TALKING ECONOMICS

For Non-Economists (and Economists Too)

VOLUME II

Macroeconomics

ALBERTO ADES

CONTENTS

Macroeconomics and its relationship with microeconomics

Socrates and Glaucon stroll across the heights of the Acropolis, the sweeping panorama of Athens unfolding below them—the Agora bustling with trade, the port of Piraeus in the distance, and beyond, the sea that carried ships and commerce to the wider world. The city, alive with movement and voices, becomes the backdrop for a new stage of inquiry.

Glaucon: Dear Socrates, you once told me that economists distinguish between microeconomics and macroeconomics. In our earlier talks we focused on individuals and their choices, but now I would like to see the bigger picture. Could you explain how these two branches differ?

Socrates: Gladly. Microeconomics, as we have discussed, examines the behavior of individuals and firms within specific markets, asking how they decide and how they interact. Macroeconomics, by contrast, looks at the economy as a whole—growth, inflation, employment, and the forces that shape the fate of entire nations.

Glaucon: Exactly, and up until now, our discussions have centered on microeconomics—on the actions of individuals and firms—whereas macroeconomics provides a broader perspective, illustrating how these individual components combine to impact the entire economy, correct?

Socrates: Precisely—both perspectives are crucial. Microeconomics helps us understand the foundation of individual actions, while macroeconomics reveals the overall picture, much like seeing the entire tapestry after examining each thread. Since macroeconomics deals with large-scale phenomena, it also involves analyzing how governments and central banks make decisions to shape the economy. For example, governments might adjust taxes or spending, while central banks may alter the money supply or interest rates to manage inflation or promote economic growth. Now, why is it so important that these policies rely on a solid understanding of how individual actors behave?

Glaucon: I suppose that for economic policy to be effective, governments need to anticipate how consumers and firms will respond. If they don't understand how people react to changes in taxes or interest rates, they might implement measures that fail to achieve their intended goals.

Socrates: Exactly. This is where macroeconomics and microeconomics intersect. Although macroeconomics addresses aggregate issues, it must be grounded in sound microeconomic principles. We cannot fully understand phenomena like inflation, unemployment, or growth without comprehending how individuals and firms make their choices.

Glaucon: I see. So macroeconomics relies on microeconomics because it provides deeper insights into human behavior and how those choices impact the broader economy.

Socrates: Precisely. Tell me, why does macroeconomics matter in everyday life?

Glaucon: I imagine it's important because macroeconomic policy decisions—such as changes in interest rates or taxes—affect everyone. They influence the prices we pay, the jobs we have, and our ability to progress over time.

Socrates: That's correct. Macroeconomics helps us understand phenomena that directly affect our lives, such as economic cycles with their periods of expansion and recession, economic growth that shapes living standards, and monetary policy that influences interest rates and inflation.

Glaucon: You mentioned expansion and recession in relation to economic cycles. Could you explain those terms a bit more? I'm not entirely sure I understand them.

Socrates: Yes; they're fundamental concepts. Let's start with expansion. It's a phase in the economic cycle where the economy grows. During this time, firms produce more, employment rises, and people's incomes generally increase. It's a period of progress and optimism, as more opportunities arise and the economy flourishes.

Glaucon: Ah, so expansion is essentially a prosperous phase for the economy.

Socrates: And recession is the opposite. It's a period during which the production of goods and services in the economy contracts. In a recession, output declines, employment often falls, and many people experience a decrease in income. This leads families and firms to reduce spending, creating a time of adjustment and concern.

Glaucon: I understand. Another question comes to mind. If macroeconomics depends so heavily on microeconomics, does that mean that, to improve a country's economy, we should first focus on changing the behavior of individuals and firms?

Socrates: An excellent point. While individual behavior is indeed foundational, public policies—both current and future—along with institutions, play a key role in shaping it. Economic policies can influence the incentives and disincentives that individuals and firms face. For example, lower taxes often encourage investment, while stable monetary policy promotes saving and long-term planning.

Glaucon: So it's a kind of cycle: individual decisions shape the overall economy, and macroeconomic policies in turn shape individual decisions.

Socrates: It's a continual interplay. That's why, to understand and improve the economy, we must study both microeconomics and macroeconomics. Each offers a distinct yet complementary perspective.

Glaucon: Now I have a much clearer understanding of the distinction between macroeconomics and microeconomics, and how they work together to illuminate the workings of the entire economy.

