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How Would Modern Macroeconomic Schools of Thought Respond to the Recent Economic Crisis?

"Would financial markets and the economy have been better off if the Fed pursued a policy of quantitative easing sooner?"

—Daniel L. Thornton, Vice President and Economic Adviser,
Federal Reserve Bank of St. Louis, *Economic Synopses*

The government and the Federal Reserve's response to the current recession continues to be hotly debated. Several questions arise: Was a $780 billion economic stimulus bill appropriate? Was the Troubled Asset Relief Program (TARP) beneficial? Should the Fed have increased the money supply sooner? Should Lehman Brothers have been allowed to fail? Some answers to these questions lie in economic theory, and whether prudent decisions were made depends on whom you ask. This article examines three modern schools of economic thought and how each school would advise was the best way to respond to the most recent crisis.

The New Keynesian Approach

New Keynesian economics, the "new" version of the school based on the works of the early twentieth-century economist John Maynard Keynes, is founded on two major assumptions. First, people are forward looking; that is, they use available information today (interest rates, stock prices, gas prices, and so on) to form expectations about the future. Second, prices and wages are "sticky," meaning they adjust gradually. One example of "stickiness" is a union-negotiated contract, which is fixed for a definite period of time. Menus are also an example of price stickiness: The cost associated with reprinting menus causes a restaurant owner to be reluctant about replacing them. Because of these impediments, market prices do not immediately adjust to unexpected changes in economic conditions. New Keynesians generally argue that the government needs to take an active role, through the use of fiscal (government spending or tax cuts) or monetary policy (lower interest rates, change in money supply, and so on), whenever economic conditions start to deteriorate (e.g., falling employment or rising inflation).

New Keynesians generally would argue that intervention during the most recent economic crisis was essential. Most New Keynesians would agree that government action, in the form of the stimulus bill and the Fed's decisions to keep interest rates low and lend to large financial institutions in danger of failing, was critical. They would argue that these actions stimulate demand for goods and job growth. Perhaps more importantly, New Keynesians would argue that these actions prevented a continued spiral downward into an even deeper recession. Federal Reserve Chairman Ben Bernanke defended the Fed's response to the crisis, saying that "if you let the big firms collapse in a disorderly way, it will bring down the whole system."

The Monetarist Viewpoint

Monetarism is the view that growth in the money supply has major influences on the growth of real gross domestic product (GDP) in the short run and inflation over longer periods. Monetarism is largely associated with the late economist Milton Friedman. Monetarists believe that New Keynesians overstate the amount of market instability in the economy. They argue that the economy will ordinarily be at a level where firms are producing at their normal capacity (what economists refer to as "potential GDP").

To counter the deepening economic and financial crisis, Monetarists have argued that the Federal Reserve should have boosted the growth rate of "high-powered money" early on, which would have increased the

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money supply (what some have called "quantitative easing").[1] Monetarists focus on controlling the growth rate of the money supply instead of controlling interest rates. Initially, the Fed reduced its interest rate target, the federal funds rate. However, beginning in mid-September 2008, the Fed began to dramatically increase the monetary base, from $850 billion to 1.75 trillion in January 2009. As Dan Thornton of the Federal Reserve Bank of St. Louis noted recently, since these measures were enacted the economy has shown signs of improvement. Thornton wonders if increasing the supply of credit sooner would have "prevented the failures of Bear Stearns, Lehman Brothers, and AIG, and also the need for the costly TARP." He notes that inflationary fears could have been abated by clearly letting the market know that the monetary base would be reduced when signs of the crisis were abated. Instead, additional inflationary fears abound with the addition of the government stimulus and programs like the TARP.

