University of Dayton
eCommons

Economics and Finance Faculty Publications | Department of Economics and Finance

1997

Tobin, James

Tony Caporale
University of Dayton, tcaporale1@udayton.edu

Follow this and additional works at: http://ecommons.udayton.edu/eco_fac_pub

Part of the Business Administration, Management, and Operations Commons, Economic History Commons, Economic Theory Commons, Finance Commons, Finance and Financial Management Commons, and the International Economics Commons

eCommons Citation
Caporale, Tony, "Tobin, James" (1997). *Economics and Finance Faculty Publications.* Paper 14.
http://ecommons.udayton.edu/eco_fac_pub/14

This Encyclopedia Entry is brought to you for free and open access by the Department of Economics and Finance at eCommons. It has been accepted for inclusion in Economics and Finance Faculty Publications by an authorized administrator of eCommons. For more information, please contact frice1@udayton.edu, mschlangen1@udayton.edu.

Tobin, James

By Tony Caporale

(Note: This is an abstract of the encyclopedia entry; to read the remainder of the entry, find the volume in an academic library or order it online using the metadata found in eCommons.)

James Tobin was born in Champaign, Illinois, in 1918. He received his bachelor's degree in 1939 and his master's degree in 1940, both from Harvard. Following naval service during the years 1942-6, he returned to his graduate studies and received his PhD from Harvard in 1947. In 1950, he joined the economics department at Yale University, and he has largely remained at Yale and has been identified with this institution throughout his career. He twice directed the Cowles Foundation for Research in Economics, first from 1955 to 1961, and then from 1964 to 1965. He also served for two years, 1961-2, as a member of President Kennedy's Council of Economic Advisors. In 1981, he was awarded the Nobel Prize in Economics for his many important and diverse contributions to economic theory. Tobin's most fundamental contributions to economics are in the fields of monetary and macroeconomic theory. His first published paper (in 1941), "A Note on the Money Wage Problem," addresses the problem of whether a cut in money wages exerts an independent influence on aggregate employment. This question was at the heart of Keynes's criticism of classical economics.

Tobin demonstrates his gift for critical thought and logical consistency by criticizing Keynes's notion of an unemployment equilibrium. He points out that a reduction in money wages will diminish the transactions demand for money and lead to a fall in interest rates, causing a rise in investment, output and employment.

Tobin does not believe, however, that this removes the need for government intervention during recessions. According to Tobin, all that is required to justify Keynesian demand management policies is sluggish wage and price adjustments.

From this early paper, it is clear that Tobin was destined not merely to *follow,* but to extend and refine Keynes's analysis. Tobin's seminal 1958 paper, "Liquidity Preference as Behavior Towards Risk," provides a new framework to deal with a question raised by Hicks in his 1935 paper, "A Suggestion for Simplifying the Theory of Money."

Hicks asks why people would hold zero interest assets (money) when other interest-bearing assets are available. In his response to this question, Tobin revolutionized monetary theory by providing a choice-theoretic model of money demand. This model was required to execute Sir John Hicks's famous "Suggestion." In addition, in this same paper, he established a whole new discipline, financial economics, by introducing the "separation theorem." This theorem explains that risk-averse people will diversify their portfolios by holding both money (a safe asset with a zero yield) and risky assets with potential positive returns. Another important prediction of Tobin's model is that the demand for money will fall as the return on the risky asset increases. In this one paper, Tobin was able to provide a firmer theoretical justification for Keynes's liquidity preference theory, advance monetary theory by utilizing a choice theoretic framework to analyze the demand for money, and become the "father" of financial economics. Tobin has made important contributions to the theory of economic growth. His 1965 paper, "Money and

Economic Growth," deals with the interaction between monetary factors and the degree of capital intensity in the economy. His analysis leads him to the conclusion that monetary policy can affect the ratio of capital to labor in long-run equilibrium. This is because an increase in the rate of money growth leads to an increase in the equilibrium inflation rate. The higher inflation rate causes individuals to substitute away from money and towards capital in their portfolios. This illustrates how Tobin's portfolio balance approach to economic questions has provided interesting answers to a variety of economic questions. However it was not until the publication of his 1969 paper, "A General Equilibrium Approach to Monetary Theory," that Tobin presented a complete formal summary of his theoretical framework. In that paper he spells out a full model of asset equilibrium and relates asset yields to the flow of investment.