PS 343: Hibbs, *The American Political Economy* 

I. **(Intro) Motivation & Theme:**

A. “...avoidance of inflation & maintenance of full employment can be most usefully regarded as the conflicting class interests of bourgeoisie & proletariat...the conflict being resolvable only by test of relative political power in society & its resolution involving no reference to any overriding concept of social welfare” (H.G. Johnson)

B. “This book deals with...connections b/w public opinion & electoral behavior, & macroeconomic policies & outcomes...macroeconomic policies & outcomes reflect intersections of both economic & political forces. This interdependence is usefully conceived in terms of demand for & supply of economic outcomes” (p. 1)
1. Perhaps no stable, long-run tradeoff INF v. UE (no std Phillips Curve), but achieve low UE (& high dY) & stabilize INF often conflicting goals:

2. “Faced with demand shifts, supply shocks, labor-cost push, & other inflationary events, political administrations repeatedly...forced to choose b/w accommodating inflationary pressures by pursuing expansive monetary & fiscal policies, thereby foregoing leverage on pace of price increases to preserve agg. demand & employ., & leaning against such pressures by tightening spending & supply of money & credit, thereby slowing inflation rate, at cost of higher UE & lower growth” (p. 2).

C. Main Themes:

1. “...economic interests at stake during [booms & busts]...

2. ...ways...class-related political constituencies perceive their interests & respond in...polls & voting... to macroeconomic fluctuations...

3. & ways...economic interests, preferences, & priorities of political constituencies transmit to macroeconomic policies & outcomes observed under parties” (p 2).
II. Preview of the Book:

A. Striking features of postwar US macroeconomic performance in historical perspective [using this also to intro thrys macroecon policy]

1. Three notable features compared to prewar eras:
   a. Comparatively high real growth (absolutely & per capita)
   b. Comparatively stable macroeconomy: fluctuations quite muted
   c. Near-continuous INF: price level rises steadily postwar; long-run flat before

2. H stresses several important institutional & policy changes since Great Depression as underlying these changes:
   a. Enhanced macroeconomic stability, & so growth, and individual security through Keynesian- (demand-management) & Welfare- (safety net) State, and related important institutional changes (esp. deposit insure & cntrl-bnk law)
   b. But also ⇒ altered private-sector (firms’, workers’) expectations ⇒ ↑INF expectations & inflationary pressure;
   c. Monetary policy & institutional changes (off gold standard, then off Bretton Woods) allowed these pressures to produce sustained inflation.
3. Understanding electorare’s reaction to these & other economic outcomes requires knowledge of the outcomes’ aggregate costs/benefits & the distribution thereof, or at least perceptions of these costs/benefits & dist.

a. The main losers from unemployment & recessions [real-side economy] are those at low end of occupational & income hierarchies; this only partly mitigated by the tax-and-transfer (T&T) system [& less so now].

b. Inflation [nominal side]: [first we will have to be sure we know what it is...]

(1) there’s little evidence that (moderate) inflation hurts aggregate, real output;
(2) its distributional consequences also generally small compared to unemployment’s;
(3) if anything it hurts the very wealthy (being asset holders);
(4) → public’s strong inflation aversion must stem largely from psychological factors &/or confusion b/w nominal inflation & relative (real) price moves, which confusion policymakers may abet.
B. Demand for & Supply of Economic Outcomes

1. See & ponder Figure I.1 (p. 4) [might start @ macroeconomic outcomes]

Figure I.1 A simplified political-economic system of the demand for and supply of macroeconomic outcomes.
2. Some questions to be addressed regarding the “demand side”:
   a. How does support for president & her party depend on current, past, & perhaps E(future) performance?
      (1) Public response (polls & votes) reveals info about its priorities & relative pref’s;
      (2) and constitutes voter’s demand for economic outcomes.
   b. How relative concern over INF & UE varies across electoral groups: Dem’s, blue collar, lower income more UE-averse, less infl-averse than Rep’s, white collar, & higher income; n.b., the relevant comparison is:
      \[ \left[ \frac{\text{UE Aversion}}{\text{INF Aversion}} \right]_i \] relative to \[ \left[ \frac{\text{UE Aversion}}{\text{INF Aversion}} \right]_j \]
   c. Also addresses a set of very precise questions regarding electorate’s reaction to economic outcomes:
      (1) Rate at which past performance is discounted,
      (2) wt on cumulative party performance relative to that of particular admin’s & pres’s,
      (3) relative weights on unemployment & inflation.
3. Some questions addressed regarding the “supply side”:

a. Policymakers seek to...
   (1) ...maintain comfortable support level during term,
   (2) ...maximize votes at election time,
   (3) ...serve ideological & distributional goals of their core constituencies,

b. ...using monetary, fiscal, and other policies...

