Discussion of Deviatov and Wallace

Interest on Cash with Endogenous Fiscal Policy

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This is a paper in what I call *New Monetarist Economics*.

I will talk more about New Monetarism than the paper.

I believe New Monetarist Economics was *almost* born here, but in any case certainly grew up here, in Mpls, with Gary and Neil two of the biggest influences.

Gary, because of leadership, and support for fundamental research even when (especially when) it does not follow the mainstream.

Neil because he is the person that inspired us in monetary economics to be serious and to not take shortcuts out of laziness or a race to get answers fast.

I was taught that it is better to get the answer right.

The principles and practices of New Monetarism are laid out in two papers by Williamson and Wright, one on "Methods" and one on "Models."

Altho there is a large body of work in the area, our label merits explanation.

We are New Monetarists because we find much that is appealing in Old Monetarist economics, epitomized by Friedman, even if we disagree on some big issues.

We have little in common with Old or New Keynesians, mainly because of the way they approach monetary economics and microfoundations, but also because of their virtually exclusive focus on nominal rigidities.

Why raise these issues? Is it only old age?

No. It heps clarify what we do and why it is interesting.

Our view: it was a healthy state of affairs when even in the halcyon days of Old Keynesianism there was the dissenting view of the Monetarists – a voice of caution to those who thought that macro and monetary economics were "solved" problems:

Solow (68): "I think that most economists would feel that short-run macroeconomic theory is pretty well in hand ... The basic outlines of the dominant theory have not changed in years. All that is left is the trivial job of filling in the empty boxes, and that will not take more than 50 years of concentrated effort at a maximum."

Many people (outside of Mpls?) argue there is now a New Keynesian consensus. It would be healthier if more people recognized that there is an alternative.

We dub our alternative New Monetarism.

And BTW - what is this concensus?

We find much sympathy for the view that there are fundamental flaws in New Keynesianism.

It must then be the case that those of us, including Wallace and epigones, who feel this way are not speaking with enough force or clarity.

We want to rectify this situation. Someone has to try - and not only Ellen arguing about the "empty boxes."

New Monetarism encompasses a large body of research:

Monetary economics: Lucas (72), and the Kareken-Wallace (80) volume, with antecendents like Samuelson (58).

More recent monetary economics: S&M approach like eg Kiyotaki-Wright (89), with antecendents like Jones (76) and Diamond (84).

Banking, intermediation, and payments: Diamond-Dybvig (83), Diamond (84), Williamson (86), Bernanke-Gertler (89), Freeman (95).

Recent finance and asset market theory: Duffie et al. (05), Weill (07), Lagos (08), Lagos-Rocheteau (09).

Principles:

1. Microfoundations matter: productive analyses of macro and monetary economics require adherence to sound and internally consistent economic theory.
2. Money matters: it is important to use models that are explicit about frictions (the Wallace dictum that *money should not be a primitive in monetary economics*)
3. Itermediation matters – eg Friedman’s "narrow banking" vs New Monetarism.
4. Modeling the frictions giving rise to roles for money or intermediation requires abstraction – eg OLG or S&M.
5. No one model is an "all-purpose vehicle" in monetary economics, *but* it is desirable to have a framework that can be applied to a variety of issues.

These principles are *not* platitudes and they *not* universally accepted.

P2 is violated by all the models used for monetary policy that either have no money – or banks or related institutions – or, if they do, they slip it in using CIA or MIU – or now even putting T-Bills and commercial bank reserves in utility or production functions.

We all learn (or at least teach) P4, that useful theories may be unrealistic, yet one commonly hears critiques of both OLG and S&M models based primarily on realism (Tobin 80; Howitt 05; Kehoe all the time).

Everyone pays lip service to P1, but New Monetarists take it more seriously (eg fiscal theory of the price level; nominal rigidities; mechanism design).