Socrates: I'm glad, dear Glaucon, that you've resolved your questions. Always remember that in economics, as in many fields, it's essential to see both the forest and the trees for a complete understanding.

Stocks and flows

> The agora lies beneath a clear sky. Socrates and Glaucon sit on a bench, watching the merchants bustle to and fro.

Glaucon: Yesterday, after our initial discussion on macroeconomics, I overheard some merchants discussing stocks and flows. One mentioned he needed to increase his stock of wheat to generate larger revenue flows. I didn't quite grasp the concept. What exactly are stocks and flows, and why are they important?

Socrates: That's a fundamental question for understanding how we measure and describe macroeconomic phenomena. It's timely to address this before we proceed further, as these concepts are often confused. Before we continue, tell me: how would you differentiate a painting from a theatrical performance, like those at the Theater of Dionysus?

Glaucon: I'd say a painting captures a single, motionless moment, while a play unfolds dynamically over time.

Socrates: Exactly. The same distinction applies to stocks and flows in economics. A stock is like a painting: it exists at a specific point in time, static in that instant. A flow is like a play: dynamic, evolving over a span of time. Do you see the parallel?

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Socrates and Glaucon begin their dialogue by exploring the essence, roles, and evolution of money, that cornerstone of economic systems. Through their exchange, they tackle one of the most significant and intricate economic issues: inflation. They examine the methods for measuring this persistent rise in prices, identify its key drivers, and consider the various ways inflation emerges, along with its distinct impacts on economies and individuals alike.

The discussion equips them with essential concepts for understanding the phenomenon, including the Phillips and Beveridge curves, which illuminate the connections between inflation, unemployment, and job vacancies. Socrates and Glaucon also distinguish clearly between the monetary and fiscal origins of inflation, pondering effective strategies to manage these dynamics and promote economic stability.

In the end, Socrates guides Glaucon toward a deeper insight into inflation and the policies required to address it successfully.

What is money, and what are its functions?

> One afternoon in the Athenian Agora, Socrates and Glaucon pondered the essence of money. They explored its key roles as a medium of exchange, a unit of account, and a store of value, while considering how these elements bolster the economy of the city-state.

Glaucon: Socrates, I want to gain a deeper understanding of what money truly is. Could you explain it to me?

Socrates: In our previous discussions on economics, we touched upon the role of money in facilitating transactions. Money, or currency, is essentially anything a society agrees to use as a medium of exchange to simplify trade. It acts as an intermediary between buyers and sellers, eliminating the need for direct bartering.

Glaucon: We use it to purchase goods and services, but why is it so crucial to the economy?

Socrates: Its importance lies in the essential roles it plays. As we noted, it first serves as a medium of exchange. Without it, we'd have to rely on bartering, which is highly inefficient. Imagine you have apples to trade for bread, but the baker doesn't want apples—he needs oil instead. You'd have to find someone willing to exchange your apples for oil, then trade that oil for bread. With money, however, you can simply sell your apples for cash and use that to buy the bread. This streamlines and accelerates the entire process.

Glaucon: That makes sense. What other roles does money serve?

Socrates: It also functions as a unit of account, providing a standard way to measure the value of goods and services, which makes comparing different items straightforward. Consider trying to weigh the worth of a book against a pound of bread without a common measure—money enables that kind of comparison.

Glaucon: So it helps us assess the value of things. Does it have any other significant purposes?

Socrates: Yes, it acts as a store of value, meaning it retains its worth over time, allowing us to save. When you set money aside, you can use it later for purchases. That said, as we discussed in our talks on inflation, its value can erode if prices rise sharply.

Glaucon: Nowadays, people are accustomed to currencies issued by governments or their central banks. Economists refer to this as fiat money, since its value isn't backed by physical commodities like gold or silver, but by trust in the issuers. I understand it wasn't always this way, though. Could you explain what was used before fiat money, how it came about, and who developed it?

Socrates: You're correct; today, fiat currency from governments or central banks is the norm. Before that, societies relied on various means for trade, some quite different from what we know as money. Let me outline how it evolved over time.

In ancient times, civilizations depended on bartering goods directly. But as we've seen, that approach was cumbersome, requiring a perfect match of wants between parties. To overcome this, people turned to items with inherent value, such as gold, silver, and other precious metals, which were widely accepted for their universal appeal. These became the earliest forms of coinage and circulated for centuries.

The concept of fiat money emerged much later. In its modern form, it first appeared in China during the Tang dynasty in the seventh century and was refined under the Song dynasty in the eleventh. The Chinese government issued paper notes backed by a promise of redemption in metal coins—what we'd now call a convertible system. Over time, however, paper money detached from those metals, relying solely on trust in the issuer.