c. ...as constrained by institutions such as...
   (1) ...central-bank autonomy,
   (2) ...executive-legislative relations,
   (3) ...federalism,

d. ...and by economic reality & conditions such as...
   (1) ...e.g., the shape of the Phillips curve, etc.,
   (2) ...international conditions, influences, and institutions.
C. Policy options, economic theory, & policy effectiveness:

1. **Four basic policy options:** monetary, fiscal, direct controls, rhetoric & persuasion. Regardless of which we stress, we must adopt a theory of how the economy works (i.e., how it responds to these policies) ⇒

2. **Monetarism:** most economists now concur that sustained INF cannot occur w/o money-supply expansion accompanying (some debate remains over whether money is *only cause* of INF & whether INF may occur for “unsustained” periods w/o accompanying money growth).

   a. **Monetarism version 1** (one to which H refers):

      (1) Many economists skeptical discretionary tax & spending manipulations can influence real economy much w/o cooperative monetary policy.

      (2) I.e., monetary policy is the powerful instrument; fiscal policy, not so much.

   b. **Monetarism version 2** (a.k.a., classical):

      (1) Some economists now seriously doubt whether even money has much if any effect on real economy; at least not beyond very short-run responses unexpected moves.

      (2) ⇒ So-called classical divide: nothing nominal, or at least certainly nothing expected & nominal, affects anything real & *v.v.*
c. **Either way**, monetarist views see Keynesian activist position that govt can & should stabilize economy at very least to rely heavily on supportive monetary.

3. **Keynesianism:**

   a. **Old Keynesianism**: large fiscal policy effect on real economy; monetary-policy primarily to provide liquidity (*i.e.*, keep money-supply growth at least sufficient for constant prices).

      (1) Govt can & should work to stabilize economy by adjusting budgets counter-cyclically. (Larger) deficits, *i.e.*, \( \uparrow G \downarrow T \), in busts; surplus (less deficits) in booms

      (2) Little or no distinction between short run & long run; issue not much analyzed.

      (3) Keynes famously: “In the long run, we’re all dead.”

   b. **New Keynesianism**: both fiscal & monetary policy can & do have sizable short-run impacts, but doubtful govt can do much about long-run conditions (except *via* public invest., esp. in edu. *etc.*). New-Keynesian-type results supported by economic models w/ following features:

      (1) Nominal contracting/bargaining (“sticky” wages and/or prices) or other nominal rigidities: debate about how important these are, how short the short run, *etc.*

      (2) Multiple non-competitive markets, *i.e.*, monopoly power: *e.g.* non-competitive labor & product markets. *Combo of 1 & 2 produces esp. effective policy.*

      (3) Limited rationality of actors
4. **Neoclassical Economics**
   a. Ricardian Equivalence: debt, if sustainable [define]—& if everyone rational & foresighted it must be—is virtually irrelevant. Merely shifts timing of revenue collection relative to expenditure, which, because...
   b. ...Rational Expectations & Rational Intertemporal Optimization ⇒ foreseeable counter-cyclical policies are at best powerless & at worst counterproductive.
   c. ⇒ some optimum level of govt activity (mostly public-goods production & public investment): policy should be fixed at those levels.

5. **Modern political economists face formidable challenge: must be economists and political scientists.**
   a. Quite difficult to get very far relying on “economic consensus” b/c, if such ever existed, not now.
   b. May be near consensus around a neoclassical/neo-Keynesian synthesis: short-run effectiveness of demand-management policy, especially insofar as unforeseen, but “long-run neutrality” (real-nominal divide).
   (1) (But how short/long is short/long run?)
   c. I’ll offer here a suggested intro-level set of macroeconomic understandings that should help.
6. Working roughly in New Keynesian mode, one of H’s core arguments:

   a. **Two central political influences on macroeconomic policy = partisanship & electoral incentives.** (As with Tufte, but with emphases reversed.)