Keynesianism (Woodford or Clarida et al.):

1. The friction giving rise to SR nonneutralities and the primary concern of central banks is sticky prices.
2. Because some prices are not flexible, inflation induces relative price distortions with consequences for welfare.
3. The key frictions in monetary theory (spatial/temporal separation, specialization, information..) are trivial.
4. There is a Phillips curve - we can induce a SR increase in output via inflation.
5. Central banks can fix the SR nominal interest rate, and the only policy issue is the choice of a rule for doing so.
6. New Keynesians are supportive of current central bank practice, and vice versa (is this the consensus?).

Old Monetarism (Friedman et al.)

1. Sticky prices, while possibly important for SR run nonneutralities, are not important for policy.
2. Inflation (uncertainty) generates big welfare losses.
3. The quantity theory (a stable money demand curve).
4. There may exist a SR Phillips curve, but policy should not try to exploit it. There is no LR Phillips.
5. Policy is viewed as determining M and specifically as minimizing the variability in the growth rate of some M aggregate.
6. M is a medium of exchange, and whether it is a private or government liability is irrelevant.

Old monetarists were critical of central bank practice, and a lasting influence is that lower inflation is better. Also - fiscal policy (stimulus package).

New Monetarism

Starting with *Models of Monetary Economies* with follow-up work mainly in Mpls Fed in the 80s.

1. Because Old Monetarists neglect key elements of economic theory, their prescriptions for policy can go wrong (Sargent and Wallace 82).

2. The fiscal policy regime is critical for the effects of monetary policy (Sargent and Wallace 81, Wallace 81).

3. Monetary economics can make good use of received theory in other fields, like finance and public economics (Bryant and Wallace 79,84).

4. The line in Kareken-Wallace (80) and Wallace (98): progress in monetary theory and policy analysis requires modeling monetary arrangements explicitly (the Lucas critique?)

To reiterate the other New Monetarist Principles:

1. frictions: Hicks, Ostroy, Townswend, Kocherlakota, Wallace.
2. simplicity and a focus on LR issues - eg cost of inflation.
3. intermediation and payments: focus on the *proces* of exchange.
4. finance and liqudity.
5. rely on and make use of sound economic theory – general equilibrium, search, and game theory; mechanism design.

Note for the Mpls crowd (Prescott?): search, bargaining, and related theories are useful tools. Disputing this is like the Amish who refuse to use buttons.

Now to briefly move on to D&W

They use a search/matching model & mech design.

The big ideas can be seen from these quotations:

"Monetary policy cannot be studied without describing fiscal policy."

"Main friction is imperfect monitoring."

"Currency is used to evade taxation [and] in the underground economy."

"Suggests a connection between the role of currency and feasible taxation."

Two important missing citations:

Andolfatto (08) and Aruoba (09)

Details:

- DW use the Cavalcanti-Wallace model (extension of STW).
- DW present some numerical examples.
- These examples illustrate ... stuff.

I am not completely sold on the approach.

Issues:

- why use a money model with $m \in \{0,1\}$?
- what is this disintegration?
- why not do a serious calibration, vs examples?

But for sure I agree with the big idea, and I always find it interesting when the Friedman rule may not be optimal.

What would I have done differently?

I would have used LW

like Andolfatto, Aruoba, ...

Especially since the model already uses the two-subperiod structure!

Don’t like QL utility?

Fine - use Rogerson lotteries.

Don’t like QL or lotteries?

Fine - use Molico.

Especially since the paper is really a set of numerical examples.

What about mechanism design? Yes. And no.

Reasons to like this work:

I do not think of this paper as a stand-alone item.
It represents another step in an ambitious research agenda.

This agenda has been dubbed (by me) New Monetarist Economics - which Neil may or may not buy into (my guess is that he probably won't).

The central point of this discussion has been that, whatever one calls this agenda, it is based mainly on research supported by the Mpls Fed.

Two final observations:

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2. We can only hope that NK will follow in these giant footsteps.