Department of Economics University of Maryland

Economics 325

**Intermediate Macroeconomic Analysis**

**Supplement 10**

Professor Sanjay Chugh

Fall 2011

The following opinion essay in the *Wall Street Journal* commends this year's Nobel Prize in Economics winners' Thomas Sargent and Christopher Sims for doing research that continued to throw important chinks in the "Keynesian school's" armor of arguments.

WALL STREET JOURNAL

OPINION

OCTOBER 11, 2011

# A Nobel for Non-Keynesians

## People's expectations about government policy make it difficult for officials to affect the economy in the ways they intend to.

By DAVID R. HENDERSON

On Monday the Nobel Committee announced the winners of the 2011 Nobel Prize in economics: Thomas J. Sargent of New York University and Stanford University's Hoover Institution, and Christopher A. Sims of Princeton University. The award was given for "their empirical research on cause and effect in the macroeconomy."

The Swedish economists announcing the award emphasized, correctly, the importance of Messrs. Sargent's and Sims's thinking about the role people's expectations play in economic decision making and the larger economy. But what they failed to mention is that their work has also offered empirical evidence that the school of thought known as Keynesian economics—which believes that government can turn a flagging economy around with the right combination of fiscal "stimulus" (generally government spending) and monetary policy—is fallible.

Mr. Sargent was an early and important contributor to the "rational expectations" revolution in macroeconomics, an area for which his sometime collaborator, Robert E. Lucas Jr., won the Nobel Prize in 1995. One of Mr. Sargent's key early contributions, along with University of Minnesota economist Neil Wallace, was the idea that people's expectations about government fiscal and monetary policy make it difficult for government officials to affect the economy in the ways they intend to.

If, for example, people get used to the Federal Reserve increasing the money supply when unemployment rises, they will expect higher inflation and will adjust their wage demands higher also. The result: The lower unemployment rate that the Fed was trying to achieve with looser monetary policy won't happen.

This conclusion was at odds with the Keynesian model, which dominated economic thinking from the late 1930s to the early 1970s. The Keynesian model posited a stable trade-off between inflation and unemployment. In 1970, major U.S. econometric models, built on Keynesian assumptions, predicted that the government could get the unemployment rate down to 4% if it accepted an increase in inflation to 4%. In a 1977 article titled "Is Keynesian Economics a Dead End?" Mr. Sargent wrote, "[I]nstead of 4-4, in the mid-1970s we got 9-9, a very improbable occurrence if econometric models of 1969 had been correct."

In his later work, Mr. Sargent explored expectations in other contexts. An important one is the issue of how a government can end high inflation. Mr. Sargent studied four countries that had hyperinflation in the early 1920s—Germany, Austria, Hungary and Poland. All used inflation to finance high government deficits. They all succeeded in eliminating hyperinflation, but to do so they had to be credible. Of course, they got rid of their old currencies and started new ones. But they also had to affect people's expectations by committing to substantially lower budget deficits. All four governments did.

Although the Nobel committee did not cite his work on unemployment insurance, Mr. Sargent, with Swedish economist Lars Ljungqvist, found that high, long-lasting unemployment benefits in Europe have caused many European workers who lose their jobs to stay unemployed for years and, thereby, erode their "human capital." This makes them less employable in the long run. The fact that the U.S. government has extended unemployment benefits in many U.S. states to 99 weeks, said Mr. Sargent in a 2010 interview with the Federal Reserve Bank of Minneapolis, "fills me with dread."

Enlarge Image

Nobel Prize winners Christopher Sims, left, and Thomas Sargent

The work of Christopher Sims also undercut the large-scale Keynesian econometric models. His work is more technical than Mr. Sargent's but just as consequential. As the George Mason University economist Tyler Cowen wrote on his "Marginal Revolution" blog, "Think of Sims as an economist who found the traditional Keynesian methods 'just not good enough' and who worked hard to improve them. He brought a lot more rigor into empirical macro and he helped define a school of thought at the University of Minnesota. . . . I think of Sims's work as more defined by a method than by any set of conclusions."

Mr. Sims's big contribution was to use a statistical tool, the vector autoregression (VAR), to model the macroeconomy and make macro forecasts. Why did Mr. Sims choose that approach? Because, he wrote in a path-breaking 1980 article, the standard macroeconometric models rested on "incredible" assumptions. He could avoid stacking the deck by basing predictions of future variables on their own past values, on the past values of other variables, and on what economists call "exogenous shocks."

Mr. Sims does, of course, think beyond pure technique, and his research is always punctilious and often portentous. In 1999, for example, he suggested that the fiscal foundations of the European Union were "precarious" and that a fiscal crisis in one country "would likely breed contagion effects in other countries."

Both Messrs. Sargent and Sims are worthy Nobel recipients, for among other things putting a sizable chink in the Keynesians' armor.

Mr. Henderson, an economics professor at the Naval Postgraduate School and a research fellow at Stanford's Hoover Institution, is editor of The Concise Encyclopedia of Economics.