Stabilization Policy, Part IV

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This post concludes the GEM Blog's four-part overview of the public policy on how to prevent future Great Recessions. The consensus quickly emerged in the aftermath of the 2008-09 extreme instability. First, the three pillars of Washington's curious thinking on the critical issue were summarized. Second, the GEM Project's analysis of acute instability was briefly outlined, providing a roadmap for effective stabilization-policy design. The third featured some detail on the flawed content of the emergent policy.

What follows is the final piece of the story. It examines the role of Ptolemaic model-building by mainstream macro theorists in the failure to put in place measures that would actually help prevent future Great Recessions. It is divided into two interrelated parts. The first explains why the macro academy was complicit in Washington's reliance on an ineffective strategy, i.e., the centerpiece of which was increased large-bank regulation in the attempt to prevent macro shocks that propagate into extreme instability. The second looks at the Achilles heel of mainstream market-centric macroeconomics, i.e., its inherent inability to rationally suppress wage recontracting and thereby microfound the central stabilization role of managing aggregate demand. In particular, it examines macro theorists' failure to vigorously oppose Congressional interventions that have weakened the demand-management tools that actually worked to tame the 2008-09 extreme instability.

Large-Bank Regulation

GEM modeling is informed by the separability of episodes of acute instability, including broad 2008-09 market failure, into an originating macro disruptions and their propagation by contracting total spending. That separation implies that there are two broad, not mutually exclusive, stabilization strategies available to policymakers: (i) prevent future shocks via some powerful regulatory reconfiguration and (ii) prevent propagation of disruptions that do occur by effectively intervening in total nominal spending.

In the stabilization program cobbled together after the Great Recession, policymakers and mainstream macro theorists chose to concentrate on the regulatory strategy and to largely limit their attention to the existing federally regulated banking system. Their near total focus on the first strategy, and a weak version of it as well, doomed the effectiveness of the policy. We know that financial risk easily migrates to and becomes concentrated in the shadow banking system, which will always prove difficult to regulate. The large, rapidly growing nonbank system largely exists to avoid regulation and, in pursuit of that goal, cultivates nimbleness. It is much easier to impose higher capital, product restrictions, and size penalties on large federally regulated banks, even if those institutions are much less likely to induce significant macro shocks than their shadow-system counterparts. Despite Dodd-Frank and the host of other new regulations, financial-market disruptions rooted in various forms of excessive risk-taking will continue to occur. (See Reinhart and Rogoff This Time Is Different (2009) and David Romer in What Have We Learned? Macroeconomic Policy after the Crisis (2014).) It is a huge mistake to put all our stabilization-policy eggs in that first-strategy basket.

Fed Stabilization Toolkit

The post-crisis policy consensus on how to prevent future Great Recessions is particularly ill-conceived with respect to the crucial task of reversing extreme demand instability when it does, in fact, occur. Readers know from the second essay that feedback mechanics between damaged investor/lender confidence and contracting total demand are aggravated, not mitigated, by prohibitions on temporary capital infusions into financial institutions that play the central role in transforming savings into total spending. Even more important are the still-evolving Congressional efforts to restrict the demand-intervention tools, discussed in the third essay, that stabilization authorities used to reverse the collapse in total spending in 2008-09. The issue here is that mainstream New Keynesian economists did not rise up to vigorously defend the successful stabilization policies against the subsequent vigorous Congressional attack.

The explanation of the shameful behavior of macroeconomists is not flattering. Successful policy design must feature the centrality of aggregate demand in any effective response to macro instability. Mainstream theorists rationally fear that a noisy defense of the Fed's actions in 2008-09 would call unwanted attention to the failure of their consensus market-centric general-equilibrium model, which they teach and feature in their published research, to accommodate any causal role from nominal demand disturbances to recognizable movement in employment and output. If the primary objective is to protect mainstream human capital and reputations, it is best to look the other way.

The academy's revealed preference for reputation preservation over effective policy advice does not, of course, make the issue of how to best prevent future Great Recession go away. In order to effectively contain welfare losses from future financial crises, policymaking must focus attention to the second (demand-management) strategy. Effective policy must be able to prevent of the acute propagation of macro shocks that results from downward spiraling total nominal spending. The GEM Project, recognizing the fundamental dynamics of extreme instability, makes the case for a different approach. The Federal Reserve should carefully identify the full range of tools made available by its balance sheet that could be useful in preventing or reversing contracting demand. The Fed should then make a concerted public effort to convince Congress of the necessity of a powerful demand-stabilization toolkit. In a future crisis, its authority to act effectively should not be in question. Opinion makers should get up to speed on the nature of extreme instability, enabling their determined support of the central bank in its engagement with Congress. In a related task, global investors and lenders should be convinced of the power of the expanded toolkit and the resolve of the Fed leadership to use it to contain the propagation of any future financial crisis or other macro shock. Such persuasion, ultimately seeking enduring credibility for the Fed's trend full-employment objective, would be the natural bookend to the earlier successful effort of central banks to convince global market participants of their commitment to low trend price inflation.

Fundamental Message

Mainstream macro theorists have a lot to answer for. Why have they got the essential mechanics of the Great Recession in particular and extreme instability in general so wrong? Why have they forgotten the essential emphasis of the Early Keynesians on the management of aggregate demand? Why have they ignored or countenanced damage to the powerful policy tools that influence total spending, especially those interventions that shape investor/lender expectations of the credibility of the trend real-side objectives of stabilization authorities?

The answer is familiar to readers of the GEM Blog. Mainstream macro theorists insist on working entirely within a market-centric general-equilibrium framework. As a result, they cannot rationally suppress wage recontracting; they cannot acknowledge the existence of involuntary job loss; they cannot model recognizably-sized movements in output, employment, and income that result from nominal demand disturbances. In make-believe mainstream analysis, spending fluctuations do not amount to much, forcing New Keynesians to look elsewhere for policies to prevent future Great Recessions. Giving in to the urge to protect reputations, they have agreed on increased financial regulation. Prevention of big-bank disruptions is the core of modern policy designed to prevent episodes of extreme instability. Strengthening demand-management is pushed aside. The Ptolemaic goal at the center of this stabilization-policy failure is to defend, despite scathing criticism, the academy's established model. We must figure out how to effectively encourage our best and brightest into taking their larger public responsibilities of macroeconomics seriously.

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