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Reply to Randall Wright

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Reply
by Allan H. Meltzer

Randall Wright has several complimentary things to say about some of my earlier work. I thank him for those remarks. Most of his comment, however, fails to respond or even discuss my current paper, and the main comments he makes about the paper are untrue.

Contrary to Wright my paper does not attack theory or oppose the development of micro foundations for macroeconomics. It is not about economic policy. Nor do I defend the IS-LM model that I spent many years criticizing. I am at a loss to understand how a reader could come away with such ideas or with a belief that I am critical of recent work on economic development and growth.

The paper proposes specific hypotheses for analyzing the role of money and uncertainty. The foundation is a micro theory in which there is production for inventory. Uncertainty about the duration of observed changes gives rise to costs of information. The reason is that permanent and transitory changes cannot be distinguished for some time after a change occurs.

I use this framework to discuss three problems related to the question that the organizers asked me to address: (1) why some prices are set, (2) why some firms set nominal prices, and (3) why some prices are "sticky" -- have substantially less variance weekly or monthly than prices in auction markets. I give explicit references to papers where the framework is more fully developed or where it has been used fruitfully in empirical studies.

I contrast this framework with others in which there are no sticky prices, no productive or useful mediums of exchange, no differences in costs of acquiring information, and no distinction between money, bonds and capital that would enlarge the role of relative price changes in the transmission of monetary and real shocks. I am critical of models with one open market interest rate and no sticky prices. I am skeptical of some of the conclusions drawn from such models.

Perhaps it seems heretical to some to point out that, while the models we use influence the way we look at the world, we make a mistake if we confuse the model
with the world. Science, well done, does not equate the model to the world; it recognizes that all useful models generate refutable propositions. The weak testing procedure called calibration that is now fashionable, is a distant substitute for serious, careful assessment of competing hypotheses.

The paper expresses the view that much recent work, including real business cycle models or overlapping generation models of money, have implications that are readily refuted. For example, it is well established that all correlations between money and income are not the result of "reverse causation" and that all unemployment is not the result of intertemporal substitution.

The paper proposes an alternative model in which uncertainty and costs of transactions and information have a large role. Money using (and other institutions) arise to reduce these costs, but some costs are unavoidable.

Wright’s comment reports on some of the research that is now underway or that has been published in the recent past. As always, some of this work will prove fruitful, some not. There is a high cost of information and great uncertainty about which will be successful.

It is my view that progress on the important issue about how a monetary economy adjusts to changes or shocks will require more attention to uncertainty about the permanence of shocks and to costs of information and transactions. That view may prove right or wrong, but it is neither a-theoretical nor anti-theory.

I respect Wright’s past work and looked forward to his comments. I regret that he avoided discussion of the issues raised in my paper and my proposals for dealing with them. Such a discussion is overdue.