      (1) Dem’s (left) seeks lower UE, higher $dY$, & will accept higher INF to get them.

      (2) Rep’s (right) seek lower INF & will accept higher UE & somewhat lower $dY$...

      (3) Also, Dem’s will exhibit greater efforts at equalization & Rep’s less.

   b. [Recall: we should think “parties of left/right...” Republicans & Democrats are only US examples. This book is on US case, but hopefully its insights will have broader worth. (I’d say have proven to have; Clark would disagree.)]

   c. Hibbs argues that partisan influences decidedly more potent, at least in US context, than electoral.

   d. [Interesting Question (= possible paper topic?): what might explain relative prominence of electoral (Tuftean) and partisan (Hibbsean) motivated policy in different contexts?]
III. (Chapter 1) Postwar Macroeconomic Performance:

A. In Historical Perspective: Figures 1.1-1.6 tell the tale

1. Figures 1.1 & 1.2: Real Growth
   a. Relatively greater postwar growth (Fig. 1.1)
   b. Relatively greater stability of postwar growth rates (Fig. 1.2 & Table)
2. Figures 1.3 & 1.4: Unemployment

a. Postwar UE is lower than pre-depression, but not dramatically (Fig. 1.3)

b. Postwar stability: UE dramatically more stable (Table in Fig. 1.3; Fig. 1.4)

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**Figure 1.3** The unemployment rate, 1890–1980. Sources: U.S. Department of Commerce, *Historical Statistics of the United States, Colonial Times to 1970*, Series D 1-10, 1971; and TROLL-Citibank Economic Database, Series NBER12-LHUR.

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<tbody>
<tr>
<td>Mean ($\bar{x}$)</td>
<td>6.12</td>
<td>11.81</td>
<td>5.23</td>
</tr>
<tr>
<td>Standard deviation ($\sigma$)</td>
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<td>8.10</td>
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<tr>
<td>Coefficient of variation ($\sigma/\bar{x}$)</td>
<td>0.66</td>
<td>0.69</td>
<td>0.27</td>
</tr>
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</table>

**Figure 1.4** Year-to-year changes in the unemployment rate, 1891–1980. Note: Standard deviation ($\sigma$) for 1891–1929 is 3.24; 1930–1949, 3.85; 1950–1980, 1.18.
3. Figures 1.5 & 1.6: Inflation

a. Postwar steady \( \uparrow \) price-level in sharp contrast to flat prices Civil to WWI: prices stable in peace, rise in war, & return, but bit higher, true well b4 Civil War insofar as known (Fig 1.5).

b. Postwar greater INF-rate stability not as obv. from fig's but there (F & T 1.6)

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![Figure 1.5](image1.png) The Consumer Price Index, 1860–1980. Sources: U.S. Department of Labor, *Handbook of Labor Statistics*, 1978, Table 116; and TROLL-Citibank Economic Database, Series NBER12-PU.

![Figure 1.6](image2.png) Consumer price inflation and deflation, annual rates, 1861–1980.

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<tr>
<td>Mean (( \bar{x} ))</td>
<td>0.93</td>
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<td>Standard deviation (( \sigma ))</td>
<td>6.27</td>
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<td>3.39</td>
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<tr>
<td>Coefficient of variation (( \sigma/\bar{x} ))</td>
<td>6.74</td>
<td>3.66</td>
<td>0.85</td>
</tr>
</tbody>
</table>
B. In International Perspective:

1. N.b., little of the US postwar experience is unique.

2. Are arguments H offers persuasive considering that effects to explain are not U.S.-unique—are the explanators stressed general enough to have accounted for similar occurrences elsewhere?

C. Some interesting notes about these comparisons:

1. Postwar era saw historically high regulation, controls, cyclical intervention, taxes, & spending. It also saw historically high growth & stability though continuous inflation.

2. The decade of *stagflation* in early/mid-70s into 80s may have bolstered those calling for reversing trend of rising govt intervention. Era’s worst recession, Volker/Reagan deflation of ‘82, slammed INF to halt, but at big macroeconomic cost (much debate on how avoidable).

