Welcome Back Ben, Tim, and Hank

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The reemergence of Ben Bernanke, Timothy Geithner, and Henry Paulson (BGP) on the policymaking scene stimulated this post. Their book, *Firefighting***:** *The Financial Crisis and Its Lessons* (2019), was preceded by a succinct *New York Times* op. ed., "What We Need To Fight the Next Financial Crisis" (September 7, 2018).

BGP take-aways. Two points are most crucial:

- "Even if a financial crisis is now less likely, one will occur eventually. To contain the damage, the Treasury and financial regulators need adequate firefighting tools." Much has been done to prevent the sort of financial breakdown that occurred in 2008-09, but that does not mean there won't be future crises capable of triggering nonstationary contractions in nominal demand. Readers of this Blog know that such contractions produce Great Recessions or much, much worse, 1930s-class Great Depressions. In rapidly evolving highly specialized economies, powerful macro shocks have an array of potential causes, most of which differ substantially from what occurred in 2008-09. The hard truth is that they cannot all be prevented and that the attempt to do so would itself greatly damage efficiency and living standards. The most effective preparation is assembling the powerful tools capable of slowing and reversing a collapse in total nominal spending.
- "But in its post-crisis reforms, Congress also took away some of the most powerful tools used by the FDIC, the Fed and the Treasury. Among these changes, the FDIC can no longer issue blanket guarantees of bank debt as it did in the crisis, the Fed's emergency lending powers have been constrained, and the Treasury would not be able to repeat its guarantee of the money market funds. These powers were critical in stopping the 2008 panic." Adequate preparation for the next crisis requires Congress to wise up and restore the demand-management powers it has taken away. Moreover, in conjunction with the stabilization authorities it must seek and enact new powers that will more promptly reverse gathering nonstationary contractions of aggregate demand. The stabilization goal should be expanded from preventing depressions to preventing Great Recessions.

Two questions. First, why did Congress believe that taking away powers that were critical in preventing the huge, unimaginable costs of a depression is a good idea? Given my position at the Fed, I had meetings with relevant members of Congress after the crisis and that question always was asked. It turns out that the take-away-powers strategy was less clueless than diversionary, as our elected representatives attempted to manage the post-crisis blame game. Congress clearly felt vulnerable in that game, especially given its aggressive pushing of Fanny and Freddie to skirt their own rules in order to greatly expand their subprime mortgage lending. Congress very much wanted the post-crisis heat directed elsewhere, and they picked the Fed (and to a lesser extent other stabilization authorities); the central bank was then painted as an incorrigible accomplice of the big banks that needed to be reined in. There was, of course, little logic to their position. I cannot forget one powerful Congressman explaining that the Fed clearly misused demand-management powers for the simple reason that their actions were not necessary. Why? There was no depression, so the Fed over-reached and must be restrained in the future.

Second, why hasn't there been a flood of the academy's prominent macro theorists pressuring Congress, vigorously supporting the BGP plea. Notably missing in the aftermath of the BGP call for better crisis-management preparation is message reinforcement from macro academy. Support has been MIA, largely because the BGP advice is at odds with what mainstream New Keynesians teach in graduate seminars and refine in scholarly publications. In particular, BGP are arguing for restoring and enhancing stabilization policymakers' capacity to manage aggregate nominal demand in crisis circumstances, slowing and reversing any gathering collapse in total spending. The problem is that nominal-demand-oriented analysis was long ago pushed off the academy's center stage. The consensus market-centric, general-equilibrium model class, lacking microfounded meaningful wage rigidity, cannot accommodate robust causality from nominal demand to total employment, output, and income. The consequences, dealt with openly, are deeply inconvenient. It is much easier to marginalize total nominal spending in mainstream thinking.

The commercial. The real shame here is that there is an alternative macro theory that is rooted in optimization and equilibrium, is consistent with the range of important instability evidence, and restores the EK centrality of nominal-demand management. Recall that the GEM Project names the umbrella concept for the class of macro instability to which the Great Recession belongs *nonstationary nominal-demand disturbances*.

At the core of the generalized-exchange model is the derivation of meaningful wage rigidity, which rationally suppresses wage recontracting. MWR microfounds the causality from nominal demand disturbances, both stationary and nonstationary, to involuntary job loss and evidence-sized responses in total employment and output. It is a necessary condition for stabilization-relevance of rational-behavior macro theory. Building on the MWR foundation, the generalized-exchange model of extreme instability focuses on the interaction of the rational behavior of aggregate nominal demand and rational-behavior labor-price rigidity.

There's more. The GEM model class accurately describes 2008-09. But, if it is a true model for highly specialized market economies, it should do more. And it does. The remainder of this post lists five non-exhaustive examples of its extraordinary power:

- It provides a rational-behavior model of chronic wage rents, which is a necessary condition for a policy-relevant understanding modern labor behavior.
- It restores pure profit to its central roles as the primary incentive to invest and guiding the rational management of productive capacity.
- It provides an optimizing, equilibrium model of eventual downward wage flexibility, i.e., wage givebacks, which is part of the rational analysis of firms' permanent downsizing.
- The two-venue model is necessary for the effective integration of economic theory with both mid-century labor economists and Organization Theory, both of which enable faculties of economics departments and business schools to better align with each other.
- It restores the methodological primacy of rational-behavior modeling, informing a dual-venue version the New Neoclassical Synthesis. Escaping the Keynesian (both Early and New) trap of relying on irrational wage rigidity is necessary in the construction of settled macro theory rooted in optimization and equilibrium

The last point is my favorite. It addresses a fundamental problem that is, since the exile of EK theorists from the mainstream academy, almost always ignored. New Keynesians insufficiently appreciate the importance of rational-behavior modeling in providing guidelines for the useful model-building. They have yet to give the core message of the New Neoclassical Synthesis the serious commitment it deserves.

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