Mitchell's Musings 5-28-12: What Exactly Do You Mean?

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Writing about the ups, downs, and trends in the economy for a general audience is tough. Readers want explanations for why things happen. Commentators on the daily scene are under pressure to come up with a story that seems to explain ongoing events. The stock market is a prime illustration, particularly when there are notable price gyrations.

While there may be news, positive or negative, about a particular stock that might account for its price movements, it is harder to come up with stories about the entire market. One simple story when the market goes up is that everyone was buying. (And the reverse when the general market declines; everyone was selling.) It sounds so sensible.

But wait! Who was everyone buying *from* when the market went up? (Or who was everyone selling *to* when the market declined?) Isn't every stock that is bought also one that is sold? So wouldn't it be equally correct to say that the market went up because everyone was selling? Note the image in the box above where the market is said to have gone up because "investors are still in a buying mood."[1] Didn't the investors who bought stock do so from investors who sold stock – and who therefore must have been in a selling mood?

The problem here is that there is no clear model behind statements such as everyone is buying or everyone is in a buying mood. Of course, there is a simple demand/supply model that one could use in describing the market of the type learned in Econ 1. In a simple demand=supply model of the stock market, the market price at a point in time represents a balance between those who think buying is the right decision and those who think selling is the right decision. The resulting price represents a kind of consensus but it is a consensus of matched but *conflicting* opinions, not a view held by "everyone." If the price goes up from Day 1 to Day 2, what has happened is that the consensus price of matched but conflicting opinions was higher on Day 2 than it was on Day 1. Of course, once you say all that, you are not saying much more than the price went up because it did, presumably not a satisfying explanation for stock market journalists to offer their readers.

Perhaps there is little harm in telling "everyone-is-buying" stories. But the language literally suggests to naïve investors who read such stories that there are no conflicting opinions in the

[1] Source of the image: http://www.laobserved.com/biz/2012/05/tuesday_morning_head_273.php.

market. From personal experience, I can tell you that when I have pointed out to folks that every stock that is bought is also one that is sold, this simple fact is sometimes received as a revelation. And once you understand that there are always conflicting opinions in the market, the incentive for momentum trading (buying because the price is going up) is reduced. That is, once the idea of conflict producing the market outcome is clear, you are no longer under the illusion that "everyone" is doing it. I have no doubt that those who write stories about everyone buying or selling would say that it's just a shorthand way for describing the more complex reality. But such shorthand tales can have consequences.

Those consequences are not confined to amateurs or to the stock market. Some time ago, my colleague Chris Erickson and I did a study of how the Federal Reserve's Open Market Committee – which sets U.S. monetary policy - viewed developments in the labor market.[2] We used transcripts of the Committee's meetings (which appear in detail after a lag of about 6 years) and other sources. It appeared that the members of the Committee had a bargaining model of the labor market in their heads that was perhaps suitable for an earlier period when unions represented a substantial fraction (but never a majority) of private-sector employees.

Committee members – this was back in the 1990s – had largely developed their ideas about the economy in that earlier powerful-union era. Their discussions went on about what workers would "demand" and what workers would "accept" for pay. When in interviews we pointed to the language as unrealistic in a heavily nonunion labor market, the tendency was to dismiss it as shorthand. But the implicit model of militant workers dictating wages led the Committee to fret about incipient inflation from what was once called wage-push, when the danger was minimal. Workers were in no position aggressively to push up wages. Loose language, in short, can have consequences, whether for amateurs or for professional policy makers.


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Eurozone warned 'severe recession' looming

By GREG KELLER
AP Business Writer

PARIS (AP) -- The 17-country eurozone risks falling into a "severe recession," the Organization for Economic Cooperation and Development warned on Tuesday, as it called on governments and Europe's central bank to act quickly to keep the slowdown from dragging down the global economy.

The topic *de jour* nowadays is problems in the euro-zone and fears that a possible result of those problems could be a European recession or financial crisis with adverse consequences for the U.S. In earlier musings, I noted that those problems could have been foreseen in the period before the euro was created; they result from countries giving up their monetary systems and becoming like state and local governments in the U.S. Absent an independent monetary system, countries, like sub-federal governments in the

[2] Christopher L. Erickson and Daniel J.B. Mitchell (October 2005), "Not yet dead at the fed: Unions, worker bargaining, and economy-wide wage determination," *Industrial Relations*, Vol. 44, No. 4, pp. 565-606. Available at http://www.anderson.ucla.edu/documents/areas/fac/hrob/mitchell_notyet.pdf.

U.S., are under tight fiscal constraint and essentially have little scope for anti-recession macro policy. During recessions, they are forced to cut spending and/or raise taxes – austerity actions which worsen the recession.

Greece has been seen as the center of the euro-related turmoil. Articles regularly appear that suggest Greece may have to abandon the euro and go back to the drachma. A recent article in the *New York Times*, for example, tells us that "economists say the drachma would be devalued by an estimated 50 to 70 percent compared with the euro."[3] But what exactly does that statement mean? Does it mean anything? Note that it sounds plausible superficially: Greece is in trouble so of course it will have drop or be kicked out of the euro-zone and experience devaluation.

One assumption of that statement is that it is really feasible for a country that has no national currency (such as Greece) to produce one. In fact, currencies are much easier to abolish than to create. Going into the euro was like going into a Roach Motel. Once you check in, you can't check out.

How exactly is Greece supposed to create a new drachma? Print them up and throw them on the street in the hopes someone will pick them up? And what does it mean to say that the new drachma – if such a currency were somehow created – would be devalued 50-70% below the euro?

Devaluation means to change a currency's value from one exchange rate to another so that it is worth less after than before in terms of some other currency. But if you don't know the initial euro/new drachma exchange rate, how can you predict a devaluation or what its magnitude would be? Perhaps the statement is intended to mean that compared to the euro/old drachma exchange rate, the new drachma would be worth 50-70% less. But the former exchange rate had something to do with prices and wages in Greece measured in old drachmas. What would those prices and wages be initially in the new drachma before it was devalued?

The more questions you ask, the less clear the statement that unnamed "economists" allegedly are saying becomes. And, as noted above, the statement – whatever it means – assumes that creating a new drachma – which can then be devalued - is feasible. Loose language is suggesting that an option exists which in fact are not readily available. Loose language is also suggesting magnitudes that have no obvious basis can be estimated.

[3] Liz Alderman, "Greek Businesses Fear Possible Return to the Euro," *New York Times*, May 22-23, 2012, http://www.nytimes.com/2012/05/23/world/europe/greek-businesses-fear-switch-from-euro-to-drachma.html.

There is one thing that the article does get right. There is already the potential for panic in Greece because of the discussion of how Greece might have to create a new drachma. As correctly pointed out in the article, such speculation could create bank runs (as Greek depositors rush to withdraw euro deposits) and is itself recession-inducing. Loose lips can sink economies, as the Europeans are learning. On this side of the Atlantic, it is also a good lesson for journalists, a good lesson for policy makers, and a good lesson for politicians in a contentious election year.

I am tempted to say that if you can't say anything sensible about economic developments, don't say anything at all. But, of course, that is a less feasible option than creating a new drachma and foretelling its devaluation.