In Europe, fiat money developed more gradually, with full adoption coming later. A pivotal shift was the abandonment of the gold standard in the twentieth century. Until then, most currencies in Europe and America were tied to gold reserves. It was during the Great Depression and the postwar era that many nations, including the United States under President Richard Nixon in 1971, severed that link, embracing fiat currency.

Thus, the money we use now lacks intrinsic value. Its worth depends on the confidence people place in governments and central banks to uphold economic stability and ensure its acceptance as payment.

Glaucon: And has fiat money always been issued by governments or their central banks? Have they always held a monopoly on its creation?

Socrates: That's an insightful question. While we're accustomed today to governments and central banks controlling the issuance of fiat money, it wasn't always so. Initially, private entities like commercial banks or prominent merchants handled it. They produced notes as promises to pay, often backed by reserves of precious metals.

In many cases, private banks issued bills that people accepted as currency because they trusted the bank's reliability. But this setup had drawbacks: without oversight, there was a risk of issuers failing to honor their commitments, leading to instability.

Glaucon: How did we transition from that to a system where governments hold the monopoly on issuing fiat money?

Socrates: Over time, governments centralized the process to prevent crises of confidence and promote greater economic stability. In the nineteenth and early twentieth centuries, many countries established central banks with sole authority to issue currency. These institutions assumed control, backing the money with national reserves or, in some cases, government assets.

The turning point came when national currencies broke free from ties to commodities like gold, enabling central banks to produce fiat money without physical backing. Modern currencies thus rest on faith in a government's ability to manage the economy and maintain the money's viability as a means of payment.

Glaucon: So, would it be fair to say that government monopoly over currency issuance is a relatively recent development in human history?

Socrates: Indeed. The centralized control by governments over fiat money is a modern phenomenon. Before that, issuance was far more decentralized and often in private hands. Today, central issuance by governments or their banks is the standard in most nations.

Glaucon: Are there any countries where commercial banks can still issue fiat currency?

Socrates: In the early twenty-first century, governments or central banks hold the monopoly in most places. Yet some historical exceptions endure. A prime example is Scotland, where commercial banks retain the right to issue their own fiat notes. Three Scottish banks—the Bank of Scotland, the Royal Bank of Scotland, and the Clydesdale Bank—produce bills in pounds sterling, though these must be backed by an equivalent value of pounds from the Bank of England. So, while commercial banks can issue them, it's under tight regulation.

Something similar happens in Hong Kong, where select commercial banks issue notes under the local central bank's oversight. Beyond these regulated instances, though, governments and central banks dominate fiat currency issuance in modern economies.

Glaucon: Even with those exceptions, state or central control is the prevailing norm today.

Socrates: Precisely.

Glaucon: I now see how essential money is to the modern economy, but can it lose its value over time?

Socrates: A keen observation. As we mentioned, inflation diminishes money's purchasing power. If prices rise, you need more of it to buy the same things, which means its value has declined. For money to function well as a store of value, it must remain stable without losing too much buying power.

Glaucon: Is there anything else worth knowing about money and its roles?

Socrates: Beyond what we've covered, it also acts as a standard for deferred payments, allowing it to settle debts due in the future—something we explored in our discussions on loans and the need for monetary stability. It fosters the trust required for long-term dealings.

Glaucon: I have a much better grasp now of what money is and why it matters so much in our lives.

Socrates: Understanding the functions of money is key to comprehending how our economy operates.

Interview with David Hume on money

> In a candlelit salon in Edinburgh during the mid-18th century, we witness an imagined interview with the renowned philosopher David Hume. The fireplace crackles softly, while a diverse audience—philosophers, merchants, students, and inquisitive citizens—gathers to hear Hume explore his ideas. The host, a respected intellectual and close friend of Hume, readies himself to launch a profound yet approachable discussion on the essay "Of Money."

Interviewer: Good afternoon. It's an honor to have with us today the distinguished Scottish philosopher, historian, and economist, David Hume. His work has profoundly shaped our understanding of the world, particularly our understanding of how economies function. Today, we'll have the chance to delve into his ideas about money. Mr. Hume, thank you for joining us.

The core driver here is the plunge in Q, which pressures P upward if other elements don't shift substantially.

Glaucon: This sheds real light on interpreting these exceptional circumstances.