D. How does Hibbs explain these prominent facts?
IV. Some background macroeconomics, a brief introduction:

A. \( MV = PQ \) (money supply times velocity of monetary exchange equals price level times quantity of output)


2. Economic theory enters when deciding what endogenous & what exogenous; *for example*:

   a. Strict Friedman-esque monetarism & classical:

      (1) \( Q \) & \( V \) exogenous \( \Rightarrow (dM)V=(dP)Q \).

      (2) Money growth=price growth, complete separation from real.

   b. Old & New Keynesian:

      (1) \( V \) exogenous, \( P \) adjusts slowly \( \Rightarrow (dM)V=(dP)Q+P(dQ) \).

      (2) Money growth initially induces real growth, prices adjust slowly to absorb money. Long-run real-nominal divide, but short-run efficacy monetary policy.
B. $Y^d \equiv C + I + (G-T) + (X-M)$  
(aggregate demand=consumption+investment+net govt spend+net exports)  

1. This also an identity: true by definition (n.b., $Y^d$=aggregate demand, not necessarily supply).  

2. Theory enters in deciding how/if AD equated to AS & of particular importance, what we decide regarding incurrence of deficits, i.e., debt accumulation, $(G-T)>0$, or surpluses, i.e., public-asset accum., $(G-T)<0$.  

   a. **Neoclassical**: Supply, $Y^s$, exogenous to these factors $\Rightarrow$ altering $G-T$ only adjusts temporal allocation of government-revenue collection. C & I, & maybe X-M, adjust to counter $G-T$ movements, leaving real economy unaffected. The exogenous supply is fully determinant.  

   b. **New Keynesian**: for any or all of various reasons (like those listed above) $G-T$ only partially offset by adjusts other variables, especially in short run $\Rightarrow$ supply, $Y^s$, endogenous.
V. Longer intro, & Hibbs’ explanation for 3 big facts of postwar macroeconomic experience:

A. Three striking facts about postwar compared to prewar econ history:

1. *Postwar*: high & sustained real income growth; relatively stable macroeconomy & higher individual security; sustained inflation.

2. *Prewar*: growth averaged lower; economy far more unstable, w/ far more severe depressions & more erratic boom-bust cycle; individual insecurity tremendously greater; & prices almost perfectly stable long-run (inflation & deflation averaged quite nearly zero over decades).

3. All of these are different now, recall Figures 1.1-1.6, why?

4. [At least, all were different as of 25 years ago. Two deep recessions (early 80s, & ‘08/‘09-), a pair of booms (late 80s; mid-90s-to-late-00s), with a smaller recession between...]

B. A first important macroeconomic identity:

1. \( MV = PQ \)
   
   a. \textit{Accounting identity}:
      
      (1) Amount of money in circulation times velocity with which it circulates through economy = price level of goods times quantity of goods (produced & exchanged).
      
      (2) Essentially, with this definition of \( V \), the identity must hold by pure accounting.
   
   b. Becomes theory (e.g., \textit{quantity theory of money}) when we add assumptions about which elements in equation are exogenous (given outside the equation, i.e., model) & which endogenous (caused within the equation, i.e., the model).
2. **New monetarism or new classical theory** argues that

   a. Velocity ($V$) determined by outside technology. Financial-technical changes (ATM’s, checking accounts, credit cards, internet banking, 24/7 worldwide...)

   b. Real quantity of output ($Q$) also determined outside the system by real factors like existent labor supply & capital, relative preferences of people for labor & leisure, *etc*.

   c. Since $V$ & $Q$ exogenous, i.e., fixed with respect to the moveable, endogenous, parts, the growth rate of the money supply directly determines the growth of prices (inflation) $\Rightarrow (dM)V = (dP)Q$.

   d. From this standpoint, nothing nominal (money, prices) affects anything real (velocity, quantity); this is the so-called *classical* or *real-nominal divide*.

   e. Money determines inflation; real economy exogenously given; end of story.
3. **Old Keynesianism & old monetarism**, contrarily,

   a. Less sanguine re: quickness prices & wages \((P)\) adjust to monetary moves.

   b. Agree that velocity is rather exogenous, but prices do not necessarily adjust smoothly & quickly to monetary changes, so \(\Rightarrow (dM)V = (dP)Q + P(dQ)\)

   c. \(\Rightarrow\) money growth partly met by price & partly by quantity increases (INF & real dY). So, money has some real effect, at least short run, and, for Old Keynesians: “in the long run, we’re all dead.”

