EconoFact Chats: Macroeconomics in the COVID-19 Era

Greg Mankiw, Harvard University

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Michael Klein:

I'm Michael Klein, executive editor of EconoFact, a nonpartisan web-based publication of The Fletcher School at Tufts University. At EconoFact, we bring key facts and incisive analysis to the national debate on economic and social policies, publishing work from leading economists across the county. You can learn more about us and see our work at www.econofact.org.

Michael Klein:

The health of the nation of the health of its economy have been hit hard be COVID-19. We look to doctors and scientists to help control the pandemic. Can we still look to economist to offer useful advice about how to heal the economy? Does standard macroeconomic analysis explain what is going on, or do the effects of a worldwide pandemic force us to rethink how the economy operates and what can be done in the current situation?

Michael Klein:

To answer these question I'm very pleased to be speaking with Greg Mankiw. Greg is known in the economics profession as a leading macroeconomics researcher. He's known to generations of students as the author of the best-selling macroeconomics textbook, now in its 10th edition. Greg has policy experience as well, most notably serving as the chair of the Council of Economic Advisers in the George W. Bush administration. He frequently contributes to the public debate including by his regular economic view columns in the New York Times.

Michael Klein:

Greg, welcome to EconoFact Chats.

Greg Mankiw:

Thank you, Michael. It's great to be with you.

Michael Klein:

It's great to have you on the podcast. Greg, can you put the current macroeconomic situation in some historical context?

Greg Mankiw:

Well, the first thing to say about it is it was an incredible economic downturn. The fall in employment from February to April was the fastest two month decline in employment that we've ever seen. The second thing to say about it is that it's very unusual in the sense that it was a recession by design. We intended this recession. By that, I mean that given the pandemic we wanted employment to fall. We wanted people to stay at home rather than going to work unless that had essential jobs, or at most they could work from home. We wanted customers to not go to restaurants, not go to stores unless they needed to, and so the whole thing was designed to be a recession, which is very unlike previous economic downturns.

Greg Mankiw:

And as a result the policy response has been different. We have a big fiscal package, The CARES Act, but I think of that policy as less stimulus in the traditional sense and more it was disaster relief. So for example, normally we would give people unemployment insurance that replaces a fraction of their former wages. Here, we're giving unemployment insurance that replaced more than 100% in many cases, and that wasn't really a problem because we didn't really want people to go back to work. We were perfectly happy to have them dis-incentivized to go to work, to stay at home.

Greg Mankiw:

The last thing to say about how different this is, how it's going to end. I don't know how long it's going to last, or when it's going to end, but the ending's not going to be determined by macroeconomics as is normally the case in recessions, it's really going to be determined by microbiology. This is really only the end when we get a vaccine or better treatment, and it's really up to the microbiologists to solve the problem for us.

Michael Klein:

Greg, in the 1970s, when you and I first studied macroeconomics the oil and the food price crises got economists to consider the supply side of the economy, what workers could produce given the technology and the machines they had available, and not just the demand side, which had been the focus of Keynesian analysis. The recession that began in 2008 focused attention on the way in which financial market distress could contribute to macroeconomic problems, which in turn could further weaken financial markets, and then through this kind of vicious cycle further weaken the economy.

Michael Klein:

So innovations in economic analysis prompted by these events led to a deeper and better understanding of the economy, and eventually they showed up in textbooks and worked in the popular press. Do you think the current crisis will forge a similar reckoning of what macroeconomic analysis may have ignored, or is this just a straightforward application of aggregate supply of how much people can produce in an economy?

Greg Mankiw:

I think we're still trying to figure that out, trying to figure out how much we need to change standard models. My own view is that the traditional theory we teach, which emphasizes the interaction between overall supply and overall demand, is a very versatile tool for thinking about the macro-economy, and what we have in the current crisis is a change in both demand and supply. We have a reduction in the demand for goods and services because people are staying at home rather than going to stores and restaurants, and we have a reduction of the supply because a lot of workers are being told don't go to work unless you're essential.

Greg Mankiw:

And so, we have a sudden, and I hope temporary, increase in what we might think of as structural unemployment. We just don't have enough jobs for people, a lot of people on temporary layoff, and they will get back to work when those reasons for structural unemployment disappear.