Socrates: Economics always reveals that beneath every equation lies an intricate reality demanding deeper understanding.

Debate between Larry Summers and Paul Krugman on inflation

> It's an October afternoon in 2024, inside the main auditorium at Columbia University in New York. Professors and students pack the room, eager to witness an imagined debate between two towering figures in modern economic theory. On stage stand Larry Summers, the former U.S. Treasury Secretary and a Harvard professor, alongside Paul Krugman, the Nobel Prize winner and longtime New York Times columnist. Their conversation centers on a question that has fueled fierce arguments since 2021: what drove the wave of inflation that swept through the global economy in the wake of the pandemic. The moderator positions herself between the two debaters, poised to steer what looks like a lively and contentious exchange.

Moderator: Good afternoon—it's an honor to welcome you all. We have the privilege of hearing from two of the world's most influential economists. To my right, Larry Summers, former Secretary of the Treasury and a professor of economics at Harvard, whose early warnings about inflationary risks sparked controversy in 2021. And to my left, the economist and Nobel laureate Paul Krugman, a leading voice advocating a more flexible approach to inflation risks, who argued that stimulus measures were essential to avoid a deep recession after the pandemic.

Today, they'll debate the causes of the inflation we've seen since 2021 and the implications of the economic policies adopted during that period. Without a doubt, this conversation resonates not only in academia but also in the lives of millions. Thank you both for joining us.

Larry Summers: Thank you for the invitation. I'm delighted to be here to discuss such a crucial topic.

Paul Krugman: Thank you—it's a pleasure to be here as well.

Moderator: Let's start with you, Dr. Summers. You were a vocal critic of the expansionary fiscal and monetary policies adopted at the outset of the pandemic.

Could you explain why you believe these policies were primarily responsible for the inflation that began in 2021?

Larry Summers: My view is that the inflation we've seen since 2021 stems largely from an excess of economic stimulus. As the world began emerging from the pandemic, governments—especially in the United States—implemented highly expansionary fiscal policies. This included massive stimulus packages: direct transfers to households, increases in unemployment benefits, and expanded tax credits. These measures aimed to support families and sustain consumption amid the crisis.

At the same time, central banks, including the Federal Reserve, kept interest rates at historically low levels. This made credit more accessible for consumers and businesses, encouraging spending and investment. Additionally, the Fed and other central banks pursued expansionary monetary policies like quantitative easing, or QE.

Moderator: Before we go further, Dr. Summers, could you explain what QE is and the effects of these measures?

Larry Summers: QE, or quantitative easing, involves the central bank purchasing large amounts of government bonds and other financial assets. This injects liquidity into the financial system and further lowers long-term interest rates, thereby stimulating spending and investment.

During the crisis, this combined fiscal and monetary stimulus boosted aggregate demand for goods and services beyond what the economy could produce. This was compounded by constraints on productive capacity and disruptions in supply chains. The imbalances between supply and demand led to a rapid and sustained rise in prices—in other words, inflation.

Paul Krugman: Larry, I understand your concern, but I think you're underestimating the role of supply shocks and other pandemic-related factors. My argument is that much of the inflation since 2021 can be attributed to issues in global supply chains, rising energy prices, and other bottlenecks caused by the pandemic. Sure, there was fiscal stimulus, but supply-side problems—like shortages of semiconductor chips, high transportation costs, and temporary factory shutdowns—played a more significant role in driving up prices. These supply issues, combined with the effects of lockdowns and an uneven global recovery, were the real drivers of the inflation we've observed.

Larry Summers: I don't deny that supply shocks had an impact. However, if we look at the scale of the fiscal stimulus, particularly in the United States, we see that the relief packages amounted to more than a third of GDP in just a couple of years. That's an unprecedented level of stimulus. Even without supply problems, that magnitude of spending would have led to overheating. Basic economic theory tells us that when demand exceeds supply, prices rise. The Federal Reserve was also slow to recognize the inflation risk and adjust its monetary policy, which amplified the problem.

Paul Krugman: But we must also consider the transitory nature of some of those inflationary factors. Increases in energy prices, for instance, have a lot to do with geopolitical conflicts and global supply disruptions. Moreover, many supply constraints were temporary and resolved gradually.

Moderator: Dr. Summers, when inflation accelerated in 2021, you suggested that to bring it down to 2%, we'd need an unemployment rate of 6% for five years. Now that inflation has finally started to moderate, how do you assess your forecast, and what brought it down?