4. **New Keynesianism:**

   a. Likewise convinced that, for one reason or another, prices &/or wages do not adjust fluidly in short run, so money growth can have short-run effects on real.

   b. In long-run, though, accepts that prices may well adjust completely to return real output to some “natural” level.

   (1) NAIRU: “Non-Accelerating-Inflation Rate of Unemployment”, self-explanatory

   (2) Or “Natural Rate of Unemployment (or Output)”, that rate obtained at equilibrium labor (output) supply & demand, absent stimulus or deflationary policy.

   (3) Closely related. Perhaps identical (though derive from different parts gen’l theory)

   c. Note: Some Neo-Keynesian and Neo-Classical synthesis over past 10-15yrs.
5. **General agreement**: inflation cannot be sustained w/o accommodating money growth.

   a. If prices continue trend upward & money does not follow suit, reviewing $MV=PQ$ shows that ($V$ fixed, $M$ not follow, so) output must fall continuously

   b. This is unsustainable. So, first part of puzzle regarding inflation must be sought in explaining how money could, would, & was expected to follow suit.

C. ⇒ Hibbs’ first point: A key factor was removal of gold standard.

1. Under gold standard, money supply fixed to amount of gold.

   a. Thus, money can’t grow to keep pace any swifter than gold supply.

   b. Which, only by mining *etc.*, so, absent technological or financial innovation (moving $V$), money growth (or growth whole LHS of eqtn) was slow at best.

   c. Thus, prices kept in tight line under Gold Standard ⇒ expectations $dM$ would not or could not accommodate expansionary policy or wage-price settlements.

2. Once gold standard removed, *opportunity* for steady inflation present

   a. New-classical stops there: seek incentives for continual $\uparrow M$ in post-gold era.

   b. Hibbs’ new-Keynesian story is a bit more revealing.
D. Second important accounting identity:

1. \( Y^d = C + I + (G - T) + (X - M) \)
   
a. Aggregate demand \((Y^d)\) equals private consumption \((C)\) + investment \((I)\) + net government spending \((G - T)\) + net exports \((X - M, \text{exports} \text{– imports})\).

b. Once again, an identity—it becomes a theory when we start specifying how the various quantities in the eq. derive (& whether & how \(Y^d\ & \ Y^s\) equate).

VI. A simple Keynesian model, ignoring government & ignoring the international economy. (Also a crude picture of what roughly true for 1\(^{st}\) half of 20\(^{th}\) C: very small government by modern standards & high protection so little or no trade.) \(\Rightarrow Y^d \approx C + I\).
A. Now, the Keynesian parts of the theory are that:

1. Economy could very easily become stuck in position where demand insufficient & so output (supply) could be higher if demand boosted (⇒ output demand-constrained);
   
   a. Keynes’ animal spirits of investors and self-fulfilling prophecies:
   
   b. In brief: if think economy will grow, will invest, & so it will; &/but also v.v.

2. Individuals’ consumption behavior is relatively exogenous; people follow simple “rules” for savings & consumption rates: e.g., “put aside” or save 20% of income. (Incidentally, consumption rates have/had been fairly constant at around 80% in the US pre & postwar.)
B. These imply two things:

1. In equilibrium, \( Y^d = \text{aggregate demand} = \text{income} = \text{output} = Y^s \); and

2. \( C = cY^{\text{disp}} \) where \( c \) is “marginal propensity to consume” from income, say 80%, and \( Y^{\text{disp}} \) is disposable (after-tax-&-transfer) income, then:

C. With small T&T (0 for convenience): \( Y = cY + I \) [substituting \( C = cY \) into \( Y = C + I \)]

1. \( \implies Y - cY = I \)

2. \( \implies (1-c)Y = I \)

3. \( \implies Y = [1/(1-c)]I \)

D. \([1/(1-c)]\) here is the so-called Keynesian multiplier.

1. E.g., if \( c = .8 \), then \( dY = 5*(dI) \). I.e., exogenous movements in investment create 5 times larger movements in output & income!

