OTHER THINGS EQUAL

Alan Greenspan Doesn't Influence Interest Rates

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A little person in a large market can't move the price very much. You know the reason. If Farmer Brown is one of a million growers of corn then even if she, say, doubled the amount of corn she grew, or cut it in half, nothing much would happen to the market price. As we economists say, the elasticity of the demand curve facing Brown is 'infinite' (all right: very high). A big change in her personal quantity supplied pushes against the going market price not at all (all right: very little).

I first got clear the notion that a supplier "faces" a personal demand curve, and that the elasticity of that demand curve is just his market power, as a junior in college, taking micro from an aged and terminally ill Edward Chamberlin, be of The Theory of Monopolistic Competition. But I didn't get it utterly, mathematically clear until I read the footnotes in the 3rd edition of George Stigler's The Theory of Price, while teaching the stuff to grad students at Chicago ten years later. I was that way in economics: a slow learner, not a natural. (I am proud to be one of Chamberlin's last students, if a slow one; it's always bothered me, though, that the final, utter clarity came from Stigler, a man whose scientific method and grasp of economic thought, not to speak of his humanity, were so defective.)

As an economist you know the Chamberlin and Stiglerian reasoning. As an economist you know the Chamberlin and Stiglerian reasoning. It would please neither of them to be linked this way: in those days Harvard monopolistic competition was arrayed against Chicago School competition, "realism" against "perfection competition," perfection won. You want to know the elasticity of demand facing Farmer Brown; or, to invert the number, how much the price she faces will fall for each percentage point she raises her quantity supplied. We all agree as economists that all she can do is fiddle with her quantities. Like OPEC with the price of crude oil, she can "set" or "announce" the price of corn all she wants—until the crows come home, you might say. But she can't actually make the market's price of corn do her bidding unless she can substantially raise or lower the amount of corn going to consumers. Price announcements do not make for market power. Control over quantities does. (That's another thing I learned from Stigler, darnit, from his theory of oligopoly.) OPEC meets in Vienna to "announce" the price of crude. But we and the journalists have finally learned that the announcement is a non-event. What matters


Other Things Equal, a column by Deirdre McCloskey, appears regularly in this Journal.
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Money was $499.5 billion. In the first quarter of 1999 it was $540.3 billion, a rise of $40 billion. That’s what Greenspan and Company did. In Farmer Brown’s equation it’s the q (excess demand facing her, $D - S$, what the world demands of her). Remember that figure: $40 billion.

What’s the $D$ (or $S = D - q$)? We’re looking for a figure for the world’s stock of IOUs, which determines the interest rate. It’s not good enough to take financial capital in New York, or in the USA, or the West. The interest rate in Riverside, California is obviously not determined by supply and demand for loanable funds in Riverside or even in California but in the world, since places to put money at interest are substitutes for each other worldwide. Any sensible theory of interest rates would include all the elements of world supply and demand for loanable funds. But that number is empirically not so easy to know as the size of Greenspan’s reach.

But we’re economists here: let’s get some rough scientific feel for it (Daniel Thornton at the St. Louis Fed has made a more conservative calculation than mine, but with the same logic and the same conclusion). Well, suppose all capital is the result of places to put money at interest. Income is the return to that capital. So the capital stock—and hence the bond stock (I realize I am making a false assumption of their identity here, but we are after orders of magnitude; you tell me what better accounting to use; it won’t change the outcome, you agree)—can be reckoned as the capitalization of world income. Suppose to be conservative it can be capitalized at 10 percent. World income in 1999, according to Angus Maddison (p. 19, in 1990 prices), was about $25,000 billion. Capital was therefore $250,000 billion.

Compare the two. The market over which Greenspan is said to have control is $250,000 billions. In a year the Fed moved $40 billion. Hmm. If the supply and demand elasticities were both 1.0 the elasticity of demand for Federal funds (as it were) would be $2 \times (250,000 / 40) = 14,000$. That’s no influence. As I said.

REFERENCES