

The Modern Revival of the “Treasury View”

J. Bradford DeLong
Professor of Economics, U.C. Berkeley
Research Associate, NBER

delong@econ.berkeley.edu

January 18, 2009 DRAFT

The Fallacy of the “Treasury View”

Back in the period between the world wars John Maynard Keynes begged the political establishment of Britain to do something—cut taxes or raise spending, but something—to boost demand, income, production, and employment. Back then the silliest and stupidest arguments made against Keynes's policy proposals were made by the bureaucrats of H.M. Treasury, with their so-called "Treasury View"¹ of Britain's economic problems: that each extra pound sterling of British government spending had to be financed by borrowing an extra pound from Britain's savers, which meant a pound less for Britain's firms to invest. Hence investment plus government spending was constant. So fiscal policy could never boost employment or production no matter what.

Ever since, historians sympathetic to those working in Britain's Great Depression-era Exchequer have protested that the bureaucrats of H.M. Treasury actually believed something different and more sophisticated than the Treasury View. They instead, historians like G.C. Peden have

¹ See Paul Krugman (2008), “Keynes’s Difficult Idea,” *New York Times* (December 24) < <http://krugman.blogs.nytimes.com/2008/12/24/keyness-difficult-idea/?apage=2>>; Allan Meltzer (1989), *Keynes’s Monetary Theory: A Different Interpretation* (Cambridge University: 0521306159).

argued, believed that spending could not be boosted quickly (so that by the time it came on line the need for it would have passed), or they believed that maintaining the gold standard was more important than boosting short-run employment (and running up the national debt would endanger the gold standard and so weaken Britain's economy in the long run, or that they were operating under the political constraint of having to set forward policy doctrines that the Chancellor of the Exchequer Winston S. Churchill could understand (and the "Treasury View" was as close as they could get to the truth and still be comprehended by their political master).²

The reason that historians sympathetic to Britain's interwar bureaucrats have worked so hard to separate their subjects from the "Treasury View" is that it is as obvious a fallacy as you ever find in economics. If no government bureaucrat can boost employment and production even in the shortest run by deciding to borrow and spend more—as the "Treasury View" maintains—than an immediate corollary is that no private entrepreneur can boost employment and production by deciding to borrow and invest more in his firm's capital stock. If the "Treasury View" is correct, then homebuilders' and financial intermediaries' decisions to build more homes were not the cause of high employment in the mid-2000s. If the "Treasury View" is correct, then venture capitalists' decisions to finance internet startups and telecom companies' decisions to invest in fiber optics were not the cause of high employment in the late 1990s. Similarly, the huge unemployment of the 1930s was not due to any unwillingness of businesses to invest produced by the panic of the stock market crash and the waves of bank runs and failures in the early 1930s. And the high employment and output in the 1920s was not driven by private business enthusiasm for investing in the "new era" technologies of radio, electricity, and internal combustion after World War I.

² See G. C. Peden (1988), *Keynes, the Treasury, and British Economic Policy* (MacMillan: 0333362721); G. C. Peden (2005), *Keynes and His Critics: Treasury Responses to the Keynesian Revolution, 1925-1946* (British Academy: 0197263224); R. S. Sayers (1976), *The Bank of England 1891-1944* (Cambridge University: 0521214750); Roger Middleton (2005), *Toward the Managed Economy* (Routledge: 978-0-415-37977-9).

It is, a belief on the "Treasury View" entails, just a coincidence that over and over again when entrepreneurs are irrationally exuberant and eager to invest in their companies' futures that employment and output are high, It is just a coincidence that over and over again when entrepreneurs are irrationally depressed and shy away from investing in their companies' future that employment and output are low and unemployment is rife. The slice of Occam's Razor leaves the "Treasury View" bleeding and motionless on the grass.

The interwar devotees of the "Treasury View" — if there really were any — thus would have out-Hayeked Hayek and out-Schumpetered Schumpeter in driving economic science backward during the policy debates of the 1920s and the 1930s. Hayek and Schumpeter thought that government could alleviate the Great Depression by boosting spending, but that it would be wrong and ultimately destructive for it to do so.³ The "Treasury View" held that government's turning the spending valve would do nothing at all.

Thus historians who have respect for their subjects like R. G. Hawtrey⁴ and Frederick Leith-Ross⁵ are as anxious to put as much daylight between their subjects and the "Treasury View" as they possibly can.

³ See Hayek (1931), *Prices and Production*; Joseph Schumpeter (1934), "Depressions," in D.V. Brown *et al.* (1934), *Economics of the Recovery Program* (Macmillan); Samuelson (2009), "A Few Remembrances of Friedrich von Hayek (1899–1992)," *Journal of Economic Behavior and Organization* 69, pp. 1-4, quoting Richard Kahn: "If Hayek believes that the spending of newly printed currency on employment and consumption will worsen our current terrible depression, then Hayek is a nut..."