Michael Klein:

So obviously we're all hoping that it's temporary, but one of the key issues in economics is not just temporary movements, what we call business cycles, but long-run growth. And one of the things that drew me to your textbook when I first began teaching macroeconomics was your innovative focus on growth. Now, they're questions about that. Recently, your colleague Larry Summers has raised the issue of what he calls secular stagnation as a reason why we might not expect growth to resume, and then there're other pessimistic views as well like those put forward by Robert Gordon in his 2016 book The Rise and Fall of American growth. This book got a huge amount of attention when it was published. What's your view of our potential for long-run growth once we come out of the pandemic episode?

Greg Mankiw:

You're right, Michael. When I teach macroeconomics I emphasis not only short-run business cycle, but also the long-run growth that explains finances and living standards from generation to generation. A standard starting point when we teach economic growth is to assume that technological progress increased productivity by some steady rate.

Michael Klein:

And technological process is really how we end up living better than our grandparents, right?

Greg Mankiw:

Yeah, exactly. The reason we were able to have higher standards of living than in the past is that we have better recipes. We know how to take capital labor and turn it into stuff that we consume in ways that weren't possible in the past. And the assumption is that tends to grow at 2% per year, which is has probably over the past century roughly, but there's nothing in economic theory that says that always has to be the case.

Greg Mankiw:

Before the Industrial Revolution we didn't have productivity growth at that rate. It was much, much slower, and there's no reason to think that the growth since the Industrial revolution is going to go on forever, so in addition to the Gordon book that you mentioned I find very persuasive, there's a wonderful paper by Nick Bloom and several coauthors called Are Ideas Getting Harder to Find? And they look at the number of people involved in the research and development process and find that it's increased substantially over the past century, and despite the huge increase in the number of scientists and engineers we're not really experiencing more rapid productivity growth, which suggests that we're diminishing returns and producing new good ideas.

Greg Mankiw:

So it's very possible as Gordon suggests that the future will not see the degree of productivity growth, technological process, that we're seen in the past. Maybe we'll just reach a higher plateau of higher productivity, but not necessarily faster growth forever. Indeed, if you want to be pessimistic it's entirely possible that with global climate change things could actually get worse, that rather than progress we'll get regress. I'm not predicting that scenario. I'm a little more optimistic in that, but I don't think it's out of the question.

Michael Klein:

And not only that but the actions people take to offset climate change would contribute to GDP but not necessarily people's wellbeing in the absent of it. It's a little bit like if you move to a rough neighborhood and you have to put more locks on your door that contributes to GDP, but it doesn't mean you're happier that you have to put more expensive locks on your door.

Greg Mankiw:

That's right, so if we find we have to build sea walls because the sea is rising, or we have to find that we have to move our cities to different locations because climate changes have made the current locations inhospitable. Yes, that's going to show up at GDP but it won't show up in [inaudible 00:09:01] of living and human satisfaction.

Michael Klein:

So shifting a little bit now from quantities to prices another innovative feature of your textbook that I really liked was its emphasis on what economists call the classical dichotomy, which means there's sort of in the long run the separation between what the prices of things are and how many things there are, and part of this is then the determination of inflation.

Michael Klein:

So I've taught for decades now that inflation is a monetary phenomemon. In the famous quote of Milton Friedman, "Inflation is always and everywhere a monetary phenomenon." You don't have to be that strong, but still there's a strong link in the long run between money supply growth and inflation, but I have to say it's becoming increasingly challenging now to teach this with the link between money growth and inflation seemingly severed, and the Federal Reserve consistently undershooting its 2% inflation target.

Michael Klein:

So Greg, how do you explain inflation or the lack of it to your students?

Greg Mankiw:

Well, I think the first thing to say about the fed undershooting is it's not that bad of undershooting. The average inflation over the past decade has been about 1.6%, which as you pointed out is less than two, but it's not a lot less than two. The fed might've been wise to not choose a specific number. If they had chosen a range like one to three they'd look a little more heroic today.

Michael Klein:

Or maybe negative 10 to 40, and then they'd always get it for sure.