Larry Summers: My estimate that several years of high unemployment would be needed to reduce inflation was based on the necessity of cooling an overheated economy. While inflation has moderated, it didn't happen without a significant increase in interest rates and decisive intervention by the U.S. Federal Reserve. Additionally, improvements in supply chains played a key role. If the Fed hadn't acted with the firmness it showed in 2022 and 2023, we might have seen a much worse scenario.

Moderator: Dr. Krugman, at the time, you argued that the shocks driving inflation were transitory. Why, then, did it take so long for inflation to moderate?

Paul Krugman: It's true that in 2021, I underestimated how long it would take for the supply shocks to dissipate. Largely, I believed that increases in energy prices, supply chain bottlenecks, and other pandemic-related issues would be temporary. However, their duration and severity were greater than many anticipated. The war in Ukraine worsened energy problems, and supply disruptions proved more persistent than expected. But what I want to emphasize is that much of the initial inflation wasn't driven by domestic demand but by these supply factors. That said, I agree with Larry that raising rates was necessary to anchor inflation expectations.

Moderator: Speaking of expectations, you've both mentioned the importance of interest rates in controlling inflation, even if the shocks were transitory. Could you elaborate on that?

Larry Summers: Interest rates are a fundamental tool for influencing inflation expectations and managing demand. Think of them as the cost of borrowing money: when they rise, it becomes more expensive for businesses and consumers to finance investments or major purchases. This tends to cool the economy, easing pressure on prices.

The issue is that if people and businesses start believing inflation will remain high for an extended period, it leads to preemptive increases in prices and wages. For example, workers will demand larger wage hikes to protect against expected inflation, and companies, anticipating higher costs, will raise prices. This cycle reinforces inflation, turning it into a self-fulfilling prophecy.

Raising interest rates reduces aggregate demand and also sends a clear signal that the central bank is committed to keeping inflation in check, which helps anchor expectations and prevent the problem from persisting.

Paul Krugman: I agree with Larry on this. Although I see many of the initial shocks as transitory, the key was to prevent inflation expectations from becoming unanchored. In such cases, if the central bank doesn't act, it risks losing credibility, making it harder to control inflation in the future.

The Federal Reserve had to raise rates, though cautiously, to demonstrate its willingness to take firm steps to control inflation without stifling the economic recovery. Credibility in monetary policy is essential for maintaining balance and preventing inflation from spiraling out of control.

Moderator: Dr. Summers, what would have happened if the Federal Reserve hadn't raised rates as it did?

Larry Summers: We would have faced much more persistent inflation. It could have led to a wage–price spiral: workers demanding wage increases in anticipation of future inflation, and businesses raising prices to cover higher costs. Inflation would have become entrenched, and the longer it lasted, the more costly it would have been to control. The classic example is the 1970s: the lack of decisive action by central banks led to runaway inflation.

Moderator: Returning to the analysis of causes, could you both estimate how much supply shocks versus demand shocks contributed to the inflation we've experienced?

Paul Krugman: It's hard to make a precise estimate, but I'd say that initially, around 70% of the inflation was driven by supply shocks. Issues in supply chains, shortages of key materials like semiconductors, and increases in energy prices played a significant role.

Part of this was because many companies underestimated the speed of demand recovery. During the crisis, they cut back on input orders and adjusted inventories, expecting a slower rebound. When demand surged back strongly, they couldn't respond in time, exacerbating inflationary pressures.

As these issues resolved, demand-side inflation became more prominent, but I still believe supply shocks explain a large part of the initial surge. In fact, a recent 2023 study by Blanchard and Bernanke titled "What Caused the U.S. Pandemic-Era Inflation?" breaks down inflation into its components and confirms that most of the inflationary increase starting in 2021 was due to supply shocks, such as increases in commodity prices and shifts in sectoral demand, rather than labor market overheating.

Larry Summers: In my view, demand shocks accounted for more than 50% of the inflation, especially in the United States. The scale of fiscal stimulus and expansionary monetary policies created excess demand that pushed prices upward. Supply shocks contributed, but without the massive stimulus, we likely wouldn't have seen such a large inflationary spike.

Moderator: Thank you both for your insights. Let's open the floor to the audience for questions.

Student: Professor Summers, how do you assess the impact of the energy transition and climate policies on inflation? Could these factors become a structural source of long-term inflation?

