Chapter Twenty Four: Chicago
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Historic Background

After Marshall, up until Samuelson, the trend was for more G

Externalities, Monopolistic Competition, Socialist planning, Keynes, etc

But then came the 70s…..

Chicago possessed a remarkable cadre of great free-market economists

Major Tenets of the Chicago School

Optimizing Behavior

People (INDIVIDUALS) optimize. They are rational, have stable preferences, look at prices, respond to incentives, and rationally gather/consume information.

Observed prices/wages are approximately in LR equilibrium

Monopoly is not that important, except when govt. mandated

Institutions are agents of efficient economic organization

Mathematical Orientation

Accepted the need for Math, and for empirical verification

They were and needed to be, technically proficient

Rejected Keynesianism.

Economies are self correcting, and generally pretty stable

Fiscal policy is laggy, or irrelevant. Money IS important

Inflation is "always and everywhere a monetary phenomena

Believed in Limited Government

Government is inefficient, clumsy, and sometimes malevolent

Regulatory capture…

Whom did the Chicago School Benefit or Seek to Benefit

If Chicago economics is true, society at large

Those who want more govt. stood to lose from Chicago Econ

As a practical matter, it was American conservatives (republicans)

Who benefited most, though

Which tenets became lasting contributions?

To many to list…

Milton Friedman (1912 – 2006)

Born in NY, went to Rutgers, Chicago and Columbia

Spend WWII in Washington, in 1948 joined faculty at U. of Chicago

Became a leading Chicago Economist, and arguable the world…

The Theory of the Consumption Function (1957)

Why no secular stagnation?

The Permanent Income Hypothesis

(Revisit the Keynes Cross)

Monetary Theory

- The demand for money – Keynes was wrong to stress interest rates
- The amount of money we demand money depends on three things
  - Total Wealth
  - Cost of holding it (interest rate, inflation, price levels)
  - Preferences (which are pretty stable)
- Note the above means that interest rates are minor
  - In the decision of how much money to hold

The Modern Quantity Theory of Money

- An increase in the quantity of money leads to
  - A desire to reduce our money stock back to where it was
  - So we all start spending it. Prices go up, quantity stays fixed..
- The cause of Inflation is the money supply
  - And he did the econometrics to show it.

The Great Depression

- Friedman & Schwartz "A monetary History of the United States: 1867-1960"
- MV=PT
  - The problem wasn't a liquidity trap
    - It wasn't that firms wouldn't borrow any more
  - It was that they couldn't…..

The Long Run vertical Phillips curve

- The Phillips curve as a mispecified model
- What if people learned from the policy
  - Adaptive Expectations (not Friedman, others)
- SR Phillips curve
  - Raise the money supply
  - Real wages fall, as the price of goods sold rises
    - So firms increase hiring
  - And if workers mistake the higher nominal wages for real
    - Their search time for a job goes down
- LR though….
  - This is a temporary phenomena
  - It was caused by unexpected inflation
  - Once we have adjusted to the inflation, back to NAIRU
    - BUT AT A HIGHER RATE OF INFLATION

This led to Friedman's "monetary rule"

- Increase the money supply by 3% a year
- Rules, not discretion.
  - Advantages
    - Past performance of the Fed did not inspire confidence
      - (Friedman wanted the fed abolished)
    - Rules would give businesses confidence
    - Rules would insulate the Fed from political influence
  - And the problem of limited economic knowledge
    - "Lags"

Other Friedman
Economic liberalism
Abolish the Draft
School vouchers
Flexible Exchange Rates
Negative income tax, Flat income tax
Legalized Drugs

Robert Lucas and RE

Rational Expectations
Extended discussion of Expected/Unexpected shocks
RE and the Business cycle
The Lucas Critique….

