The Missing Motivation in Macroeconomics

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Thanks to Rachel Kranton.

I. Introduction

- Macroeconomics changed.
- Objection to casual ways.
- Derivation from economic principles.

Five Neutralities

- Independence of consumption and current income (given wealth).
- Modigliani-Miller theorem.
- Natural rate theory.
- Inability to stabilize output with rational expectations.
- Ricardian equivalence.

Consequences of Neutralities

- Neutralities fly in face of Keynesian economics.
- Anti-Keynesian conclusions:
  Previously unsuspected.

Reaction to Neutralities

- New Classical Economists:
- A Tell-Tale:
  - Keynesian economists:
    Wrong thinking.
  - Scientific reasoning:
    More precise economics.

Reaction of Keynesians

- New Keynesians:
  - Acceptance of utility/profit maximization for microfoundations.
  - View the neutralities as having generality.

Generality of Neutralities

- **Neutralities describe equilibria of competitive economies with complete information irrespective of preferences:**
  - ***As long as those preferences correspond to economists' typical descriptions of them.***

New Keynesians Add Frictions

- Credit constraints.
- Market imperfections.
- Information failures.
- Tax distortions.
- Staggered contracts.
- Uncertainty.
- Bounded rationality.

New Stance

- Derive behavior from utility and profit maximization.
  - Captures *purposefulness.*
- Question the generality of the preferences that lead to the five neutralities.

Preferences Narrowly Defined

- **Missing motivation:**
  - **Fail to incorporate norms of decision-makers.**
- **Norms:**
  - **How they and others *should* behave.**

Norms: Violation of Neutralities

- Consumption dependent on current income.
- Investment dependent on cash flow.
- Wages and prices dependent on nominal considerations.
- Income and employment dependent on systematic monetary policy.
- Consumption dependent on social security.

Bias in favor of Keynesians

- **Keynesians:**
  - **Theory based on observations of motivations.**
- **Neoclassical methodology:**
  - **Cannot pick up differences between real behavior and behavior derived from abstract preferences.**

Exogeneity of Norms

- **Norms assumed to be exogenous.**
- **Standard method in economics.**
- **Withhold doubts until the end.**
- **Endogeneity of norms will rarely nullify conclusions drawn here.**

Outline of Lecture

- I. Introduction.
- II. The Missing Motivation.
- III. Ricardian Equivalence.
- IV. Consumption.
- V. Investment.
- VI. Natural Rate Hypothesis.
- VII. Rational Expectations.
- VIII. Methodology.
- IX. Conclusion.

II. Norms: The Missing Motivation

- **Have already discussed the missing motivation.**

III. Ricardian Equivalence

- Standard Model.
- Parent’s utility:

$$U_1(c_1, U_2 (c_2)).$$

- Child’s utility:

$$U_2 (c_2).$$

Reasons for failure of Ricardian equivalence

- (1) infinite horizons.
- (2) strategic bequests.
- (3) childless families.
- (4) uncertainty.
- (5) differential borrowing rates
- (6) growth in excess of the interest rate.
- (7) lack of foresight about future taxes.
- (8) foreign ownership of debt.
- (9) tax distortions.
- (10) no bequests.

Ricardian Equivalence as Tell-Tale

- *Theoretical* challenge.
- Unsuspected by economists.
- Two possible conclusions:
  - Realignment of macro.
  - Missing motivation.

Bequest as Gift

- Andreoni.
- Bequest: type of gift.
- Social security transfer:
  - More money is parent's.
  - Greater gift to child.

Warm Glow and Norms

- Gift gives “warm glow.”
- Why?
- Parent thinks she is doing what she *should* be doing.
- Norms for bequests.
- Historic change in nature of bequests.

IV & V. Consumption & Investment

- Relative to Life Cycle Hypothesis:
  - Excess dependence of consumption on current income.
- Relative to Modigliani-Miller:
  - Excess dependence of investment on cash flow.

VI. Natural Rate Theory

- Description of reality.
- Acceptance:
  - Theoretical:
    - Care only about real outcomes.
  - Empirical:
    - Failure to reject.

Excess Sensitivity in Wages

- **Natural rate theory:**
  - **Only real considerations.**
- **Excess sensitivity:**
  - ***Nominal* considerations affect real wage setting.**

Starkest Example

- **Money wage rigidity:**
  - **Bunching in wage change distributions:**
    - **Australia.**
    - **Canada.**
    - **Germany.**
    - **Japan.**
    - **Mexico.**
    - **New Zealand.**
    - **Switzerland.**
    - **United Kingdom.**
    - **United States.**

Great Depression

- Absence of deflationary spirals.
- Explained by money wage rigidity.

Norms: Explanation for Sticky Money Wages

- Money wage rigidity:
  - Impossible to explain with only real considerations.
- Amendment to standard model:
  - *Norm* for wages.
  - Employees lose utility from money wage decline.
- Direct evidence:
  - Bewley interviews.

Violation of Natural Rate Theory

- **Acceptance of money wage rigidity.**
- **Broader implications of such violation.**
- **Money wage rigidity:**
  - **Because workers have a norm.**
- **At *least* one clear violation of natural rate theory.**

Tip of Iceberg

- **Further empirical possibility:**

  If there is *one* way in which nominal wages enter utility functions because of norms regarding wages, there could be *many other* ways.

Norms for Wage Increases

	Raise	Inflation
Barbara:	5 %	4 %
Ann:	2 %	0 %

- **79 %: Barbara *worse off* economically.**

  64 %: Barbara *happier*.
- **Explanation: Norms for wage increases.**

Shiller

- If my pay went up I would feel more satisfaction in my job even if prices went up as much.

Public:	49% agreed.
Economists:	90% disagreed.

Phillips Curve: Downward Sloping

- **With such a norm, at higher inflation workers will not experience disappointment from receiving lower nominal wage increases than they think they should receive.**
- **At higher inflation, *all things equal*, wage bargains will result in lower real wages.**
- **That will reduce the relative price that the typical firm wants to set.**
- **And therefore it will raise the rate of sustainable employment.**

Low Inflation/High Inflation

- **Low Inflation: Downward sloping Phillips Curve.**
- **High inflation: Upward sloping Phillips Curve.**
- **Reason for monetary vigilance.**

Prices

- **Prices are like wages.**
- **Strong evidence of price stickiness.**
- **Customers dislike price *increases*.**

VII. Rational Expectations Theory

- I will skip rational expectations.
- Piggy-backs on natural rate.

IX. Conclusion

- **Macroeconomics gives again and again examples where the substantive economics is changed by the presence of norms regarding how people think they should behave.**