Larry Summers: The energy transition and climate policies, such as decarbonization, can create what we call structural supply shocks. Shifting to cleaner energy sources involves high initial costs—infrastructure investments, technology, and production changes. These costs may be passed on to consumers, raising prices in the short and medium term. Additionally, efforts to reduce carbon emissions might limit the supply of certain goods and services, potentially pushing inflation upward. However, in the long run, if managed well, these policies can also foster technological innovations and economic efficiency, helping to stabilize prices.

Student: Professor Krugman, some argue that expansionary fiscal policy might have been more effective if focused on infrastructure investment rather than direct transfers. What do you think of that critique?

Paul Krugman: That's a valid point and worth discussing. Infrastructure investment has positive long-term effects because it boosts the economy's productive capacity, which could have alleviated some of the bottlenecks we faced. However, during the pandemic, the immediate priority was to keep families afloat and prevent a collapse in consumption. Direct transfers achieved that goal quickly. In contrast, infrastructure projects often take longer to implement and yield economic benefits. Ideally, we should have balanced both: transfers for the short term and infrastructure investment to strengthen growth and stability over the long term.

Student: My question is for both of you: What have we learned about the magnitude of public spending multipliers over these past few years?

Larry Summers: These years have reinforced the idea that public spending multipliers are contextual and depend on economic conditions. During the pandemic, we saw higher multipliers in specific sectors, especially when the economy faced supply constraints or pent-up demand. For instance, fiscal stimuli in the form of direct transfers were effective in sustaining consumption, but once productive capacity reached its limits, that additional spending translated into greater inflationary pressure rather than sustained output growth. This underscores that multipliers can be significant in deep recessions but more limited in economies near full capacity.

Paul Krugman: I agree with Larry that multipliers are highly context-dependent. However, I think these years also challenged some traditional beliefs. For example, it was thought that multipliers would be relatively low in advanced economies with developed financial markets. Yet in the U.S., we saw certain public spending programs have a substantial impact in stabilizing the economy in the early months of the pandemic. Another lesson is that multipliers tend to be higher when interest rates are near zero, because there's no "crowding out" of private investment by public spending.

Larry Summers: That's true, Paul, but we also need to consider the costs of maintaining expansionary policies for too long. While multipliers can be high in acute crises, the marginal benefits diminish quickly as the economy recovers and inflationary risks rise.

Paul Krugman: I agree there are limits, but we must remember that multipliers are just one part of the equation. The most important thing is to design policies that stimulate demand while also enhancing long-term productive capacity.

Moderator: Thank you all. It was an enlightening debate.

Bonus: Sargent and Cochrane debate the sources of inflation

> A packed auditorium brims with students, scholars, and economists. Spotlights illuminate the central stage, where two towering figures in the world of economics—Tom Sargent and John Cochrane—stand face to face, refining their notes and sharpening their arguments. The Stanford University logo graces the backdrop. The audience's murmurs gradually fade as the moderator, a professor of economics, prepares to formally introduce this imagined debate between these intellectual heavyweights on the fiscal roots of inflation. A vibrant energy charges the air.

Moderator: Good afternoon. We're honored to have two distinguished economists with us: Tom Sargent, Nobel laureate in Economics, known for his work on rational expectations and fiscal and monetary policies, and John Cochrane, an economist at the University of Chicago, recognized for his research on the fiscal theory of the price level. They will debate the fiscal sources of inflation and discuss the similarities and differences between their theories. Let's start with you, Professor Sargent. Would you share a brief overview of your perspective on the fiscal sources of inflation?

Tom Sargent: Thank you, it's a pleasure to be here. My view on the fiscal sources of inflation rests on the idea that inflation can emerge when a government can't finance its deficits sustainably. Put simply, when a government funds its deficits by issuing money rather than through more sustainable means, like raising taxes or cutting spending, this leads to an increase in the money supply. If that isn't matched by growth in goods and services, it results in higher inflation. This is especially problematic when fiscal deficits persist without a credible plan to reduce them.

Panel with Alan Greenspan and Janet Yellen on the Fed

> At Harvard University, experts in monetary policy are gearing up for an imagined panel with Alan Greenspan and Janet Yellen, two former chairs of the U.S. Federal Reserve. The audience eagerly anticipates insights into Greenspan and Yellen's experiences and viewpoints on the Fed's inner operations, the hurdles of monetary policy during economic crises, and the trajectory of the global economy. They aim to grasp how these leaders' choices influenced financial stability and to draw valuable lessons for tackling upcoming economic challenges.

