,743	+ 6.89
U.S. Government deposits	334	- 41	- 1	- 0.30
Time deposits—total*	66,081	+ 1,093	+ 2,443	+ 3.84
States and political subdivisions	5,895	+ 162	- 1,736	- 22.75
Savings deposits	30,820	+ 370	+ 8,503	+ 38.10
Other time deposits‡	26,809	+ 468	- 3,112	- 10.40
Large negotiable CD's	11,201	+ 605	- 4,853	- 30.23
Weekly Averages of Daily Figures	Week ended 12/29/76	Week ended 12/22/76	Comparable year-ago period	
Member Bank Reserve Position				
Excess Reserves (+)/Deficiency (-)	+ 58	- 7	+ 116	
Borrowings	1	0	24	
Net free(+)/Net borrowed (-)	+ 57	- 7	+ 92	
Federal Funds—Seven Large Banks				
Interbank Federal fund transactions				
Net purchases (+)/Net sales (-)	- 46	+ 613	+ 1,339	
Transactions with U.S. security dealers				
Net loans (+)/Net borrowings (-)	- 124	+ 165	+ 620	

*Includes items not shown separately. ‡Individuals, partnerships and corporations.

Editorial comments may be addressed to the editor (William Burke) or to the author. . . .
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