2. Generalizing, exogenous (outside) movements in anything in \( C + I + (G-T) + (X-M) \) are multiplied \( 5X \) in their total effect on output \( (Y) \).
VII. What could have caused postwar economy to be so much more stable than prewar?

A. Govt’s now tax & spend much more, & do so largely in manner tied automatically to income of individuals. Called automatic stabilizers...

1. E.g., income taxes & income-related transfers create net income-tax rate of $t$. Say 20%.

2. This changes $C = cY$ from above because now individuals can only consume from their disposable (after-tax) $Y$. Say $c = .8$ like before, then:
   a. $Y = c(Y^{\text{disp}}) + I$ where $Y^{\text{disp}} = Y - tY = \text{income after the net income-tax}$
   b. $\Rightarrow Y = cY - ctY + I$
   c. $\Rightarrow Y - cY + ctY = I$
   d. $\Rightarrow Y(1-c + ct) = I$
   e. $\Rightarrow Y = \frac{1}{(1-c+ct)}I$ or, equivalently, $Y = \frac{1}{(1-c(1-t))}I$

3. So, if $c = .8$ still & $t = .2$ (roughly true of postwar era), then $Y = I/(1-.8+.16) = I/.36 \approx 2.78*I$
4. Hibbs: Changing Multiplier Explains Much of Pre/Post-War Stability Difference

a. Multiplier now $\approx 2.78$. Pre-war, $\approx 5$. [Back-of-envelope guesstimates.]

b. Any random shocks that hit exogenous factors (fluctuations in those *animal spirits*, e.g.) were multiplied 5-fold pre-war, now, thanks to dampening effects of tax-and-transfer system, they are only multiplied 2.78-fold.

c. Thus, postwar stability is very easy to explain from Keynesian or New Keynesian viewpoint. Less obvious what classical explanation would be.
B. What about the postwar inflation record?

1. H’s arg simple: stability & security from postwar Keynesian policies also insulated wage & price setters from most disastrous effects of refusing to moderate wage/price-growth

2. \( MV = PQ \): Under gold std, \( M \) relatively fixed by gold supply, \( V \) exogenous \( \Rightarrow \) any attempt to raise prices beyond velocity increase results in \( \downarrow \) output (\( \uparrow \) UE, \( \downarrow \) profits, bankruptcy)

3. \( MV = PQ \): Now \( M \) free from gold supply \( \Rightarrow \) price & wage setters know that if demand/cede too-big raises (\( dP \)), govt may/likely accommodate by \( \uparrow \) money (\( dM \)), or real-demand if can (i.e., if fiscal policy effective).

4. Wage & price setters therefore both (relatively) less afraid of excessive wage & price hikes, knowing policymakers (govt, bank (b/c govt leans on it), both) will bail-out by \( \uparrow \) demand &/or money.
VIII. Neoclassical Attack:

A. $C = cY$ is *ad hoc*; in particular: $c$ is endogenous, not exogenous:

1. People adjust spend, save, & invest decisions to $E$ (econ situation), including $E$ (policy) $\Rightarrow$ if govt $\uparrow (G-T)$, no multiplier; private actors just $\downarrow (C & I)$ to cover $E(\uparrow$ future taxes).

   a. Std (neo-Keynesian) story: Govt borrows 10 extra $\Rightarrow O \rightarrow CO$, total borrow req $\uparrow$ only 5, so crowd out as $r \uparrow 1$pt.

   b. Neoclassical counter: $G-T \uparrow 10 \Rightarrow$ priv save $\uparrow 10$, so demand & supply funds no $\Delta$, so no multiplier but also no crowd-out or any real effect (no $\Delta r$)
B. Inflation is “always & everywhere” money-supply growth:

1. Wage/price settlements only proximate causes; root cause always \(dM\).

2. Causes of INF must lie in incentives facing monetary policymakers, not directly in any new insensitivity of wage & price setters to possible negative repercussions of excessive wage-price hikes.

C. Neoclassical must provide some other set of explanations for facts 1, 2, & 3 about pre- vs. post-war econ history. [We’ll see some parts...]