Moderator: Good afternoon, everyone, and welcome to this special interview where we'll discuss the workings and role of the Federal Reserve in the U.S. economy. We're honored to have two figures who led the Fed during pivotal periods: Alan Greenspan, who served as Fed Chair from 1987 to 2006, and Janet Yellen, who chaired the Fed from 2014 to 2018 and later became Secretary of the Treasury. Thank you both for joining us.

Alan Greenspan: Thank you for the invitation. It's always a pleasure to talk about how the Fed operates and its role in the economy.

Janet Yellen: Thank you so much for having us. I'm delighted to share some of my experiences and thoughts on monetary policy and the economy.

Moderator: Let's start with an overview of how the Federal Reserve functions. Dr. Greenspan, could you explain in broad terms how the Federal Reserve is structured and what its main function is?

Alan Greenspan: The Federal Reserve, or simply the Fed, is the central bank of the United States. Its primary function is to ensure economic stability by formulating and implementing monetary policies that promote maximum employment, stable prices, and moderate long-term interest rates.

The Fed has a unique structure that blends elements of the public and private sectors. It consists of the Board of Governors, based in Washington, D.C., and 12 regional Federal Reserve Banks spread across the country, in cities like New York, San Francisco, and Chicago, among others.

The Board of Governors has seven members appointed by the U.S. President and confirmed by the Senate. These members serve 14-year terms, providing stability and continuity, and they're responsible for overseeing and regulating the nation's banks and crafting policies based on economic conditions.

The 12 regional Federal Reserve Banks serve as the Fed's operational arms in their respective areas. Each has its own president and staff who monitor local economic conditions and provide critical insights that inform monetary policy decisions.

Moderator: Thank you for that detailed explanation, Dr. Greenspan. Dr. Yellen, could you explain how these two components—the Board of Governors and the regional banks—work together to formulate and implement monetary policy?

Janet Yellen: The Fed's monetary policy is primarily shaped by the Federal Open Market Committee, or FOMC, which is the Fed's key decision-making body. The FOMC includes the seven members of the Board of Governors and the 12 presidents of the regional Federal Reserve Banks. While all presidents participate in discussions, not all vote on decisions. The voters are the seven Board members, the president of the New York Fed, and four other presidents who rotate annually.

The FOMC meets eight times a year to review economic and financial conditions and determine the appropriate stance for monetary policy. Their main tool is the federal funds rate, which is the interest rate at which commercial banks lend money to each other overnight. By adjusting this rate, the Fed influences the cost and availability of credit throughout the economy, affecting spending, investment, and employment.

The relationship between the Board and the regional banks is collaborative. The regional bank presidents bring local perspectives and essential economic analysis to the table, helping the Fed gain a comprehensive and diverse view of the U.S. economy and ensuring that conditions across all regions are considered.

Moderator: It's fascinating to see how local perspectives are integrated. Dr. Greenspan, how is monetary policy managed during periods of economic stability?

Alan Greenspan: In times of economic stability, the Fed's monetary policy focuses on adjusting the federal funds rate to influence economic activity. When the economy is growing too quickly and there's a risk of inflation, the Fed raises the rate to make credit more expensive, which moderates spending and investment. Conversely, if the economy is slowing and there's a risk of recession, the Fed lowers the rate to stimulate spending and investment by making credit more accessible.

During my tenure, the Fed took a data-driven approach, monitoring a wide range of economic indicators like employment, inflation, and output to fine-tune monetary policy. We also aimed to balance economic growth with price stability, which are our core objectives.

Moderator: Dr. Yellen, you took over in 2014, after the 2008 financial crisis. How did the approach to monetary policy change during your leadership?

Janet Yellen: My term began in 2014, when the economy was in a fragile recovery phase. One of our main concerns was ensuring a full recovery before shifting monetary policy toward a more neutral stance. So, we adopted a gradual normalization approach. Instead of raising interest rates quickly, we did so cautiously, based on available economic data, and communicated our intentions clearly to the public to avoid market surprises.

We also continued the practice of quantitative easing (QE), which started during the crisis, by purchasing large amounts of financial assets to keep long-term interest rates low and support economic recovery.

Additionally, we increased the Fed's transparency by holding regular press conferences and releasing more detailed economic projections. This helped markets and the public better understand our decisions and expectations for the economy.

Moderator: And then, under Jerome Powell, how did monetary policy evolve?

Janet Yellen: Powell continued many of the policies we put in place but also introduced significant changes. One of the most notable was the shift to an average inflation targeting framework. This approach allows inflation to temporarily exceed the 2% target to make up for periods when it was below. It recognized that in a low-interest-rate environment, greater flexibility is needed to support economic recovery and maximum employment.