Greg Mankiw:

I think they could've gotten away with a narrower range than that, Michael, but given the level of imprecision in macroeconomics and macroeconomic policy I wouldn't make a big deal of the difference between 1.6 and two, but you're absolutely right there've been huge puzzles about inflation over the past decade. Let me mention just two. One is that during the financial crisis in The Great Recession of 2008 and 2009, we had very high unemployment, you might've expected disinflation or deflation.

Michael Klein:

So disinflation is inflation coming down and deflation is actually negative inflation that prices would be falling.

Greg Mankiw:

Exactly. That's what we experience during The Great Depression so you might've thought something like that would've happened in the great recession, it didn't. And then, similarly after the very robust recovery as we got down to very low unemployment rates in 2018 and 2019 you might've thought that inflation would start rising, and it didn't, so inflation stayed very close to 2% in both episodes. So why is that?

Well, I don't think we know for sure but one common explanation is that expectations have become well-anchored as the fed has really convinced people that 2% is what they're aiming for.

Michael Klein:

So what we teach and what economists think is that people's expectations of inflation actually drive what inflation is, so again when you and I were first studying in the 1970s inflation was wildly unanchored and drifting very high, and that helped contribute to the high rates of inflation at that time.

Greg Mankiw:

That's exactly right. And so, the question is how did we get them anchored? I think we got them anchored through a lot of fed credibility and good fed policy, but under what circumstances might they become all unanchored? We know from sailing that sometimes boats slip their anchor and become unanchored.

Michael Klein:

To make sure people understand the metaphor you're recording this in Nantucket while you look out at the Atlantic Ocean, right?

Greg Mankiw:

Yes I am. There's a lot of white caps out today, so there might be actually a few boats becoming unanchored, and so the question's what might happen in the future to make expectations become unanchored, and we don't think we know the answer to that, but something to keep an eye on.

Michael Klein:

And the failure of inflation to emerge has prompted a lot of discussion, and part of this is what's called modern monetary theory, or known by its acronym MMT. I've written an EconoFact memo with Ken Kuttner of Williams College on modern monetary theory and it seems to say that we don't have to worry about government deficits because governments have a monopoly over printing money and they can just print money to pay for the things that they're buying.

Michael Klein:

You recently published a piece on MMT in the American Economic Association's annual Papers and Proceedings and parts of this were reproduced in the popular press. Can you tell us your views on modern monetary theory?

Greg Mankiw:

Yeah. It took me a while to figure them out because modern monetary theorists and mainstream macroeconomist at times seem to be speaking different languages, so I spent the last summer actually reading a book about MMT to try to figure it out, and there's some common ground, and there're some disagreements.

Greg Mankiw:

So I agree with MMT advocates that governments can always print money to cover budget deficits. That's what seigniorage is all about. That's what economists call the revenue for creating money. But the MMT advocates leap to the conclusion that the governments don't need to worry about their intertemporal budget constraint.

Michael Klein:

And that means that eventually you have to pay back what you've borrowed.

Greg Mankiw:

Yeah, exactly. So just as people have budget constraints so do governments, so why does the ability to print money mean you don't have to worry about your budget anymore? Well, most economists think that if you print too much money you'll get inflation, and rather than going to hyper inflation you'd rather actually default on your debt, that government default might be a better outcome than hyperinflation, and so therefore even where you could print money you may not choose to, so the ability to print money may not be as profound as MMT advocates suggest.

Greg Mankiw:

And part of this becomes that advocates of MMT have a different view of the inflation process. They tend to argue that inflation results from a class conflict between capital and labor, and that when you get inflation in this way you can often ameliorate that by incomes policies like wage and price controls. Most economists look at the historical experience with wage and price controls and are much more skeptical that it offers a useful approach to controlling inflation.

Michael Klein:

The last time those were tried in the United States was under President Nixon, right?

Greg Mankiw:

Yeah, exactly, and I don't think most people think of that as a good experience. It was also tried during World War II and some economists like John Kenneth Galbraith were still big advocates of wage and price controls in the aftermath of the World War II experience, but I think most mainstream macroeconomists do not see that as a useful policy tool.

