Fooling The New York Times

Author : James Annable

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Two weeks ago, the Editorial Board of the *New York Times* joined Donald Trump in criticizing the Federal Reserve for not reducing interest rates. Both contend that lower rates are needed to promote economic growth. The interest rate they are talking about is the overnight fed funds rate. At the end of the Great Recession in 2009, the FFR was in a zero-to-.25 percent range, the lowest ever. At the end of 2015, the Fed began a series of quarter-point increases in their target range that pushed the FFR up to the current range of 2.25-to-2.5 percent, which is the lowest ever for an economy with relatively low unemployment. By contrast, in the early 1990s recession, the FFR remained above 2.7 percent.

The *NYT* editorial ("The Federal Reserve Is Courting Trouble", 4/9/2019) is firmly rooted in mainstream New Keynesian macroeconomics. The curious *NYT*-Trump alliance illustrates a fundamental message of the GEM Project: monetary policy advice from today's macro academy badly misleads. Three excerpts from the editorial capture the *NYT* argument:

"The Federal Reserve, along with Congress, failed to take sufficient steps to revive the economy after the 2008 financial crisis. One simple measure of the inadequacy of the government's response is that inflation has remained persistently below the 2 percent annual rate the Fed regards as optimal, a sign of an underachieving economy. Some liberals have complained for years about the Fed's lack of urgency as millions of Americans struggled to find jobs, or lived without significant wage increases. Since President Trump's election in 2016, a growing number of Republicans have decided they, too, favor stronger economic growth. Mr. Trump himself has been particularly outspoken, loudly and repeatedly pressing the Fed to reduce borrowing costs."

"The core of the problem is the Fed's inflation target. Since the double-digit inflation rates of the late 1970s, the Fed has focused on maintaining slow and steady inflation. In 2012, it formalized an annual target of 2 percent. But the Fed has fallen short of that mark in six of the last seven years, and its top officials predict it will miss the the target again in 2019."

" …the Fed should have kept interest rates lower for longer after the 2008 recession, to deliver a significantly stronger dose of economic stimulus, and that it should show a little less fear of inflation the next time the economy needs its help."

The NYT monetary-policy advice is rooted in two ideas the Editorial Board got from mainstream macroeconomics. First, there is a stable two-way relationship between product-price inflation and unemployment in the U.S. economy. That belief is implicit in the editorial's focus on the inflation when addressing the complaint that the jobless rate did not fall fast enough in the recovery from the 2007-09 recession. The NK message is: Get inflation right, and you get unemployment right. A corollary to this this trust in the simple Phillips Curve is that it is best to assign primacy to the central bank's inflation target. Monitoring inflation effectively monitors unemployment. That conclusion is consequential. In a timely example, that today's inflation rate is running below its target indicates that the current jobless rate, hovering around 3.8%, should be pushed lower. Conversely, whenever inflation is above the Fed's objective, unemployment should be pushed higher.

The second idea is that interest rates are the dominant determinant of investment spending. That motivates the editorial's complaint that "the Fed should have kept interest rates lower for longer after the 2008 recession, to deliver a significantly stronger dose of economic stimulus" and consequently lower unemployment path. Investment is widely understood to be the most powerful engine of economic stimulus and is clearly what the Editorial Board has in mind.

As noted, both ideas are torn from of the New Keynesian playbook. As already noted, the first is demonstrated in its strong form by the fundamental NK monetary-policy theorem: Low and stable inflation should be the Fed's single objective. Single-objective policymaking has been mainstream orthodoxy at least since the publication of Woodford's New Keynesian bible, *Interest and Prices: Foundations of a Theory of Monetary Policy*, in 2003. The second is illustrated in the famous NK 3-equation model, used in classrooms and for policy advice, that identifies interest rates as the primary determinant of investment spending.

Both ideas badly describe actual economies and have done so since the advent bureaucratic corporations in the

Second Industrial Revolution. It turns out to be critical that those highly-specialized firms, which produce more than half national output, have workplaces inherently restricted by costly asymmetric employer-employee information. The GEM Project has used information-challenged workplaces to derive meaningful wage rigidity from rational exchange organized by dynamic general decision-rule equilibrium. MWR is the keystone macro concept that rationally suppresses wage recontracting and produces (i) downward nominal wage rigidity over stationary business cycles and (ii) the rational payment of wage rent. As a result, the generalized-exchange model breaks down both the tight mainstream cyclical relation between inflation and unemployment and the centrality of interest rates in investment spending. It blows the *NYT* venture into monetary policy advice out of the water.

The breakdown of the first idea is obvious from derivation of rational nominal wage rigidity. Given that labor costs are the most important influence on product prices, downward rigid wages over the business cycle imply that prices are also sticky and must be out of synch with rapid cyclical movement unemployment. That, of course, is what the evidence shows. Inflation as an adequate indicator of real-side (unemployment) behavior must be rejected. Any attempt to substitute inflation monitoring for the monitoring of joblessness and other broad real-side-related variables makes no sense. If the Fed had been wholly focused on inflation in the autumn of 2008, they would have thought nothing much was happening. Luckily for us, Bernanke’s Fed was not that dumb.

The breakdown in the second idea also important. A curious feature of mainstream market-centric general-equilibrium macro modeling is that it eliminates pure profit. In both the GEM model and the real world, profit expectations play the critical role in investment-spending decisions, reducing interest rates to a relatively minor role. You cannot understand economic stimulus absent understanding the relative roles of interest rates and profit, the first relatively weak and the second relatively strong. Those roles help explain how the many years of a near zero fed-funds rate could coexist with the painfully weak recovery from the Great Recession. If business leaders had expected robust profits, investment spending and the macro recovery would have been much more robust.

The *NYT* argues that “the Fed should have kept interest rates lower for longer after the 2008 recession”. The editorial doesn’t mention that the central bank kept the short-term rate they control, the fed funds rate, near zero for the entirety of the recovery period. That lower interest rates would have produced noticeably greater investment is a canard that is perpetuated for the convenience of mainstream market-centric theorists. The *NYT* also doesn’t mention that the prolonged spell of low interest rates has badly distorted financial arrangements, pushing pension funds, insurance companies, wealth-management firms, etc. into more risky assets. After the Great Recession, prudential risk-management has been a focus the Fed’s efforts to prevent future crises. Systematically pushing many financial institutions into accepting substantially greater risk is nobody’s notion of a good idea.

The GEM Project easily demonstrates that lowering the already near-zero fed funds rate in the recovery from the Great Recession would have done little to stimulate investment and growth. It is even more obvious that reducing the already low fed funds rate in today’s full employment economy would not noticeably stimulate growth. Instead, monetary policy should restore a normal interest-rate structure that is consistent with acceptable financial-risk management. Finally, I cannot resist a quibble. The Editorial Board affirms their amateur status in central-bank analysis by putting the membership Fed’s monetary policymaking committee at 17, overstating the actual membership by five. Ten District Bank Presidents sit at the table during FOMC meetings but only five of their votes (on a set rotation) count.

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