Under Powell, the Fed also showed a greater willingness to use a broader range of unconventional tools, especially during the COVID-19 pandemic—for example, special lending programs for businesses and local governments, and purchases of corporate bonds.

This reflected an adaptation of monetary policy to extraordinary circumstances to maintain financial stability and support the economy.

Moderator: And looking to the future? How should monetary policy evolve as we move forward?

Janet Yellen: Going forward, the Fed will need to be even more flexible and adaptive. It's important to continue using a mix of traditional and unconventional tools while maintaining clear and transparent communication with the public.

It's essential to pay attention not only to national economic data but also to global developments that could affect the U.S. economy. Interconnections between countries mean that international events—from financial crises abroad to shifts in global supply chains—can have ripple effects here.

Moderator: Let's talk now about the recent period of high inflation starting in 2021. What were the causes of this inflation surge, and how can we avoid a repeat?

Alan Greenspan: The high inflation period that began in 2021 stemmed from a combination of exceptional factors. First, there was a significant surge in demand for goods as economies reopened after COVID-19 lockdowns. This coincided with major disruptions in international supply chains, which limited the availability of key inputs and drove up prices.

Adding to this was a second major shock: the Russia-Ukraine war, which triggered rises in energy, food, and other commodity prices. This conflict worsened existing inflationary pressures, particularly in Europe and emerging markets.

We also have to consider the fiscal stimulus implemented during the pandemic. While necessary to prevent a deep recession, it boosted aggregate demand in a context of constrained supply, amplifying inflationary tensions.

To avoid a repeat, we'll need more careful design of macroeconomic policy in crisis situations, better international coordination, and stronger resilience in supply chains against global shocks.

Janet Yellen: I agree with Alan. Another lesson from this period is the need for more proactive monetary policy in managing inflation expectations. In the future, the Fed should be prepared to adjust policy more quickly if inflation expectations become unanchored. Clear and effective communication is crucial for that.

To prevent a recurrence, the Fed and fiscal policymakers also need to coordinate more closely to ensure that economic stimulus is proportionate and doesn't excessively contribute to inflation. The right mix of monetary and fiscal policies will be key to maintaining economic stability.

Moderator: Thank you both for your insights and reflections. It's been an enriching conversation about the past, present, and future of U.S. monetary policy. Any final comments?

Alan Greenspan: I'd like to emphasize the importance of adaptability and data-driven decision-making in monetary policy. It's essential that the Fed remains an institution that learns and evolves as circumstances change.

Janet Yellen: I agree. The economy is constantly evolving, and the Fed must evolve with it, always upholding its commitment to transparency and economic stability. Thank you again for this opportunity to share our experiences.

Moderator: Thank you both for being with us today. And thank you to our audience for joining us.

Panel with Christine Lagarde and Mario Draghi on the ECB

> We are at the European Central Bank in Frankfurt. An imaginary panel takes place with two influential figures in global economic policy: Mario Draghi, former president of the ECB and former prime minister of Italy, and Christine Lagarde, current president of the ECB. The audience seeks to deepen their understanding of monetary policy management in the eurozone.

Moderator: Good afternoon, everyone. We are here to discuss how the ECB works, the history of its creation, and how it compares to the U.S. Federal Reserve. Thank you both very much for being here.

Christine Lagarde: Thank you for the invitation. It's a pleasure to be here and discuss the role of the ECB.

Mario Draghi: Indeed, thank you very much. This is a great opportunity to reflect on the work we've done and the ECB's role in the global economy.

Moderator: Let's start with the history of the ECB. President Draghi, could you tell us about the origins of the European Central Bank and why it was founded?

Mario Draghi: The European Central Bank (ECB) was established in 1998 as part of Europe's economic integration process. Its creation stemmed from decades of efforts to integrate the economies of European countries and promote

ABOUT THE AUTHOR

Alberto Ades (@adesalb on X) is an economist with more than thirty years of experience in global financial markets. He is currently Director of Research and Strategy at NWI Management.

Over the course of his career, he has held senior positions at BofA Merrill Lynch, Citigroup, and Goldman Sachs, where he led research teams and developed pioneering economic and financial models.

He earned a PhD in Economics from Harvard University and a law degree from the University of Buenos Aires. His research has been published in leading academic journals, including the *American Economic Review* and the *Quarterly Journal of Economics*, and he frequently contributes commentary to both local and international media.

Originally from Argentina, he now resides in New York.