Utah Foundation Research Brief

Thoughts on the Current Recession: Chicago Economics

September 14, 2009

This brief is part of a series of research briefs Utah Foundation is publishing on the economy. The series examines the current economic recession from a variety of schools of economic thought. These schools of thought represent different approaches to understanding how the economy works and what actions to take when the economy falters. We began the series with a discussion of Keynesian, Austrian, and Post-Keynesian economics, and we now finish the series by examining the Chicago school of thought. Understanding these different schools of thought will help readers further understand the roots of the economic crisis and potential solutions.

Chicago Thoughts on the Current Recession

The Chicago school of economic thought favors empirically proven economic theory (largely through the use of statistics), as well as free-market, libertarian-based policies. Chicago economists generally support low taxation, minimal private sector regulation, and small government. Unlike Austrians, who are supporters of pure free-market economics, some Chicago economists do support the Federal Reserve's use of monetary policy. This is because the school was heavily influenced by the work of Milton Friedman and the principles of monetarism.

Monetarism emphasizes the role of monetary aggregates in economic policy analysis.[1] The school's economic policies are based in its acceptance of short-run monetary non-neutrality, which is the idea that changes in the money supply lead to temporary changes in real output and employment. As a result, monetarists believe monetary policy can be used to manage short-term full employment, inflation, economic growth, and stability.[2]

While monetarists favor the use of monetary policy, there is disagreement on whether it should be implemented through the use of rules or through the discretion of policy makers. Milton Friedman was a strong supporter of monetary rules and believed the money supply should grow by the same annual percent, irrespective of current macroeconomic conditions.[3] This would prevent the money supply from being influenced by political ideology. Other monetarists, such as Karl Brunner and Allan Meltzer, favor activist rules that allow policy makers to change the money supply in response to prevailing economic conditions.

After a decade of increasing influence, monetarism's reputation began to decline in the late 1970s and early 1980s and many Chicago economists turned their focus to areas such as the rational expectations hypothesis, the "Lucas Critique" of macroeconomics, and the real business cycle theory.[4] The real business cycle theory, originated by Robert Lucas and further developed by Edward Prescott and Charles Plosser, uses changes in productivity to explain the cyclical ups and downs in economic activity.[5] It states that total output of an economy is directly related to the value of goods and services produced by a firm—and therefore related to the total time people spend working and the quantity of equipment. If the effectiveness of the workers and equipment increases, then the value gained from their increased productivity becomes higher. The effectiveness of workers and equipment is increased by improvements in skills and technology.

In order to take advantage of the value gained from increasing productivity, firms invest in more buildings and equipment and hire more workers. Increasing profits lead to additional income for workers, and consumption increases. As a result, macroeconomic variables such as total output, consumption, investment, and employment rise above their long-term trends.

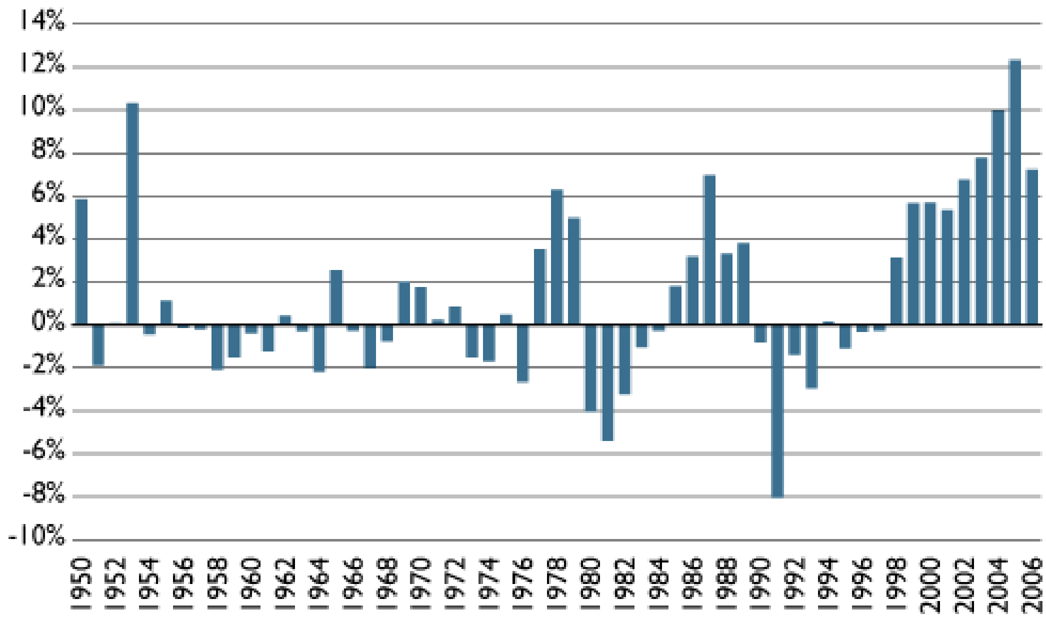
In context of real business cycle theory, booms are the result of several quarters of above average productivity growth, while recessions are the result of several quarters of below-average productivity growth. While this theory explains the fundamentals of the business cycle, most Chicago economists acknowledge that economic recessions can be caused or exacerbated by other factors as well, such as liquidity shortages or collapses in international trade.[6]