⁴ R. G. Hawtrey (1925), "Public Expenditure and the Demand for Labour," *Economica* 13 (March), pp. 38-48.

⁵ Frederick Leith-Ross (1929), "Memorandum to Sir Richard Hopkins and P.J. Grigg," quoted in Peden (2005), pp. 79-80.

The Modern Revival of the “Treasury View”

For this reason it is an astonishing surprise to see the “Treasury View” revived today by economists of the modern Chicago School—without, apparently, any of them having any knowledge of the history of the doctrine or why it was rejected and abandoned in the 1930s and has been buried ever since. From the Cato Institute, we have Michael Cannon claiming that fiscal policy cannot affect the flow of output and employment: “The only way Congress can spend money is to extract it from the private sector – either by taxing it, borrowing it, or seignorage...”⁶ From the University of Chicago, John Cochrane—a very clever man, author of the best papers I have seen on the equity premium puzzle⁷—writes: “the money has to come from somewhere. If the government borrows a dollar from you, that is a dollar that you do not spend, or that you do not lend to a company to spend on new investment. Every dollar of increased government spending must correspond to a dollar less private spending. Every job created by stimulus spending is one job not created by the private spending it must displace...”⁸ And there are a host of others,⁹ including Eugene Fama, who provides the longest and most complete explanation of the revived “Treasury View.”

⁶ Michael Cannon (2009), “Contribution” to John Boehner, ed. (2009), “Stimulus Spending Skeptics: Economists Express Doubts About Trillion Dollar Spending Plan” <<http://republicanleader.house.gov/UploadedFiles/stimulus skeptics.pdf>>.

⁷ See John Cochrane (2001), *Asset Pricing* (Princeton: 0691121370).

⁸ John Cochrane (2009), “Fiscal Silliness” (University of Chicago) <<http://faculty.chicagosb.edu/john.cochrane/research/Papers/fiscal2.htm>>.

⁹ Including Antony Davies, Joseph Zoric, Edward Lopez, Justin Ross, Steven Horwitz, Richard Wagner, Stephen Entin, Gary Wolfram, Lawrence Franko, Michael Sykuta, David Laband, Howard Baetjer, Henry Thompson, and Gene Smiley. See John Boehner, ed. (2009), “Stimulus Spending Skeptics: Economists Express Doubts About Trillion Dollar

Fama's "Treasury View"

Fama's argument¹⁰ begins with the (correct) assertion:

There is an identity in macroeconomics... private investment [PI] must equal the sum of private savings [PS], corporate savings (retained earnings) [CS], and government savings [GS]....

$$(1) PI = PS + CS + GS....$$

But then Fama attempts to derive conclusions from this accounting identity:

[T]he equation... must hold in the world as a whole.... The quantities in the equation are not predetermined from year to year, and government actions affect them.... Government bailouts and stimulus plans seem attractive when there are idle resources - unemployment. Unfortunately, bailouts and stimulus plans are not a cure. The problem is simple: bailouts and stimulus plans are funded by issuing more government debt. (The money must come from somewhere!) The added debt absorbs savings that would otherwise go to private investment. In the end, despite the existence of idle resources, bailouts and stimulus plans do not add to current resources in use. They just move resources from one use to another.... The added debt absorbs savings that would otherwise go to private

Spending Plan" <
<http://republicanleader.house.gov/UploadedFiles/stimuluskeptics.pdf>>.

¹⁰ Eugene Fama (2009), "Bailouts and Stimulus Plans" (University of Chicago) <<http://www.dimensional.com/famafrench/2009/01/bailouts-and-stimulus-plans.html>>.

investment... which means private investment goes down by the same amount.... "Stimulus" spending must be financed, which means it displaces other current uses of the same funds, and so does not help the economy today...

We can immediately recognize that Fama's argument must be wrong. First, it proves too much: not just that government spending cannot boost employment and output, but also that private enthusiasm like the enthusiasm for housing construction in the mid-2000s or high-tech investment in the late-1990s cannot boost employment and output either. Second, the savings-investment equation Fama claims to derive his conclusions from is an *accounting identity*. It holds in all models of the economy—including models in which fiscal policy has powerful effects on output. The equation has implications for the effects of fiscal policy only when combined with auxiliary hypotheses—for example, the hypothesis that changes in government spending do not lead to any changes in corporate saving or private household saving. But Fama does not provide any reason or explanation for why he (or we) should adopt this auxiliary hypothesis.

