Stabilization Policy, Part I

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Date : Dec 22, 2017

The greatest damage done by the Ptolemaic intent of mainstream macro theorists is providing support for ill-conceived stabilization policymaking. Exhibit A is the manifestly wrong policy consensus on how to prevent future Great Recessions that emerged after the 2008-09 crisis. If it is not reworked, the Federal Reserve will confront future episodes of extreme instability deprived of many of the tools that, less than a decade ago, pulled the economy back from depression. The huge socioeconomic cost of acute instability in combination with the likelihood of future financial-market disruptions motivates this critical look at consensus stabilization policy.

The examination is divided into four posts. This one describes the three pillars of the policy that was quickly cobbled together after the massive market failures of 2008-09. Next week will outline some GEM Project analysis that explains the fundamental nature of extreme instability in highly specialized economies. Readers will be relieved that, unlike much economics today, the argument is intuitive and thus easily grasped. The modeling crucially supports a much superior policy design for the prevention of future Great Recessions. The third post illustrates consensus policy gone bad with some of the egregious mistakes made in the aftermath of the 2008-09 extreme instability. The fourth returns to my hobbyhorse, examining the role of macro theorists' defense of their mainstream market-centric, general-equilibrium model class (despite its misalignment with the most important evidence) in burdening the U.S. with a manifestly wrong stabilization policy.

<u>Three Pillars of Mainstream Stabilization Policy</u>

The professed objective of the post-crisis reworking of U.S. stabilization and regulatory frame-works is to prevent future Great Recessions. Public support for the overall effort was largely rooted in the promise of the first pillar of the new consensus: Taxpayer funds will never again be used to inject capital into big banks. Eliminating such bailouts is a central rationale for, and most broadly cheered accomplishment of, the centerpiece 2010 Dodd-Frank legislation. Sheila Bair, while head of the FDIC, was one of the architects of that hurriedly constructed law: "We worked hard to make sure taxpayer bailouts [to big banks] are completely prohibited. I think the language is very tight on that. One of the things that frustrates me with critics of Title II is that they perpetuate the myth of Too Big To Fail [TBTF] by insisting that the government is still going to do bailouts, notwithstanding clear language in Dodd-Frank to the contrary." (*Washington Post*, May 18, 2013)

Bair's zeal is badly wrongheaded. Closer analysis of the crisis, presented over the next two weeks, turns her TBTF argument upside down. It will be easily shown that, rather than protecting taxpayers, prohibiting government capital injections into the banking system helps expose them, in circumstances like 2008-09, to trillions of dollars in losses. It is a really bad idea that is rooted in profound ignorance about how highly specialized economies actually work.

The second pillar of stabilization policy is that size matters. It was quickly concluded that the existence of the largest banks is inherently damaging to economic stability. In response, a multi-pronged program of sharply increasing capital requirements on the biggest banks was implemented. History has demonstrated, however, that even outsized capital cannot prevent the sort of bank runs experienced in the Great Recession. Warren Buffett, in his 2010 testimony before the Financial Crisis Inquiry Commission, was on-target: "No capital requirements protect you against a real run. I mean, if virtually all of your liabilities are payable that day, you can't run a financial institution and be prepared for that. And that's why we've got the Fed and the FDIC." Thoughtful regulators accept Buffet's assessment. They admit, usually quietly, that the purpose of ever-higher, ever-costlier size-related capital was instead to force the biggest institutions to break themselves up.

The third pillar is the Congressional desire to remedy what many lawmakers concluded to have been an overreach for power during the Great Recession, especially by Ben Bernanke and the Federal Reserve. Pursuit of this rein-in-the-Fed objective, receiving little attention outside Washington, was variously motivated. First, and foremost, was the conviction that many of the powers used by the Fed to tame the 2008-09 instability were usurped from, and rightfully belong to, Congress. Many want it back. Second is the ideological belief, oblivious to the evidence, that spontaneous market adjustments are sufficient to prevent harmful macro instability. Third, and related, some in Congress assert that, given the Great Recession did not in fact morph into a 1930s-class depression, the extraordinary Fed intervention into the private economy was unnecessary. Fourth, a kind of cronyism conspiracy theory fueled the widely whispered belief that the real object of the Fed's actions was to help their big-banker friends. In order to make sense out of the three pillars of today's consensus, we need to understand the real-world economics of the 2008-09 extreme instability; such comprehension must reflect facts, not half-baked, self-serving fictions.

On this reign-in-the-Fed point, macro academics mostly looked the other way. An important question is why the academy did not loudly object to the attack on the stabilization policies of the central bank. The reason is already clear to readers of this blog. Flawed mainstream thinking has little room for the early Keynesian demand-management strategy that was aggressively (and successfully) pursued by Bernanke’s Fed. The academy’s badly flawed New Keynesian model of instability deemphasizes the role of adverse nominal demand disturbances in generating recognizable cyclical movement in employment, output, and income. That deemphasis is rooted in their inability to microfound meaningful wage rigidity and its rational suppression of labor-price recontracting. Deep down, they know that preserving the central bank’s capacity to manage total nominal spending is crucially important but choose not to call attention to the debilitating limitations in their mainstream model. It is Ptolemaic thinking at its most damaging.

Trump Policy

This critique of the state of stabilization policy has not mentioned Donald Trump. Beyond being generally dismissive of policies of the Bush and Obama administrations, including Dodd-Frank, the Trump Administration has yet to put forward specific ideas on how to prevent future Great Recessions. My guess is that they never will provide a coherent assessment of this crucial policy issue. On balance, inattention from this Administration is probably a good thing.

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