D. Hibbs’ argument, essentially a (new) Keynesian one, is simpler:

1. High, sustained real-income growth:
   a. H argues +/- explicitly that successful KWS implementation spurred growth.

2. Macro stability & individual security stems very directly from KWS.

3. Removal Gold Std ⇒ opportunity for sustained INF; motive force behind the sustained INF is actually the stability & security achieved by KWS.
Table 1.1  Response of inflation to business cycle contractions, 1890–1980

<table>
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<tr>
<th>Response to—</th>
<th>Change in the CPI inflation rate</th>
<th>Change in the gap between actual and trend log per capita Real GNP (× 100)</th>
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<tbody>
<tr>
<td>Mild and moderate contractions</td>
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<tr>
<td>1895–1896</td>
<td>+3.92</td>
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<tr>
<td>1903–1904</td>
<td>−3.77</td>
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<td>1923–1924</td>
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<td>1953–1954</td>
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<td>1957–1958</td>
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<td>1959–1961</td>
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<td>Strong contractions</td>
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<td>1892–1894</td>
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<td>1919–1921</td>
<td>−25.1</td>
<td>−20.4</td>
</tr>
<tr>
<td>1929–1933</td>
<td>−5.27</td>
<td>−45.4</td>
</tr>
<tr>
<td>(1929–1932)</td>
<td>(−10.9)</td>
<td>(−41.4)</td>
</tr>
</tbody>
</table>

Note: The gap between actual and trend log (base e) real GNP per capita measures the severity of cyclical contractions. Trend values are the fitted values from the regression ln Y = a + bT + error, where Y is real GNP per capita and T is a time index. Trend values are obtained from regressions applied to two separate time periods: 1890–1949 and 1950–1980. Mild contractions refer to cycles in which the change in the gap (× 100) between actual and trend real GNP per capita was less than 5.0; moderate contractions designate cycles in which the change in the gap fell between 5.0 and 10.0; strong contractions denote cycles where the change in the gap was greater than 10.0.

IX. Direct evidence relating to these arguments:

A. INF response to econ. booms & slumps (Table 1.2, p. 24)

1. Prices (i.e., inflation) relatively insensitive to (real) slumps post-war. Increasingly so over time.

2. Gen’ly, real slumps had induced (or were induced by) deflations or disinflation in pre-war.

3. More rigorously:
4. Using Annual Data from 1890-1949:

\[
\text{DCPI}_t = +0.07 + 0.54 \sum_i \text{DCPI}_{t-i} + 30.4 \left[ \ln Y - (\ln Y)^* \right]
\]

T-stats: (0.09) (3.21) (2.92) \[ R^2 = 0.38 \]

5. Using Annual Data from 1950-1980:

\[
\text{DCPI}_t = +0.32 + 1.01 \sum_i \text{DCPI}_{t-i} + 9.00 \left[ \ln Y - (\ln Y)^* \right]
\]

T-stats: (0.51) (5.97) (0.83) \[ R^2 = 0.69 \]

6. Equations demonstrate 3 things:

a. Price level was mean-reverting pre-war but strongly trended postwar (seen in 2nd coefficients being <1 or \( \approx 1 \), respectively).

b. Overall predictability of inflation increased dramatically, nearly doubling (compare \( R^2 \)).

c. Prices responded more & more certainly to output booms & slumps in prewar than in postwar period (seen in 3rd coeff's & s.e.'s).
7. Hibbs already offered one important argument as to why; he now adds a more-proximate cause that wages increasingly set in staggered, long-term (3-yrs on average), nominal contracts in postwar period as unions became firmly established aspect of political-economic landscape.

a. Wages, \( \therefore \), simply cannot adjust as swiftly & surely to output fluctuations. His point: such contracting practice would not have been sustainable if postwar KWS hadn’t assured that cost of failure to adjust would be mitigated.

b. Firms, meanwhile, knew unions there to stay & that KWS operating, so could allow such wage rigidity to buy some labor peace (avoiding strikes & other disruptions, \( etc. \)).

