Discussion of Willett’s
The Roles of False Mental Models and Time Inconsistency Problems in the Generation and Prolonging of the Euro Crisis

Eric Fisher
California Polytechnic State University
Federal Reserve Bank of Atlanta
29 November 2011
What is a language?
What is a language?

Watching children play a game of soccer, Wittgenstein had the deep insight that a language was a game.
Some Philosophy

What is a language?

Watching children play a game of soccer, Wittgenstein had the deep insight that a language was a game.

The language is not a list of well formulated formulas (WFF’s) and rules for transformation. It is inextricably linked with the actions of a community.
What is a language?

Watching children play a game of soccer, Wittgenstein had the deep insight that a language was a game.

The language is not a list of well formulated formulas (WFF's) and rules for transformation. It is inextricably linked with the actions of a community.

This observation has important implications for economists’ theories of sunspot equilibria.
Extrinsic and Intrinsic Variables

Extrinsic variables *are not* agents, endowments, preferences, firms, production sets, or distribution of profits.
Extrinsic and Intrinsic Variables

Extrinsic variables are not agents, endowments, preferences, firms, production sets, or distribution of profits.

Could monetary variables be extrinsic? Not if money is in the utility function.
Extrinsic and Intrinsic Variables

Extrinsic variables are not agents, endowments, preferences, firms, production sets, or distribution of profits.

Could monetary variables be extrinsic? Not if money is in the utility function.

Cass and Shell (JPE, 1983) emphasized that there could be no sunspot equilibria if agents could insure against sunspot states. They showed that sunspots mattered if there was incomplete market participation, as in the model of overlapping generations.
Where do we draw the line?

Krugman (NBER Macroeconomics Annual, 1996) makes this point in a debate with Obstfeld about models of exchange rate crises.
Krugman (NBER Macroeconomics Annual, 1996) makes this point in a debate with Obstfeld about models of exchange rate crises.

If there can be self-fulfilling crises, then he argues that fixed rates must go hand in hand with capital controls.
Krugman (NBER Macroeconomics Annual, 1996) makes this point in a debate with Obstfeld about models of exchange rate crises.

If there can be self-fulfilling crises, then he argues that fixed rates must go hand in hand with capital controls.

One wonders why he does not argue for greater sophistication in capital markets to insure against sunspot equilibria.
Krugman (NBER Macroeconomics Annual, 1996) makes this point in a debate with Obstfeld about models of exchange rate crises.

If there can be self-fulfilling crises, then he argues that fixed rates must go hand in hand with capital controls.

One wonders why he does not argue for greater sophistication in capital markets to insure against sunspot equilibria.
What is a Fundamental?

The Maria Bartiromo Market Hairdex
http://www.dimgroup.com/stockjunkies/maria.html

Maria Hair
Status

Market Analysis

When Maria's cowlicks go completely out of control, this means that something big is in the offing and it is going to be good news for the market. It might be a big merger, higher jobless claims or a drop in the prime rate, but certain follicles are especially sensitive to changes in the air. Get on the phone to your broker and BUY, BUY, BUY!

When Maria's hair gives you this "what, are you still holding equities?" look it is time you liquidated your position. Is it the end of the world? No, but you might consider battening the hatches and bracing for a serious market correction.
Willett’s False Mental Models

Is the ratio of Greek debt to GDP a fundamental? It seems so.
Willett’s False Mental Models

Is the ratio of Greek debt to GDP a fundamental? It seems so.

If the market keys on this fundamental, then the euro crisis is not a sunspot.
Willett’s False Mental Models

Is the ratio of Greek debt to GDP a fundamental? It seems so.

If the market keys on this fundamental, then the euro crisis is not a sunspot.

Willett’s examples

1. German belief that excessive fiscal deficits were the only major problem.

2. Monetary integration is different from trade and financial integration
I know that you think unicorns haunt financial markets in October in odd years.
The Semantics of a False Mental Model

I know that you think unicorns haunt financial markets in October in odd years.

If we are going to make a market, you need to know that I believe in your false mental model. But you cannot know that I believe you are off your rocker.
The Semantics of a False Mental Model

I know that you think unicorns haunt financial markets in October in odd years.

If we are going to make a market, you need to know that I believe in your false mental model. But you cannot know that I believe you are off your rocker.