Gary Becker (1930-2014)

The economics of Discrimination
"A taste for Racism"
Government as a means of breaking down racism
Or of perpetuating it

(for all future examples – assume whites a majority, and racist towards blacks – though the logic works for many other examples as well)

Racism of Employers….
An Employer with a "taste" for racism..
Is willing to spend more (pay a premium) for a white worker
If enough employers are racist, you will get two wage rates,
A higher white rate, and a lower black rate…
An employer who only hired white workers
Will have a more expensive product, cetarus paribus
Effects – the more competitive the industry, the more costly it is to be racists
Non-racist consumers will simply choose the less expensive good
Racist consumers will pay a premium for white made goods
But ONLY if they can actually differentiate them
(white waiters, but black dishwashers, for example)

A consumer with a "taste" for Racism
Will only consume white produced goods.
If whites outnumber blacks (in numbers or purchasing power)
In a small market, blacks will be frozen out
As the size of the market grows, more black consumers exist
And the more potential customers a firm is giving up
To cater to its racist majority customers.
Thus some firms will specialize in catering to blacks
And potentially, to black and non-racist white, consumers

Implications
as markets become thicker, racial barriers will start to break down
monopolistic/non-competitive markets will retain racial discrimination
(government is a monopolistic/non-competitive entity)

- In this view, Legal Racial Discrimination in the South of the U.S.
    - Became in necessary in the 1920's
        - Because the Racial barriers had begun to break down
    - Jim Crow a reaction to change,

Investment in Human Capital

- Example: Musical Tastes
    - Many tastes take time to develop (classical music, beer)
- For other tastes, there is a period of search
    - Going from nursery rhymes to good modern pop songs
        - Is a big improvement, a small investment = much joy
    - Going from modern pop songs to the next generation, not much
        - Once you have 50-100 favorite songs,
            - How many more do you need to listen to,
                - To find one that is actually better?

- General Knowledge vs. Specific Knowledge
- General Knowledge - you carry from job to job, place to place
- Specific Knowledge – applies to a specific job, place or person
    - Why don't Americans learn foreign languages?
- Examples: Thai Cuisine, restaurants of N. Va or Don Muang
    - Knowing a Schiling equilibria
        - Vs. American Standard bathrooms at Thammasat
- Is a college degree about acquiring human capital, or signaling?

Some implications…

- It is easier to move jobs/change careers when you are young
    - Far less specific knowledge
- As you get older, general knowledge locks you into a career
    - But you still have the ability to change firms
- Specific Knowledge is, well, specific…
    - And thus CAN'T be known to a central planner
        - (back to Hayek and the socialist calculation debate)

Theory of the Allocation of Time

- Households are not just bundles of consumption
- They are also producers, and have to allocate time
- Time intensive, and goods intensive, commodities
- Three (of many) implications
    - Higher earnings will shift consumption towards goods
    - Increased household productivity = women in labor force
    - When both spouses earn, fewer children (goods over time)

On the Family
Children as an investment
"Children have one mouth, but two hands"
Children as a consumption good
Quality vs. quantity decisions
And the opportunity cost of children
Productivity gains in the last 100 years…

Baumol's cost disease…..
As productivity in one sector increases,
More resources are devoted to another one…

Numeric Example, Forks and Spoons
Assume: The economy produces two goods, forks and spoons
Everybody wants to consume an equal number of them
Everybody works 40 hours a week
It takes 4 hours to produce a fork, and
It takes 4 hours to produce a spoon.

So, to produce one fork and spoon takes 8 hours, and 40/8 = 5
Everybody produces/consumes 5 forks and 5 spoons a week
And spends 20 hours producing each

Now, assume a change in technology lets us make spoons in 1 hour….

To produce 1 fork (4 hours) and 1 spoon (1 hour) takes 5 hours,
And 40/5 = 8
Everybody produces/consumes 8 forks and 8 spoons a week,
Spending 32 hours making forks, and 8 hours making spoons

As household maintenance costs have gone down, families have shifted
Fewer, but higher quality, children
Women have been freed to enter the labor force

D.I.V.O.R.C.E.
In a marriage market, two informational constraints
(henceforth I will assume a man courting/searching for a women)
The more women you date
(not sleep with gentleman – it is not the same thing)
The more potential partners you meet.
But the longer you date one women
The more you know about her, and her suitability
So a rational women-consumer will date in such a way as
MBm/MCm = MBo/MCo
But Total Benefit will decline over time, because
You can only benefit from a wife if you have one…

Once married, you gain more knowledge of the one,
For good or ill, and

Any sudden shock (fame, fortune, etc.) can upset the calculation
For one partner or the other…

Question: Can China win a war?
Changing Chinese demographics
D-Day vs post 9/11 U.S. casualties
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