Causes of the Current Recession

Because the current recession is longer and deeper than any other U.S. post-war economic downturn, many Chicago economists are turning to explanations outside the real business cycle theory. For instance, Gary Becker and Richard Posner, both well-known University of Chicago Professors, believe the current recession is the result of a burst investment bubble caused by the mismanagement of the money supply, overconfident investors and bankers, and overleveraged financial institutions.[7] Posner states that the bubble started in housing, but extended to commercial real estate and other sectors of the economy. The investment bubble was the result of low interest rates, creative mortgages, and the deregulation of the banking industry which allowed for increased engagement in risky investments.[8]

Related to Posner’s assessment is the idea that the Federal Reserve and other financial institutions misperceived housing price dynamics, which contributed to the recession as well. Erik Hurst, an economist at the University of Chicago, argues banks failed to recognize that long-term annual housing appreciation averages about 1.1% to 1.2% nationally, and that historically, increases in real housing prices of 15% or more over a three-year period are always followed by a substantial housing bust (Figure 1).[9] Alan Greenspan, Chairman of the Federal Reserve from 1987-2006, often dismissed the idea of a national housing bubble, arguing appreciating housing markets were region-specific incidences. Hurst intimates that the Federal Reserve ignored the warning signs and continued to target general inflation rather than raise interest rates to counter the housing boom.

Figure 1: National Home Price Appreciation, 1950-2006
(Annual Percent Change)



Source: "Irrational Exuberance," 2nd Edition, 2006, by Robert J. Shiller

Like Becker, Posner, and Hurst, Milton Friedman, founder of the monetarist movement, would have likely blamed the cause of the current recession on the Federal Reserve’s mishandling of the money supply. For instance, instead of following his prescription of stable growth in the money supply of 3% to 5% per year, money was allowed to fluctuate dramatically throughout the last decade. Friedman argued that because economic fluctuations are caused by changes in the money supply, eliminating large changes would limit economic cycles.

Chicago Solutions to Recessions

Some Chicago economists believe in the positive, short-term effects of activist monetary policy. In fact, Lucas proposed that the real business cycle theory explains such a high percentage of postwar business-cycle fluctuations because stable monetary policy during this period prevented financial instabilities from creating larger fluctuations in the business cycle.[10]

Most Chicago economists, however, feel the government should refrain from implementing any major fiscal or monetary stimulus. This is based on the view that workers, consumers, business executives, and investors can anticipate and adjust to changes in the economy faster than the government can implement policies.[11]

For example, government often reacts to rising unemployment by expanding benefits. However, it can take several months for new unemployment benefits to be fully realized. Chicago economists argue that in the interim, business and labor realize the problems with their falling profits and paychecks and make the appropriate adjustments by cutting prices and settling for lower wages.[12]

The adjustments made by business and labor immediately help the economy start growing again. Chicago economists argue that by the time the unemployment benefits are available, the economy is already on the mend. Therefore increased government spending provides little gain, but can complicate short- and long-term economic recovery. In the short-term, increased government spending can accelerate the recovery, causing inflation to rise and deepening the budget deficit at a time when it should be shrinking.[13] The budget deficit therefore becomes more difficult to pay off in the long-term, hindering future economic growth and stability.

Chicago Solutions to the Current Recession

In December 2008, Economist Robert Lucas wrote an article for the Wall Street Journal supporting the Federal Reserve's use of $600 billion to purchase private securities.[14] Lucas saw this $600 billion influx as a necessary bailout because of the emerging liquidity shortage. By purchasing the securities, the Federal Reserve was fulfilling its role as lender-of-last resort. Lucas argues such government action is appropriate because it is fast and flexible—it directly addresses the liquidity shortage and can quickly be removed from the economy with the onset of inflation. Because the cash comes in the form of loans it entails no "new government enterprises, no government equity positions in private enterprises, no price fixing or other controls on the operation of individual businesses, and no government role in the allocation of capital across different activities."[15]

Economist Gary Becker, on the other hand, is not as supportive of the Federal Reserve's recent actions. He argues the Federal Reserve's seemingly arbitrary choices about which banks to bail out, close, or merge significantly added to the enormous uncertainty already prevalent in financial markets.[16] Becker also believes the Federal Reserve is losing its independence and being used as a tool of the current administration. He is concerned about its support of the large federal deficits being generated through fiscal stimulus. While Becker feels such stimulus may be necessary during times of war, it is not appropriate during recessions—especially since he believes the $787 stimulus package will do little to actually stimulate the economy. Instead he sees it as an attempt to direct long-term government spending to the areas desired by the President and Congress.[17]