The New Classical School of Thought

The New Classical school is the "new" version of the school based on the works of Adam Smith, Alfred Marshall, and other "classical" economists that existed before the arrival of Keynes. It is based largely on three assumptions. The first is that people maximize: Households try to maximize their economic well-being and firms try to maximize profits. Second, like New Keynesians, they believe people are forward looking. Third, like Monetarists, they believe that markets adjust—prices change so that buyers and sellers can make transactions—and that the economy normally operates at its potential. To a New Classical economist, recessions are not necessarily as "bad" as they typically are to a New Keynesian. Recessions (and their counterpart, booms) are instead often seen as a healthy rebalancing of the economy. Because information is limited, misperceptions are inevitable. But as more information becomes available, behavior changes as mistakes are corrected.

New Classical economists would argue that the government and the Fed's response to the crisis was too aggressive and will create more problems in the future. They would argue that the credit boom was partly fueled by the Fed keeping credit too cheap for too long (firms and households borrowed heavily because credit was cheap—interest rates were low and loans were easy to get). Because people are forward looking, uncertainty discourages risk-taking, which inhibits markets from recovering (which they will do, since markets adjust). To New Classicals, uncertainty is exactly what the Fed and government are generating through expensive and poorly defined programs like the TARP. If the market cannot accurately value something, its ability to adequately recover is delayed. Similarly, uncertainty regarding future inflation and wealth is introduced with the stimulus bill that balloons government spending. It has been argued that the recent increase in the personal saving rate may merely reflect the fact that households are saving money for the day when they will be taxed to pay for today's increase in the debt. Like Monetarists, the New Classical school would agree that a clear agenda with regard to monetary policy is necessary for markets to operate efficiently.

What Do Macroeconomists Agree On?

Economists will always debate about the prevailing state of macroeconomic theory. The "good news" is that there is a core of macroeconomic principles on which all economists agree. One of these principles is that there is no trade-off between the rate of inflation and the rate of unemployment in the *long run* but there is a trade-off in the short run. Specifically, if a central bank attempts to lower inflation by raising its target interest rate or reducing money growth, there will be higher unemployment temporarily. Another principle is the idea that people are forward looking; thus, expectations matter for assessing the impact of monetary and fiscal policy.

Future analysis of the most recent crisis will aid in the evolution of macroeconomic thought. What we learn could shape the response to future episodes of economic turmoil.

—By Michelle T. Armesto, Senior Research Associate, Federal Reserve Bank of St. Louis

[1] High-powered money, also known as the source base, can be thought of as the raw material for creating new loans and thus an increase in the money supply.

Recent Articles, Further Reading, and Resources on Schools of Economic Thought

Economic Education resources from the Federal Reserve Bank of San Francisco (www.frbsf.org/)

- Major Schools of Economic Theory
  www.frbsf.org/publications/education/unfrmd.great/greatschls.html
- Great Economists and Their Times
  www.frbsf.org/publications/education/unfrmd.great/greattimes.html
- Great Economists Treasure Hunt
  www.frbsf.org/education/activities/treasurehunt/index.html

Video essays (www.pbs.org/wgbh/commandingheights/hi/ideas/vid_essaylist.html) excerpted from the PBS "Commanding Heights: The Battle for the World Economy" website offer 15 mini-lessons on a variety of economic topics. Episode one essays focus on economic schools of thought.

Essays from *The Concise Encyclopedia of Economics* (http://www.econlib.org/library/CEE.html), by David R. Henderson, ed. (on the Library of Economics and Liberty website, http://www.econlib.org/index.html). The links below are for the schools of thought discussed in the essay:

- "Monetarism" by Bennett T. McCallum
  www.econlib.org/library/Enc/Monetarism.html
- "New Keynesian Economics" by N. Gregory Mankiw
  www.econlib.org/library/Enc/NewKeynesianEconomics.html
- "New Classical Macroeconomics" by Kevin D. Hoover
  http://www.econlib.org/library/Enc/NewClassicalMacroeconomics.html

"Crankonomics: What David Brooks Thinks Of Us," by Susan Lee, Forbes, January 19, 2009; www.forbes.com/2009/01/18/david-brooks-economics-oped-cx_sl_0119lee.html

New Ideas From Dead Economists: An Introduction to Modern Economic Thought, by Todd G. Buchholz with a foreword by Martin Feldstein. Second revised edition. New York: Plume, 2007.

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