Mitchell's Musings 1-23-12: Assume No Ladder?

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There are many economist jokes out there.[1] One involves two economists walking down a street. One points out to the other that a twenty-dollar bill is lying on the sidewalk. The other says it can't be true because someone would have picked it up. The joke, of course, is intended to point out the danger of over-reliance on economic theory to the point that contrary empirical evidence is rejected.

The other joke involves two economists who find themselves at the bottom of a deep hole with no way out. One says to the other, "Let's assume a ladder." The same lesson is intended; it is best not to rely on theory when empirical evidence points elsewhere.

My son Joshua passed me a blog-column by John Cochrane of the University of Chicago responding to attacks by Princeton economist and NY Times columnist Paul Krugman. The Cochrane blog-column post is at

http://johnhcochrane.blogspot.com/2012/01/stimulus-and-etiquette.html

so you can read it for yourself. But in essence, Krugman has been arguing for a more vigorous stimulus program – through both monetary and fiscal policy - to bring down the unemployment rate, here in the U.S. and - more recently - in the E.U. He has been frustrated by stimulus-policies-don't-work arguments that have come from "Chicago-school" economists. Cochrane complains about both what he feels are *ad hominem* attacks by Krugman and about a need for modesty in macro-economic modeling and policy prescriptions.

[1] There is even a "stand up economist" comedian on the web http://www.youtube.com/watch?v=cW9dxFrAk-I.

But here is the problem, embodied in a quote from the Cochrane blog-column:

> *Many stimulus advocates point to WWII spending. Think about what that means: all those tanks, ships, and airplanes on the ocean floor were not a terrible economic sacrifice we paid to win a desperate war. Every ship the Germans sunk let the government buy another ship, and gain a ship and a half worth of GDP in the process!*

There are really two ideas here. One is that World War II spending in fact seemed to bring down the unemployment rate dramatically. The other is that it is unfortunate that the spending had to go for items that were destroyed in war. Both propositions are hard to dispute. But only the first one is relevant.

It seems that there is a new economists joke in formation here. It goes like this: Two economists find themselves stuck at the bottom of a hole but they know that in the past there has been a ladder in the hole capable of reaching the top. Rather than look to see if there is still a ladder somewhere in the hole, one says to the other, "Assume there is no ladder." They make that assumption, don't search for the ladder, and remain stuck in the hole.

Let's put aside political gridlock and institutional barriers to macro-policy. The place to start is whether there is any historical evidence that there is a set of policies that could get us out of our current economic hole. World War II does come immediately to mind. But could it be that there are now structural changes in the economy that would prevent such a World War II-type jump in spending from having the same effect at present that it did back then? Possibly - we can't be 100% sure what worked then would work now. There is always a model of some complexity that can arrive at any conclusion. But is it really best to start with the assumption that there is no ladder out of the hole when – at least in the past – there has been one?

Perhaps another way for any macro-economist to put this matter is to imagine he/she was a benevolent dictator whose sole goal, say as of January 2009, was to bring the U.S. unemployment rate down to some acceptable level in 2 years. As a benevolent dictator, he/she would control the Fed absolutely – buying and selling assets and creating money with no legal impediments. He/she would control taxes and spending absolutely – no Congressional opponents, etc. Could getting the unemployment rate down be done under those circumstances? The virtue of putting the question in that extreme way is that if the answer to the question was surely "no," then in the real world (without absolute power), the answer would also be "no."

However, it really is hard to answer "no" to the benevolent dictator question, especially given the World War II experience. But if you don't like "Big Government," you are going to want to find some way to answer "no." Or, if not exactly "no," it is always possible say we can't be

100% sure what would happen today and maybe there could be some inadvertent offsets or undesirable consequences.

Being a benevolent dictator is, as noted, an extreme. But in the real political and institutional world in which monetary and fiscal policy is made, even a modest move toward doing anything feasible to lower unemployment is going to involve some governmental action. Obviously, you shouldn't assume a ladder if it is clear that none is there nor has one ever been there. But if your predilection is not to look and see if there is a ladder, you will surely remain stuck in the hole.