Greg Mankiw¹¹ says that he believes that Fama does have a reason for assuming that private household and corporate saving are unchanged:

Fama's arguments make sense in the context of the classical model... presented in Chapter 3 of my intermediate macro textbook,¹² even if Fama in his brief essay does not spell out all the details of that model.... I would go on to the Keynesian model.... But whether one leaves the classical model behind to embrace the Keynesian model is a judgment call...

¹¹ N. Gregory Mankiw (2009), "Fama on Fiscal Stimulus" (Harvard) <<http://gregmankiw.blogspot.com/2009/01/fama-on-fiscal-stimulus.html>>.

¹² N. Gregory Mankiw (2002), *Macroeconomics* 5e (Worth: 0716752379).

But Fama’s piece does not contain a single word indicating that he is working in the classical model of Mankiw’s chapter 3: he does not spell out any features, let alone details, of that model. And Fama does include many words stating that he is not: one of the key assumptions of the classical model is that the labor force is fully employed. But Fama explicitly says that his conclusions apply “when there are idle resources—unemployment.” Mankiw is wrong: Fama’s arguments cannot be made sense of as an implication of his working within the classical macroeconomic model of Mankiw’s chapter 3.

Tim Peterson comments¹³ that he believes Fama is working in a model “with interest inelastic money demand. For those of you who have done Macro 101 at college, this is a version of Hick’s IS-LM model with a vertical LM curve...” But once again there are no words in Fama’s essay even hinting that he is implicitly working in such a model. Such a model has a velocity of money produced by a pure cash-in-advance constraint—a higher interest rate has no effect on the velocity of money at all. And such a model has an unchanging money multiplier—the opportunity to earn higher profits from the spread between loan and deposit rates does not induce banks to raise their deposit-reserve multiples at all as interest rates rise. These are both very special assumptions that require defense. Yet Fama does not even provide acknowledgement: the monetary system is nowhere mentioned in his essay.

We are left with a mystery: the modern-day devotees of the “Treasury View” claim that fiscal policy can never have any effects on employment and output, but they never present any model of the macroeconomy that would give the rest of us any reason to suppose that that claim might be true.

¹³ Tim Peterson (2009), “I Have Thought About the Fama Article a Bit More...” <<http://delong.typepad.com/sdj/2009/01/famas-fallacy-v-are-there-ever-any-wrong-answers-in-economics.html#comment-6a00e551f080038834010536d0b4f8970b>>.

Where Are the Intellectual Heirs of Milton Friedman?

It is important to mark the wide gulf that distinguishes the modern-day devotees of the “Treasury View” from the post-World War II Chicago School of Milton Friedman. Consider how Milton Friedman analyzes the issue of fiscal policy—here in reverse, considering the effects of a reduction in the government deficit via a tax increase.¹⁴ Friedman starts with the NIPA savings-investment identity:

[H]igher taxes would leave taxpayers less to spend. But this is only part of the story. If government spending were unchanged, more of it would now be financed by the higher taxes, and the government would have to borrow less. The individuals, banks, corporations or other lenders from whom the government would have borrowed now have more left to spend or to lend—and this extra amount is precisely equal to the reduction in the amount available to them and others as taxpayers... this directly offsets any reduction in spending by taxpayers...

But Friedman does not end his analysis there. The shift in fiscal policy will have an effect on employment and production if it affects the flow of spending and incomes. When the federal government borrows less, interest rates fall, and:

[l]ower interest rates make it less expensive for people to hold cash... some of the funds not borrowed by the Federal government may be added to idle cash balances... it takes time for borrowers and lenders to adjust to reduced government borrowing...

Only if the change in fiscal policy does not affect the quantity of money—does not influence how much in the way of deposits banks accept per dollar of reserve balances—and does not affect the velocity of

¹⁴ Milton Friedman (1972), "Comment on the Critics," *Journal of Political Economy* 80:5 (September-October), pp. 914-5
<<http://www.jstor.org/stable/pdfplus/1830418.pdf>>.

money—does not affect how long the average household or business holds a dollar in deposit balances—will the flow of spending and income be unaffected and thus will employment and output be unaffected as well. Friedman goes on to argue that the effects of a one-shot transitory fiscal policy are “certain to be temporary and likely to be minor”—much less powerful than monetary policy would be (which the “Treasury View” also entails has no effect on employment and output)—but he does not pretend that the fact that the NIPA savings-investment identity holds by definition and construction means that fiscal policy has no effect on output and employment.

