Lessons from Covid-19 and Trump for Theory and Policy

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Three themes

1. Equilibrium models often don’t suffice: the world is full of surprises, and the presumption that we quickly return to an equilibrium trajectory is misleading/wrong
   1. Especially when surprise reveals/creates macroeconomic inconsistencies, so some contracts have to be broken

2. Policy often lies within the nether land between “temporary and transitory” and “permanent”
   1. Commitment is difficult
      1. May be impossible in some states of nature—undermining credibility of commitment in first place
   2. Commitment is especially in a contestable democracy with disputed values, and in a world of deep uncertainty
   3. May still strive to increase the extent of commitment, eg. on climate change and/or to formulate commitment in a more credible way (“do what it takes”)

3. The centrality of inequality
I. Disequilibrium with noise

- Covid 19 like 2008 crisis were events beyond those anticipated in rational expectations model
  - Typical of the political and economic events that mark history (wars, trade wars)
  - Necessitating moments of adjustments where macroeconomic inconsistencies get created or revealed
  - Reflecting key feature of economy: absence of complete set of markets
- Behavior in such circumstances can’t be well-described by subjective utility theory and by models with r.e. and common knowledge
  - Deep uncertainty: no basis for forming probability judgments
  - Lack of common knowledge means (in standard theory) that there will be “bets” based on differences in views, and more broadly “pseudo-wealth”—beliefs about wealth—will be untethered to actual wealth
  - Macroeconomic inconsistencies will occur (contracts will be broken, plans won’t be fulfilled); and it may take considerable time for resolution
• Major departure from DSGE models, which neither predicted crises nor provided adequate prescription on how to respond
  • No tinkering with model can resolve problem: flaw is in equilibrium assumption
  • Schizophrenia: moment after disequilibrium revealed assumed economy goes back on to equilibrium trajectory
  • No theory on how equilibrium attained—outside of representative agent model
  • In fact, more plausible adjustment models suggest that decentralized adjustment processes may be disequilibrating


Response

• Strong preference for flexibility (Kreps, 1979)

• Reflected in large increase in precautionary savings—greater than one would expect from subjective utility functions with reasonable degrees of risk aversion

• Savings put into more flexible assets, like money and land, rather than “hard” capital goods

• When combined with (a) imperfect mobility of resources across sectors and (b) macroeconomic externality: can give rise to high levels of unemployment
Dynamics

• The shock (Covid-19) creates or reveals inconsistencies

• Absence of policy interventions would create more inconsistencies--for instance, it would lead to the destruction of some firms and organizational capital that could lead to bankruptcies, which makes the effects of the initial shock longer-lasting

• Bankruptcy and the evisceration of balance sheets may impair quick recovery
  • Benefit from providing assistance up front—beyond the immediate effect of alleviating current suffering

• This recovery will also be impeded by lack of comprehensiveness in current measures
  • Automatic destabilizers associated with state and local government
  • Some sectors, like education/knowledge, particularly hard hit with inadequate assistance
    • Particularly disturbing given objective of “building back better”
A new policy framework

• Less reliance on top-down arbitrary anchors
  • Europe: 2% (inflation), 3% deficit/GDP, 60% debt/GDP
  • Good news: many already abandoned
  • This is not the time to focus on budget deficits—for countries like the US with easy access to credit at low interest rates

• More reliance on automatic adjustments
  • Macro: automatic stabilizers
  • Micro: built in program adjustments to reflect key predictive drivers (demography, inequality, etc.)

• More emphasis on flexibility where we need it
  • Climate change: avoiding extreme events
    • Could be 21st century innovation story
    • Rejecting approach of standard IAM, simply accepting 3.5 degree C.
  • Allows better “tuning” of political agenda in reaching consensus on responding to the unexpected
2. Between the permanent and transitory

• Value of commitment: seemingly reduces uncertainty, high cost to uncertainty

• But commitment to policies based on misunderstandings of evolving economy will a) be unsuited to current situation b) likely eventually be broken; and therefore are not credible: uncertainty may be even larger than with more flexible, adaptive policies

• Especially true in political context: current government cannot fully commit successors

• Value in looking for politically sustainable policies, reducing vagaries resulting from changing politics
Economic policy in contestable democracies often has disappointing results

- Dividend tax cut (2003) leads to less investment
  - Firms take advantage of low dividend tax rate to distribute dividends, leaving them less able to take advantage of new opportunities
- Corporate tax case (2017) did not lead to more investment
  - Since tax is close to tax on pure profits, first order effect is negligible
  - Incentive to shift profits from future to low tax periods
  - May actually discourage investment

Political sustainable climate change policy

• Beliefs that over the long run, there will be stronger policy responses induces firms *now* to begin green transition
• More firms invest in green transition, stronger political economy impetus for pricing, public investment, and regulations to sustain green transition
• More public commitment to green transition, the stronger these effects
• Tying one’s hand: global commitments, through international institutions
  • Recent WTO proposal for countervailing duties against environmental dumping
III. Inequality

• Large increase in inequality over past 40 years previously noted
  • Growing consensus that we paid a high economic, social, and political price

• Virus was not an equal opportunity virus
  • Exposed and aggravated inequalities

• Representative agent models particularly unsuited for understanding macroeconomy
  • Bifurcated responses between bottom and top
  • Large increases in precautionary savings

An exciting and challenging time for economics

• Response to pandemic was unprecedented—and succeeded in forestalling what might have been a far worse economic calamity
• The pandemic and experiences of the past four years have exposed some limits of standard models and policies
• Redirecting our attention to surprises and disequilibrium events and how we do and should respond
• Encouraging a reformulation of thinking about transitory and permanent policy changes, and the benefits, costs, and limitations of commitments
• And once again moving inequalities to the center of attention