Michael Klein:

And then, it was tried in other countries as well typically without success as countries tried to bring down high inflation. But what you're suggesting Greg is that modern monetary theory is actually about fiscal policy not monetary policy, and now of course we have some of the largest deficits on record and the debt to GDP, the amount of deficits that government has accumulated over time relative to national income the debt to GDP looks like it's going to exceed 100%. These are levels that haven't been seen since the end of World War II.

Michael Klein:

So Maury Obstfeld and I have an EconoFact memo on the resolution of very high levels of debt. What's your view on the current fiscal policy? Should we now be like Saint Augustine and pray to be chased, but not quite yet?

Greg Mankiw:

In the midst of a crisis worrying about the debt is probably not the first priority unless financial markets are going to force you to do so, so as of right now I'd probably agree with a lot of MMT advocates that we shouldn't be worrying about the budget deficit, but I think your Saint Augustine quotation is right, you need to be chased as some point even if it's not now. It's going to be when this crisis is over we need to get fiscal policy back on track like after World War II where we had slow declines in the debt to GDP ration over many decades.

Greg Mankiw:

How to do that is a big policy debate. I'm an advocate of smaller governments. I'd be delighted if they could figure out ways to do that all on the spending side, but my guess is realistically we're going to need new revenue sources as well. My two favorite are a carbon tax to deal with climate change, as I talked about earlier, and a value added tax, which is a tax they use in many European countries that's a relatively efficient way of raising substantial amounts of revenue.

Michael Klein:

So Greg, I'd like to conclude by asking you about some of your experience working in government in the service of the country. You've had experience at the highest levels of government economic policy making. As I said, you were the chairman of the Council of Economic Advisers. What was that experience like for you, and from that experience what's your sense of how economic analysis affects political decisions, and how does politics affect the analysis of economist who are working for the government?

Greg Mankiw:

One thing to say is that I probably never worked as hard as I did during those two years working as chairman of the Council of Economic Advisers. The White House is a busy place and people get there early and leave late, so I really worked harder in those two years than I did in any two years I've been at Harvard, but it was an absolutely fantastic experience and if there're any academic economists out there listening to this I would encourage them to take advantage of the opportunity of participating in public service both because you're making the world a better place, and you also learn a lot about economics, about how economics can be used, and the limits of economics from actually being a participant in the policy process.

Greg Mankiw:

There're a couple of other things that I want to say about that experience. First, is that when you work as an economist in government you have to realize that you're really not a decision maker, you're really an adviser, so in [inaudible 00:18:26] here I had no real power over anything but I got to talk to a lot of people who did have power, and so your ability to influence policy comes from your ability to persuade and to provide useful information to the decision makers, and the decision makers are elected officials.

Greg Mankiw:

I fortunately got to work for George W. Bush who really did want to listen. I ended up having tremendous respect for him as an individual, and I felt very honored to be able to work for him for those two years recognizing that in the end it was always his decision, not mine, because he's the guy that got elected. I get the sense the current occupant of the Oval Office may not listen quite as much to his advisers, but I don't know. I'm not there, so I can't say that for sure.

Greg Mankiw:

The second thing to say about being an economist in government rather than academia is that you have to give up some of your freedom of speech. When you're in academia you get to say whatever you want whenever you want to say it because you're an independent scholar, but when you're working in government you're part of a team of policy makers and when you speak you're speaking as a representative of that team, and so you really can't just say what happens to be on your mind. You have to be cognizant of the fact that you are representing a team and edit yourself, which can for someone with a lot of opinions like me that can be hard. I oft want to speak my mind, but you can't always do that when you're part of government, but it's well worth the sacrifice because you can learn a lot and have some input into the policy process and in a small way make the world a better place.

Michael Klein:

Yeah. I had a similar experience when I served in the US Treasury in the Obama administration. It was just really one of the highlights of my career. So Greg, thanks very much for speaking with me today and for your insights on the macroeconomic situation, which is certainly very challenging and will give economists a lot to talk about, and think about, and hopefully help out with over the next few years.

Greg Mankiw:

You're welcome, Michael. It was a pleasure.

Michael Klein:

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