For Friedman, the NIPA savings-investment identity is the prelude to the analysis and not the analysis itself. For Friedman, the meat of the analysis involves going deeper by:

- arguing that savings and income levels will adjust so that the economy will quickly move to a point at which unwanted inventory accumulation is zero (that's the "IS curve").
- analyzing the combination of possible values for interest rates and output levels at which unwanted accumulation is zero (that's the shape and position of the "IS curve").
- assessing how the changing financial asset supplies and demands in the economy pick out a particular point on the IS curve (that's the "LM curve").

in all of this using the analytical apparatus set out in 1937 by John Hicks.¹⁵ Friedman thus gives reasons for his belief that the change in private household and corporate saving in Fama’s equation (1) that will accompany an increase in government spending will be small, and thus provides reasons to fear that a fiscal boost program will not be very effective. Fama and his peers, however, do not appear to recognize that this is an issue that needs to be addressed: they think that the invariance of private and corporate saving to a change in government spending is something that does not need to be justified.

¹⁵ John Hicks (1937), “Mr. Keynes and the ‘Classics’: A Suggested Interpretation,” *Econometrica* 5:2 (April), pp. 147-59.

It is safe to claim that Fama and Cochrane and their cohorts either do not remember or never encountered Friedman (1972) and that they are unacquainted with what Milton Friedman called his framework for monetary analysis. It is not that they regard Friedman’s framework for monetary analysis as having been superseded by another, more modern and more rigorously-specified general equilibrium model—they present no model at all, only an accounting identity. Yet the name of Milton Friedman is something they still use for conjurations—in fundraising, in the name of the Milton Friedman Institute now being established at the University of Chicago, and in their intellectual identity as members of the Chicago School.

I confess I do not have an answer. I only have a question: Where *are* the intellectual heirs of Milton Friedman?

References

John Boehner, ed. (2009), “Stimulus Spending Skeptics: Economists Express Doubts About Trillion Dollar Spending Plan”
<<http://republicanleader.house.gov/UploadedFiles/stimulus skeptics.pdf>>.

Michael Cannon (2009), “Contribution” to John Boehner, ed. (2009), “Stimulus Spending Skeptics: Economists Express Doubts About Trillion Dollar Spending Plan”
<<http://republicanleader.house.gov/UploadedFiles/stimulus skeptics.pdf>>.

John Cochrane (2001), *Asset Pricing* (Princeton: 0691121370).

John Cochrane (2009), “Fiscal Silliness” (University of Chicago)
<<http://faculty.chicagogsb.edu/john.cochrane/research/Papers/fiscal2.htm>>

Eugene Fama (2009), “Bailouts and Stimulus Plans” (University of Chicago) <<http://www.dimensional.com/famafrench/2009/01/bailouts-and-stimulus-plans.html>>.

Milton Friedman (1972), "Comment on the Critics," *Journal of Political Economy* 80:5 (September-October), pp. 914-5
<<http://www.jstor.org/stable/pdfplus/1830418.pdf>>.

R. G. Hawtrey (1925), "Public Expenditure and the Demand for Labour," *Economica* 13 (March), pp. 38-48.

Friedrich A. von Hayek (1931) [1967], *Prices and Production* (Augustus Kelley).

John Hicks (1937), "Mr. Keynes and the 'Classics': A Suggested Interpretation," *Econometrica* 5:2 (April), pp. 147-59.

John Maynard Keynes (1932), *Essays in Persuasion* (Macmillan).

Paul Krugman (2008), "Keynes's Difficult Idea," *New York Times* (December 24) <<http://krugman.blogs.nytimes.com/2008/12/24/keyness-difficult-idea/?apage=2>>.

Frederick Leith-Ross (1929), "Memorandum to Sir Richard Hopkins and P.J. Grigg."

N. Gregory Mankiw (2009), "Fama on Fiscal Stimulus" (Harvard) <<http://gregmankiw.blogspot.com/2009/01/fama-on-fiscal-stimulus.html>>.

N. Gregory Mankiw (2002), *Macroeconomics* 5e (Worth: 0716752379).

Allan Meltzer (1989), *Keynes's Monetary Theory: A Different Interpretation* (Cambridge University: 0521306159).

Roger Middleton (2005), *Toward the Managed Economy* (Routledge: 978-0-415-37977-9).

G. C. Peden (1988), *Keynes, the Treasury, and British Economic Policy* (MacMillan: 0333362721).

G. C. Peden (2005), *Keynes and His Critics: Treasury Responses to the Keynesian Revolution, 1925-1946* (British Academy: 0197263224).

Tim Peterson (2009), "I Have Thought About the Fama Article a Bit More..." <<http://delong.typepad.com/sdj/2009/01/famas-fallacy-v-are-there-ever-any-wrong-answers-in-economics.html#comment-6a00e551f080038834010536d0b4f8970b>>.

R. S. Sayers (1976), *The Bank of England 1891-1944* (Cambridge University: 0521214750).

Joseph Schumpeter (1934), "Depressions," in D.V. Brown *et al.* (1934), *Economics of the Recovery Program* (Macmillan).