Comment on Casey Mulligan: Keynes in Both Fresh and Salt Water

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Dear Editors:

Mulligan presents a fresh water model of three independent building blocks: (1) output is produced according to labor and capital inputs, in both present and future. Equilibrium holds in labor and capital markets, and thus (2) supply of labor (current and future) equals its demand, and (3) the supply of capital (consumption foregone) equals its demand. Departures from equilibrium are allowed through “residuals”—that is, a “productivity shock” regarding block (1) above, a “labor market distortion” regarding (2), and a “capital market imperfection” regarding (3).

Mulligan identifies the cause of the current recession to be in the labor supply residual, and thinks this was also the main factor behind the Great Depression. He focuses on (2), and dismisses any shocks in productivity or in financial capital markets as the culprits. The evidence he presented was that “employment was low while total factor productivity and real pre-tax wages were high.” Recent public policies caused the supply of labor to shift relative to its demand: hikes in the federal minimum wage for three consecutive times and also the Treasury and FDIC’s plans for modifying mortgages that created marginal income tax rates in excess of 100 percent.

I mention that the model is also compatible with explanations coming from (1) and (3), whether they are complementary or not. These days no one wishes to pinpoint
an adverse productivity shock as the culprit for this recession because the fall in employment was clearly accompanied by total factor productivity growth. Yet, even fresh water economists can still spot causes in the role that monetary policy played in affecting financial capital markets. But in a just published working paper in the NBER, Mulligan dismisses again an explanation based on the financial market. For him, this is only “theatrics.”

Is Mulligan claiming that the Great Recession came solely because wages were too high? If so, this is how Pigou, not Keynes, was diagnosing the Great Depression. And here, like Pigou, Mulligan is dead wrong.

Mulligan cites page 17 of GT’s chapter 2 as evidence that Keynes’ diagnosis of the 1929–33 period was similar to his own: Keynes also favored (2). Yet I presume that what Paul Krugman and others claim to be the proper Keynesian diagnosis is what comes only in GT’s chapter 19, where Keynes was theoretically ready to argue that cutting wages would only worsen the depression.

As money and finance can mess things up in the real macroeconomy, block (3) pinches salt on (1) and (2).

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REFERENCES AND FURTHER READING

