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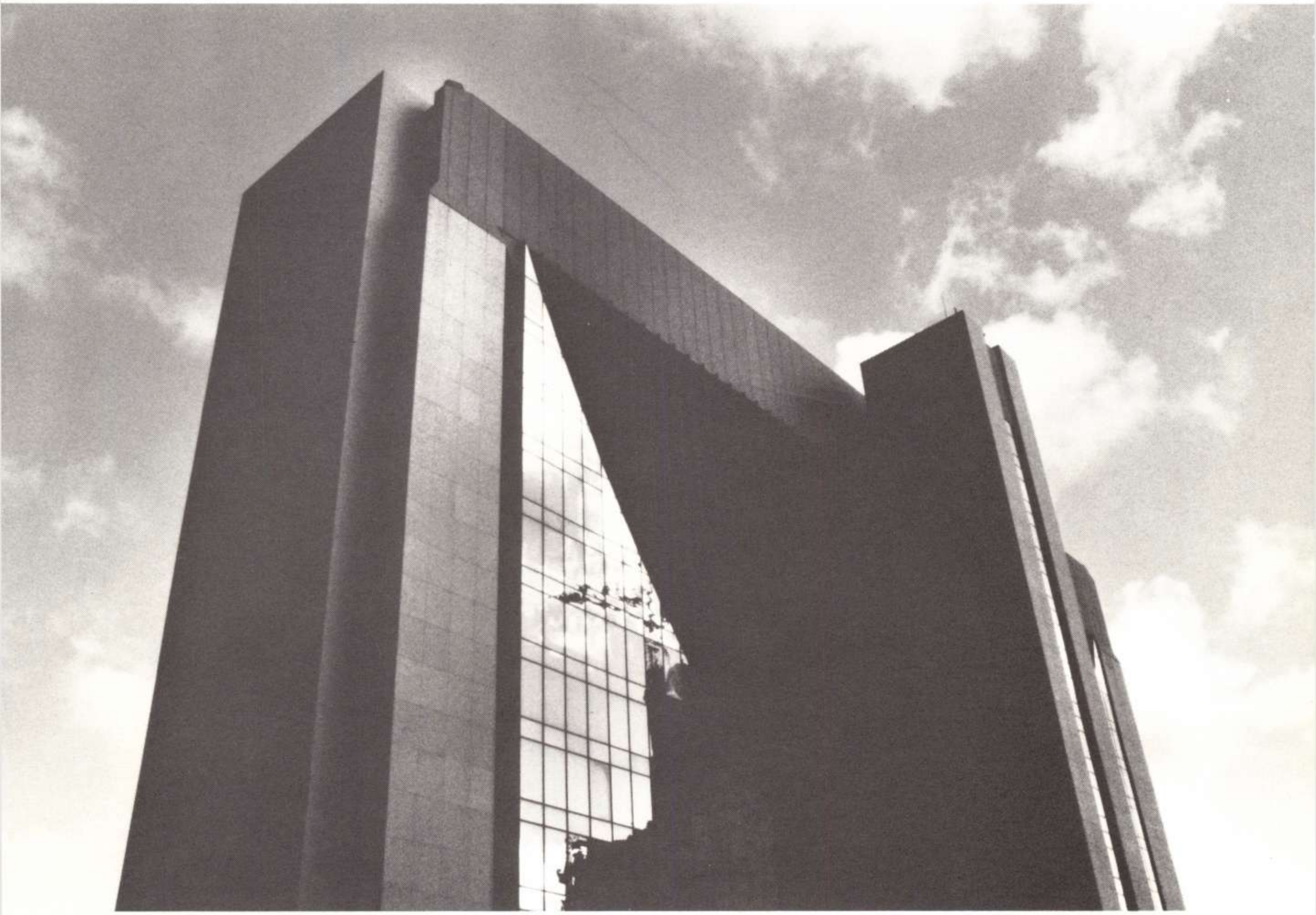

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This publication primarily presents economic research aimed at improving policymaking by the Federal Reserve System and other governmental authorities.

Produced in the Research Department. Edited by Arthur J. Rolnick, Kathleen S. Rolfe, and Alan Struthers, Jr. Graphic design and charts drawn by Phil Swenson, Graphic Services Department.

Address requests for additional copies to the Research Department, Federal Reserve Bank, Minneapolis, Minnesota 55480.

What's Wrong With Macroeconomics

Neither macroeconomists nor government policymakers have been very successful lately in dealing with the ups and downs of the U.S. economy. In its 1980 midyear review, in fact, the Joint Economic Committee (JEC) reportedly told Congress that economists have not been able to accurately predict when the last six recessions would start, how long they would last, or how deep they would be. As a result, the JEC said, the government has treated recessions "inappropriately as short-term emergencies," and its attempts at quick fixes "too often have been too late and too ineffective" to do any good.*

The economists writing in this *Quarterly Review* agree that quick fixes don't work as economic policies —but not just because they come at the wrong time. These economists believe the basic problem is deeper, at the core of macroeconomics. Traditionally this field, in its theory and tools as well as its policy approach, has ignored the fact that individual behavior changes with government policies.

Examples of the Wrong Approach and the Wrong Tools

In the first paper in this issue, Preston J. Miller criticizes today's much discussed "quick fix": a tax cut. Rather than debating how much to cut taxes now in response to a recession, he says, policymakers should be deciding on their long-run strategy over the course of the business cycle. In particular, he says in "Deficit Policies, Deficit Fallacies" (p. 2), the government should change from a policy of running deficits, which a tax cut would only continue, to a policy of balancing the budget on average over the business cycle. This change in policy, Miller says, could reduce inflation without severe output costs if it were well understood. Once people believed that the long-term policy really had changed, they would change their expectations and their behavior.

*See Hobart Rowan, No fast cures: 'quick fixes' only make economy worse, study says, *Minneapolis Star* (August 25, 1980): 1D.

The tools macroeconomists use to predict the effects of alternative policies don't appear to recognize those sorts of changes. In "The Search for a Stable Money Demand Equation" (p. 5), James N. Duprey describes the problems the Federal Reserve and others have been having with a particular equation, one intended to help predict how much of its wealth the public will want to hold as money. This equation has been failing dramatically as a predictor: the historical relationships between the demand for money and things like spending and interest rates are no longer good guides to the future. This is partly because of the tremendous innovations going on in the financial industry, Duprey says, and when the industry settles down the equation may become more reliable for predicting under current policies. But it will never allow the Fed to predict how money demand will change under alternative policies, Duprey says, because the equation simply is not built to capture how changes in policies change the decisions of economic agents.

A Diagnosis and a Prescription

In the last paper in this *Quarterly Review*, "Rational Expectations and the Reconstruction of Macroeconomics" (p. 15), Thomas J. Sargent explains more generally and technically what is wrong with macroeconomics and what can be done to set it right. As the title of his paper suggests, Sargent believes the whole field of macroeconomics must be rebuilt. All macroeconometric models have the problems money demand equations do. To correct them, Sargent says, economists must formulate and simulate econometric models which explicitly let individual behavior change with government policies; he suggests ways to do that. And because future as well as current policy actions affect individual behavior, all policymakers must take a long-term approach. Sargent says they must think of their options not as isolated actions but as strategies or rules for setting policy instruments over time in response to particular economic conditions.