More on Woodford

Author : James Annable

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This post continues last week's look at Michael Woodford's macroeconomics, largely because I just re-read his far-ranging interview with Douglas Clement in *The Region* (September 2014). A couple points came quickly to mind. First, Woodford's attention to the most fundamental macro questions is admirable. Unlike many of his New Keynesian colleagues, he is reluctant to sweep big issues under the rug: "… a key issue for macroeconomics, and in particular for understanding why monetary policy matters, is to understand why adjustments to changing market conditions don't occur more smoothly and more immediately…. In what one can probably call the mainstream approach to this question – and certainly the one that I've used in a lot of my own modeling – the way that we try to think about that is by supposing that, for some reason, decisions aren't being constantly made, and so prices are not constantly being reoptimized. Then one can look at the consequences for equilibrium and how it adjusts over time under that assumption." (p.22)

Second, I appreciate Woodford's willingness to provide updates on his evolving thinking about the nature of money, i.e. the "some reason" that money matters. As I understand it, his recent take is that decisionmaking incidence is restricted by cognitive limits rooted in neural pathways' capacity to process information. From the 2014 interview: "I think it's right to suppose that things aren't constantly readjusted optimally, but it may be wrong to think that people are perfectly aware at every moment of what it would be in their best interests to do, if only they were not subject to 'menu-costs' or some other barrier to more constant adjustment. Rather, the failure to adjust probably has to do with failures of knowledge to be quite that precise in quite such a timely way. If you ask what the costs of more frequent price adjustment really are. I suspect they are costs of having to pay more attention and make more precise decisions all the time about what exactly it's best to be doing." (p.24)

It appears that Ricardo Reis's (2009, p.7) "sticky information", rooted in "costs of acquiring, absorbing, and processing information", is being recycled. But Reis-class inattention has never been a convincing explanation of powerful nominal rigidity. By their nature, important economic decisions involve substantial stakes for the decision-makers. If so, how can serious theorists take the cognitive-limits argument seriously? In the most notable example, we know that rational employees must pay attention to wage recontracting decisions because of their central importance to their livelihood; they must always choose wage reductions that do not violate their opportunity costs in lieu of losing their jobs. Such a crucial choice is never pushed aside because the cost of paying attention is too onerous. Serious economics cannot be silly. It makes no sense that being in the moment, paying "close attention" to an event critical to one's livelihood, is too much of a bother. Moreover, it is time for macro theorists to pay attention to the universal fact that employees are not *offered* wage cuts that they are hypothesized to be too distracted to consider.

Woodford's version of the mainstream market-centric general-equilibrium model class continues to avoid confronting the absence of involuntary job loss, the evidence of which is most indicative of the nature of macro instability. Why not just come clean and admit that the most crucial phenomenon in macroeconomics is has been pushed aside because consensus theorists have yet figure out how to microfound wage rigidity powerful enough to suppress rational labor-price recontracting. Woodford should pay attention to the admonition of my former MIT colleague and his former teacher, Bob Solow, to go forth and save policy-relevant micro-coherent macroeconomics by microfounding meaningful wage rigidity.

Selective use of evidence, a deeply troubling characteristic of modern analysis, segues to the more general problem. Pushing aside widely known, crucial facts in order to defend consensus thinking is no more than Ptolemaic misdirection, providing cover for the failure of mainstream market-centric general-equilibrium modeling to be stabilization-relevant. It is deeply troubling that Woodford and other leading macro theorists collude in an effort to mislead.

What to do? Generalized-exchange macroeconomics can break the profession out of its Ptolemaic downward spiral. The new model class is micro-coherent and stabilization-relevant, fitting the broad range of critical facts produced in episodes of macro instability. It also derives from axiomatic model primitives meaningful wage rigidity capable of suppressing wage recontracting, by making it irrational to offer wage cuts, and thereby motivates the causal link from nominal demand disturbances to same-direction changes in employment, output, and pure profit. That microfounded causation is surely the elemental answer to why money matters.

In an encouraging part of the Clement interview, Woodford appears reluctant to accept that mainstream New Keynesian macroeconomics is settled theory, claiming an open mind with respect to fundamental macro innovations: “… my *own* work is indeed still pushing on asking whether the foundations can be further improved, without presuming whether an improved model will necessarily deliver something similar to our current understanding, or whether it might result in more far-reaching changes…. But that’s not a claim that some other idea, yet to be developed, won’t turn out to add something important to the New Keynesian framework, or even show that one could dispense with important parts of it because there’s actually a better approach.” (pp.24-25) Woodford would greatly benefit from examining GEM macroeconomics from that perspective, assessing its claim to being a far better approach. If generalized exchange makes good on the promise to be both micro-coherent and stabilization-relevant, providing an improved roadmap for understanding a broad range of macro instability in highly specialized economies, he should look hard at the cost/benefits of market-centricity.

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