We both have to act as if unicorns haunt financial markets in October of odd years.
The Semantics of a False Mental Model

I know that you think unicorns haunt financial markets in October in odd years.

If we are going to make a market, you need to know that I believe in your false mental model. But you cannot know that I believe you are off your rocker.

We both have to act as if unicorns haunt financial markets in October of odd years.

We cannot buy insurance against marauding unicorns.
The Semantics of a Sunspot Variable Matters

This may be the central point of Duffy and my work.
The Semantics of a Sunspot Variable Matters

This may be the central point of Duffy and my work.

What is a sunspot variable? It has all the elements of a common language.
This may be the central point of Duffy and my work.

What is a sunspot variable? It has all the elements of a common language.

If the ECB just made it common knowledge that they are not in the business of reacting to fiscal policy, would the crisis evaporate?
Is Greece a Country?

Neither Greece nor California has its own currency
Is Greece a Country?

Neither Greece nor California has its own currency

Greece has an army, and California has its national guard
Is Greece a Country?

Neither Greece nor California has its own currency.

Greece has an army, and California has its national guard.

Greece has its own language, but California does not.
Is Greece a Country?

Neither Greece nor California has its own currency.

Greece has an army, and California has its national guard.

Greece has its own language, but California does not.

Greek debt and California debt are held as assets.
Is Greece a Country?

Neither Greece nor California has its own currency.

Greece has an army, and California has its national guard.

Greece has its own language, but California does not.

Greek debt and California debt are held as assets.

What happens when California loses competitiveness? It loses people and national political clout.
Willett’ discusses some other mistakes

Some other False Mental Models
Willett’ discusses some other mistakes

Some other False Mental Models

1. Only needed to worry about inflation and fiscal policy
2. Maastricht criteria were really enforceable
3. Did not need to worry about lender of last resort
Fiscal Federalism

The TARP program was a transfer from (future) taxpayers of Montana ($0k per resident) to those of Delaware ($29k per resident)
The TARP program was a transfer from (future) taxpayers of Montana ($0k per resident) to those of Delaware ($29k per resident).

Does the Fed have to conduct open market operations using Treasury securities? Obviously not.
Fiscal Federalism

The TARP program was a transfer from (future) taxpayers of Montana ($0k per resident) to those of Delaware ($29k per resident).

Does the Fed have to conduct open market operations using Treasury securities? Obviously not.

If the people of Montana do not like giving money to the people of Delaware, they can accordingly vote in the next Presidential election.
The TARP program was a transfer from (future) taxpayers of Montana ($0k per resident) to those of Delaware ($29k per resident).

Does the Fed have to conduct open market operations using Treasury securities? Obviously not.

If the people of Montana do not like giving money to the people of Delaware, they can accordingly vote in the next Presidential election.

Tough nuggies for the Germans. Was für eine Unverschämtheit!
The primary objective is price stability. This is a better design than that of the Fed.
Tasks of the ECB

The primary objective is price stability. This is a better design than that of the Fed.

Basic tasks

- definition and implementation of monetary policy
- foreign exchange operations
- official foreign reserves (portfolio management)
- smooth operation of payment systems.
Tasks of the ECB

The primary objective is price stability. This is a better design than that of the Fed.

Basic tasks

▶ definition and implementation of monetary policy
▶ foreign exchange operations
▶ official foreign reserves (portfolio management)
▶ smooth operation of payment systems.

Further tasks

▶ Banknotes
▶ Statistics, in cooperation with the NCBs
▶ financial stability and supervision
▶ International and European cooperation
Tentative Conclusions

Financial architecture and financial regulation are the issues we really ought to study.
Tentative Conclusions

Financial architecture and financial regulation are the issues we really ought to study

I, for one, do not know what an optimal currency area really is.
Tentative Conclusions

Financial architecture and financial regulation are the issues we really ought to study.

I, for one, do not know what an optimal currency area really is.

The ECB may as well get down to the business of price stability. They do it well.
Financial architecture and financial regulation are the issues we really ought to study.

I, for one, do not know what an optimal currency area really is.

The ECB may as well get down to the business of price stability. They do it well.

What is my cure? The issue is not an economic one. Europe needs a popular election for President (Chief Fiscal Officer) of the Euro Zone. Let’s see how much the European elites like real democracy.