Response to Comments

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Robin Matthews and James Tobin raised related issues about uncertainty and rules. One of the main policy implications of the type of rational expectations model discussed in my paper is that pure discretionary policy is generally inferior to a policy rule. A principal advantage of rules is that rules reduce costs of acquiring information and reduce uncertainty about current and future policies.

A policy rule may be complex or simple. Built-in budget stabilizers that make changes in government spending and taxes conditional on the state of the economy are a type of policy rule. None of the versions of monetarism that I discuss, or know, denies a role of this kind for government policy. The issue is whether government contributes to stability or increases instability.

Keynes was not opposed to rules. On the contrary, he favored fiscal and monetary rules when setting out the policy proposals that he believed were implications of his work. In the General Theory Keynes favors state direction of investment because he claimed (or perhaps hoped) that the state would reduce the volatility of investment and, thereby, reduce fluctuations in income and employment. This belief (or hope) was misguided.

There is very little in the General Theory about public works or counter-cyclical fiscal and monetary policy. Keynes certainly made proposals along these lines but to find these proposals, one must look more to his public statements and less to his theoretical work in and after the General Theory. As a policy adviser or public person, Keynes at times favored activist policies that are not closely related – or are contrary – to the policy rules that he advocated in his theoretical work. These proposals are the basis for many Keynesian proposals.

Keynes the theorist who favored institutional changes and policy rules to increase stability is much closer to the monetarists than to Keynes the public person. Both Keynes and the monetarists favor predictable, stable monetary policies. Monetarists emphasize the uncertainty produced by
government policies and deny that activist monetary policies reduce variability and uncertainty. They favor constant growth of money to reduce the variability of GNP. Instrument stability is one possible way to reduce monetary variability. Monetarists typically favor stable growth of a monetary aggregate, not a stable value of a monetary instrument such as the monetary base or total reserves.

Charles Goodhart directs much of his attention to the endogeneity of the money stock and intermediation. In association with Karl Brunner, I have devoted much of my professional life to these issues, so I am not often called to account for neglecting them. I do not see major relevance for this issue in a comparison of Keynes and monetarism, however. The reason is that in both Keynes' theory and in the monetarist theories I consider here, the economy is closed. Governments and central banks can control money, if they choose to do so. The choice of policies and policy rules or procedures affects the variability that the economy bears.

In practice, many central banks, including those in the United States and the United Kingdom do not control interest rates. Typically, they set short-term interest rate targets to achieve a desired path for money or GNP. Deviations from the prescribed path induce an adjustment of the interest rate targets. Interest-rate control is often a means of achieving a path for the monetary aggregates. I believe, this method of monetary control increases the variability of money, prices and real output and creates an excess burden. The excess burden would not be changed if exactly the same path for money was achieved with money exogenous in the short-run. The issues about exogeneity and excess burden are not the same and are not closely related. The latter is important and neglected, and it is the latter that I want to emphasize.

It is not useful to treat expectations as non-ergodic, since that rules out any serious economic analysis of future states. I see no benefits to Paul Davidson's suggestion, and I do not believe it is based on a proper reading of the General Theory or the Treatise on Probability. Keynes was capable of telling us, in his terminology, that the "weight" on the probability assigned to future events is — or must be — zero. I read him as saying the opposite.

The chart that Lord Kaldor introduced to show that expectations are irrational and that
rational expectations are impossible is totally irrelevant for both purposes. The fact that the coefficients changed after price variability increased is consistent with statistical theory. Further, it is consistent with the famous Lucas critique of econometric policy evaluation, based on rational expectations. A change in regime – formation of an oil cartel or a change from fixed to floating exchange rates – changes the variances and covariances of variables and the coefficients of structural equations. Finally, rational expectations does not imply that people do not make errors. The claim is very different. People use information efficiently and act as if the subjective probability on which they base their decisions are accurate representations of the actual distributions of the same events. If the variances of the distributions are relatively large, rationally expected outcomes can be very different from actual outcomes. Keynes, like the monetarists, was interested in variability.