Kevin Murphy, a University of Chicago economist, would agree with Becker's thought. He argues the effectiveness of the 2009 stimulus package all depends on what assumptions are made about the economy. He admits it will work if one assumes that government spending is more efficient than private sector spending, and that the benefit of government spending outweighs the economic loss that will arise from raising taxes to payoff the deficit. From Murphy's perspective, however, these are large assumptions to make, especially since the need to act quickly and the desire to spend a lot of money in a short period of time adds to the inefficiency of the stimulus. He also disagrees with the notion that the stimulus is infrastructure investment. To be true investment, the government should direct the money to areas that are booming. To be true stimulus, however, the funds need to go toward geographical regions that are struggling.[18]

Historical Notes on Chicago Thought

The Chicago school's name comes from its close ties to the ideology of prominent members from the University of Chicago's faculty (it is also referred to as the freshwater school). It is based on the writings of Frank H. Knight, whose work focused on how risk and uncertainty affect profit and perfect competition.[19] Other leading members of the Chicago school include Milton Friedman and George Stigler. The school lost popularity during the 1950s and 1960s when Keynesian theory was at it peak, but regained status in the 1970s and 1980s. Today it is known for its strong empirical and statistical work in neoclassical price theory.

Endnotes:

[1] Bennett McCallum, "Monetarism," in *The Concise Encyclopedia of Economics*, 2nd ed., ed. David Henderson (Indianapolis: Liberty Fund Inc., 2007), http://www.econlib.org/library/Enc/Monetarism.html (accessed 27 April 2009).

[2] McCallum.

[3] Milton Friedman, *Capitalism and Freedom* (Chicago: University of Chicago Press, 1962), 54.

[4] Some Chicago School economists, such as Steven Levitt, have found success through applying economic reasoning to other social sciences, such as political science, legal theory, history, and sociology.

[5] Satyajit Chatterjee, “Real Business Cycles: A Legacy of Countercyclical Policies,” *The Federal Reserve Bank of Minneapolis*’ *The Region*, March 1999, http://www.minneapolisfed.org/publications_papers/pub_display.cfm?id=3570 (accessed 29 April 2009).

[6] Casey Mulligan, “What Caused the Recession of 2008? Hints from Labor Productivity,” Working Paper 14729 (Cambridge: National Bureau of Economic Research, 2009).

[7] Gary Becker, “Why the Warnings Were Ignored: Too Many False Alarms,” *The Becker-Posner Blog*, 12 October 2008, http://www.becker-posner-blog.com/archives/2008/10/why_the_warning.html (accessed 30 April 2009).

[8] Richard Posner, “Macroeconomic Policy and the Current Depression,” *The Becker-Posner Blog*, 7 December 2008, http://www.becker-posner-blog.com/archives/2008/12/macroeconomic_p.html (accessed 30 April 2009).

[9] *Erik Hurst*, “Current Recession Not the Great Recession,” Presentation at the Working with Private Equity Groups Entrepreneurial Roundtable, 7 February 2009, http://www.chicagobooth.edu/news/2009-02-07_hurst.aspx (accessed 30 April 2009).

[10] Chatterjee.

[11] Peter Kilborn, “Fresh Water Economists Gain,” *The New York Times*, 23 July 1988 http://www.nytimes.com/1988/07/23/business/fresh-water-economists-gain.html?pagewanted=2&pagewanted=print (accessed 28 April 2008).

[12] Kilborn.

[13] Kilborn.

[14] Robert Lucas, “Bernanke is the Best Stimulus Right Now,” *The Wall Street Journal*, 23 December 2008, http://online.wsj.com/article/SB122999959052129273.html (accessed 4 May 2009).

[15] Lucas.

[16] Gary Becker, “Central Banks cannot Easily Maintain their Independence,” *The Becker-Posner Blog*, 26 April 2009, http://www.becker-posner-blog.com/archives/2009/04/central_banks_c.html (accessed 4 May 2009).

[17] Becker, “Central Banks cannot Easily Maintain their Independence.”

[18] Kevin Murphy, “Evaluating the Fiscal Stimulus,” Presentation at the Myron Scholes Global Markets Forum at the University of Chicago Booth School of Business, 16 January 2009, http://faculty.chicagobooth.edu/brian.barry/igm/Evaluating_the_fiscal_stimulus.pdf (accessed 14 September 2009).

[19] “Frank Hyneman Knight,” in *The Concise Encyclopedia of Economics*, 2nd ed., ed. David Henderson (Indianapolis: Liberty Fund Inc., 2007), http://www.econlib.org/library/Enc/bios/Knight.html (accessed 5 May 2009).

Article printed from Utah Foundation Research: **http://www.utahfoundation.org/reports**

Copyright © 2009 Utah Foundation. All rights reserved.