**Economics 21 Spring 2015**

**Week 10: Discussion Section**

These questions relate to the Blog post “The Keynesian Illusion” by the economist David Levine that is found on Moodle. There is a technical description of the macromodels that Levine likes (called Real Business Cycle Models), and I have placed the Wikipedia’s description of them on Moodle. There is also a brief discussion of these models in Blanchard on p. 547. What I like about the Levine post is that it gets to the core of why some economist (and Levine is a very good economist) can’t get their heads around Keynesian economics.

1) One of the first lessons that students are taught in economics is that “there is no free lunch”. Some people find this depressing, and some people (like Levine) may have learned this lesson too well.

a) How does this lesson relate to Levine’s first few sentences: “The philosophy of Keynesianism has an intense appeal. The cure to economic ill is for the government to spend more money - and no reason to worry about how it is paid for. Not only does the Keynesian medicine cure our ills - it even tastes good going down?”

b) How does this lesson relate to Levine’s discussion of a perpetual motion machine and M.C. Escher’s drawing?

2) So the central question of our course is, in a deep sense, “when is there a free lunch?” With respect to this question consider this quote from Barack Obama’s First Inaugural Address in 2009, “Our workers are no less productive than when this crisis began. Our minds are no less inventive, our goods and services no less needed than they were last week or last month or last year. Our capacity remains undiminished.” If our capacity remained undiminished, why was it that in January 2009 when Obama spoke, GDP was 95% of what it had been a year earlier?

3) Levine has an explanation in his 4 person economy.

a) What happens to the economy when the phone guy decides a tattoo is not worth the effort it takes him to make a phone?

b) Levine suggests several things the government might do to solve this problem. What are the problems with each one:

i. Give the phone guy a phone

ii. Give the phone guy money

iii. Force the phone guy to make a phone

iv. International transfers – Germany takes a phone away from its phone guy and gives it to the Greek phone guy

4) With all the discussion of perpetual motion machines, Escher drawings, Keynesian inability to correctly measure angles, and Rube Goldberg devices, you can be forgiven if you missed Prof. Levine’s solution to the problem of the phone guy choosing not to produce a phone. What is his solution? [Hint: this is a trick question]

**Where does Levine go wrong?**

5) First, Levine repeats the dogma of New Classical economists that the 1970’s was the death knell of Keynesian economics because stagflation was something that Keynesian models can not explain:

“the U.S economy fell into a decade of "stagflation" with high unemployment and high inflation - something that Keynesian theory could not explain (inflation is supposed to cure the unemployment) - and something that Keynesian economists spent countless hours and professional publications trying to explain - and with so little success that besides a few die-hards the rest of the profession quite rightly abandoned the theory”. p. 4

Can our AS-AD model, which is quite Keynesian, explain stagflation?

6) More important, in fact most important, is that Levine fails to distinguish between an economy that is operating below full employment and an economy that is operating at full employment. This is seen in several places:

a) On p. 1, Levine quotes Richard Posner, “it is consumption, rather than thrift, that promotes economic growth”, and on p. 4, “there is no investment and no R&D without savings – so beware the theory [that] the way to higher growth is through lower savings” and “Bear in mind that the main tenet of Keynesianism is that the key to growth is to avoid saving.”

There are two types of GDP growth:

i) From below full employment to full employment, and

ii) Growth of the full employment level of GDP itself.

We have not yet gotten to ii) in the course, but when we do, you will see that savings is transformed from a villain into a hero. So savings is a drag on growth in the short run, but a source of growth in the long run. The reason for this is that in the long run, we assume that savings will increase investment one for one, but in short run we do not. Keynes said it best in a quote that should be more famous than it is:

“An act of individual saving means — so to speak — a decision not to have dinner to-day. But it does not necessitate a decision to have dinner or to buy a pair of boots a week hence or a year hence or to consume any specified thing at any specified date. Thus it depresses the business of preparing to-day’s dinner without stimulating the business of making ready for some future act of consumption. It is not a substitution of future consumption-demand for present consumption-demand — it is a net diminution of such demand... If saving consisted not merely in abstaining from present consumption but in placing simultaneously a specific order for future consumption, the effect might indeed be different. For in that case the expectation of some future yield from investment would be improved, and the resources released from preparing for present consumption could be turned over to preparing for the future consumption”.

Chapter 16, General Theory of Employment, Interest, and Money, 1936

b) When an economy is at full employment, is there the possibility of a free lunch? How does this relate to Levine’s statement on p. 4, “we can have employment in Germany or in Greece but not both”?

c) The microeconomic version of full employment, and Levine is a microeconomist, is a Pareto efficient allocation of resources– this is an allocation of resources such that it is impossible to make someone better off without making someone else worse off. How does this relate to Levine’s “no free lunch” world-view?

d) Given peoples’ tastes, is there any way to improve the economy’s performance once the phone guy no longer wants a tattoo bad enough to produce a phone? Is the 4 person at a Pareto efficient allocation after the phone guy no longer wants to produce a phone?

e) With respect to Pareto efficiency, here is an exchange between Ben Bernanke and Jeffrey Lacker, the President of the Richmond Federal Reserve Bank, in 2009 at the depths of the Great Recession:

"I am going to regret this, but I am going to ask you a question,” Mr. Bernanke said to Mr. Lacker. “Do you think the United States economy is at a Pareto efficient point at this moment?” “Probably,” the Richmond Fed president replied. “With the best position we can be at right now?” Mr. Bernanke continued. “Roughly speaking. All constraints taken on board” [Mr. Lacker replied]. Bernanke continued, “The question was, ‘Is the United States economy at a Pareto efficient point at this moment?’ And the answer was ‘yes.’ Okay. So that is obviously a different view.”

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From <http://www.nytimes.com/2015/03/05/upshot/ben-bernanke-has-an-impressive-passive-aggressive-streak-and-other-things-we-learned-in-the-new-fed-transcripts.html>

Unfortunately, Prof. Levine is not alone.