(1) Note: this one version of what sometimes called ‘the historic (class) compromise’ or ‘the postwar settlement’

8. This may all be changing or have changed to considerable degree:

a. Declining unionization & relative decline of unionized, mass, standardized production sectors

b. Increasing openness [Why would this matter?]

c. Back-to-back severe recessions ‘79-80 & ‘81-‘82 may have changed political & economic landscape for long time to follow.
B. Other key changes in the institutional structure of American pol-econ

1. **Financial System**: government (& esp. central bank) as *lender of last resort* (part of FDR’s *New Deal*)

   a. Federal deposit insurance (FDIC, FSLIC) → bank panics have vanished. Hard to over-estimate importance. Almost every prewar depression (which were massive by modern standards remember) began w/ bank panics.

      (1) Bank collapses have occurred; but not general panics.

      (2) (Fear, but not panic, in 2008 started our most-recent, and most-severe bust since at least early 80s, probably since Depression, recessionary bout.

         (a) Note the strong Fed and then, at least initially bipartisan, government rescue.

         (b) From this perspective, lesson learned. Interesting that public not convinced necessary or that worked...)

   b. Large network of federal loan guarantees, subsidies, & agencies → socialization of risk, lowers effective interest rates facing many buyers (& investors) & so allows many more transactions to occur that o/w could not

      (1) (review supply & demand curves, consumer & producer surplus, & Harberger triangles of lost exchanges... [next page])
Distortions (Taxes, Externalities, T-Costs, Info Asymm., Quotas, Price Ceilings/Floors, Etc.)

\[ P \]

\[ S(P) \]

\[ S'(P) \]

\[ D(P) \]

\[ D'(P) \]

\[ T-Cost Example \]

\[ \rightarrow \text{Firms open a wedge b/w what seller receives & buyer pays} \]

\[ w/o T-Cost: \]

Cons: \( A + B + C \)
Prod: \( D + E + F \)

\[ w/T-cost: \]

Cons: \( A \)
Prod: \( I - \)

T-Costs:
Borne: \( B + D \)
Unconsumed Trades: \( C + E \) (Herberger)
2. Introduction of a central bank with legal capacity/responsibility to conduct counter-cyclical monetary policy for nation (Treasury-Federal Reserve Accord of 1951):

Figure 1.7 Monetary stability over time: M2 growth rates (percent per annum), 1868–1980. Sources: U.S. Department of Commerce, Long Term Economic Growth 1860–1965, Series B112, 1966; and TROLL-Citibank Economic Database, Series NBER12-FMM2X.

<table>
<thead>
<tr>
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<tbody>
<tr>
<td>Mean ((\bar{x}))</td>
<td>5.78</td>
<td>5.80</td>
<td>6.08</td>
</tr>
<tr>
<td>Standard deviation ((\sigma))</td>
<td>5.69</td>
<td>10.47</td>
<td>2.68</td>
</tr>
<tr>
<td>Coefficient of variation ((\sigma/\bar{x}))</td>
<td>0.99</td>
<td>1.81</td>
<td>0.44</td>
</tr>
</tbody>
</table>
a. Using Annual Data from 1890-1929 (Table 1.3, p. 32):

\[
\begin{align*}
    DM2_t &= +4.85 +0.25DM2_{t-1} -0.01DM2_{t-2} +0.06DCPI_{t-1} -10.9[\ln Y_{t-1} - (\ln Y_{t-1})^*] \\
    T-\text{stats}: (2.43) (1.19) (-0.05) (0.24) (-0.72) & \quad R^2 = 0.00
\end{align*}
\]

b. Using Annual Data from 1950-1980:

\[
\begin{align*}
    DM2_t &= +1.62 +0.52DM2_{t-1} +0.07DM2_{t-2} +0.29DCPI_{t-1} -19.0[\ln Y_{t-1} - (\ln Y_{t-1})^*] \\
    T-\text{stats}: (1.91) (2.88) (0.41) (2.01) (-1.79) & \quad R^2 = 0.55
\end{align*}
\]

c. These equations demonstrate two things:

1. Monetary policy became much more predictable [what part tells you that?]
2. Monetary policy became much more counter-cyclical [what part tells you that?]

3. Whether this had large effect in achieving postwar stability much debated
   [I find evidence here & elsewhere pretty convincing (see, e.g., Galí in AER on continued empirical power of AD-AS model)—when policy actually conducted counter-cyclically.]

C. Plus the fiscal-policy changes & introduction &/or ↑T&T & other automatic stabilizers.