Woodford's Really Bad Advice

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This post looks at some monetary-policy advice from Michael Woodford, an acknowledged leader of mainstream New Keynesian macroeconomics. His leadership role demands attention. The advice is featured in the first chapter of Woodford's 2003 New Keynesian bible (*Interest and Prices*); despite the intervening Great Recession, his views have not changed. His closely argued exposition of the large NK literature remains uniquely indicative of the stabilization irrelevancy of the market-centric general-equilibrium model class that has long dominated the macro mainstream.

I know something about monetary policy from three decades as first a senior staffer and then a statutory advisor to the Federal Reserve. I have always been troubled by the New Keynesians' central monetary-policy theorem: Central banks are restricted to the single objective of low price inflation. *Interest and Prices* asks many of the correct questions about that theorem (p.14): "But why should it follow that there is a need for public commitment to a target inflation rate…? Why is it not enough to appoint central bankers with a sound understanding of the way the economy works and then grant them complete discretion to pursue the public interest in the way they judge best? Should it not follow from my analysis that this would result in price stability, to the extent that it is possible given the instruments available to the central bank and the information available at the time policy decisions must be made?" Woodford's justifications for the singular commitment to an inflation target are at the heart of NK advice to monetary authorities: enhancing monetary-policy predictability and solving the famous Kydland-Prescott time-inconsistency problem.

The most troubling question rarely gets asked in mainstream debate. Why do those obviously inadequate reasons for the inflation-focus policy theorem remain compelling to serious economists? Actual monetary-policy predictability would be sharply improved by adoption of two (nominal and real-side) goals. In a powerful Great Recession example, i.e., the collapsing demand that occurred in the second half of 2008, investors and lenders would have had a benchmark employment commitment. There would have been no confusion about policymakers' real-time intention to pay little attention to contemporaneous measures of inflation, instead focusing directly on job loss, production contraction, and other Keynesian real-side indicators. There would be no implicit message that markets alone have the effective capacity to restore full employment.

Moreover, in the Great Recession policymakers properly ignored the time-inconsistency issue. That "problem" is a strong candidate for the most honored yet least useful concept in macroeconomics. From Woodford (p.15): "…if a [central] bank acts at each date under the assumption that it cannot commit itself to any future behavior (and is not bound by any past commitments), it will choose a systematic pattern of behavior that is suboptimal." That is just wrong. Time-inconsistency is not a particularly difficult practical problem. Independent, competently staffed central banks can, and do, manage it efficiently. The evidence here includes the Fed's quick decision in 2008 to focus on its real-side objective. Limiting monetary objectives to a single explicit (low inflation) target is a consequential choice that requires meaningful justification, not smokescreens used to obscure fundamental problems in the mainstream capacity to explain instability.

The need for smokescreens is the real reason for the appalling NK policy advice. Eliminating the employment objective is a Ptolemaic convenience that helps obscure the failure of the consensus market-centric general-equilibrium model class to accommodate involuntary job loss. In the mainstream world, episodes of adverse demand disturbances must produce very mild employment contractions employment, affecting rational job search and quickly corrected by market forces. Such voluntary joblessness is reasonably deemphasized as a monetary-policy concern. Think about the NK eliminating an explicit co-equal employment objective. The primacy of inflation management cannot survive the Keynesian reversal of neoclassical macro causation microfounded by the GEM Project's derivation of meaningful wage rigidity. In highly-specialized economies, nominal demand disturbances induce same-direction changes in employment, output, profits, and wage income. In modern economies, monetary authorities must pay at least as much attention to real-side behavior as they do to inflation.

An inescapable message of the 2007-09 Great Recession is the rejection of the market-centric single policy focus on low, stable inflation. The price level was clearly an inadequate indicator of the danger posed by the acute demand instability that began organizing itself in the second half of 2008. The Federal Reserve would have been derelict in its responsibilities if it had not focused on direct measurements of total spending as well as job loss, production contraction, and other indicators of the collapsing real economy. The GEM Project with its keystone MWR Channel provides a useful framework for understanding the substantially lagged relationship, especially in periods of contraction, between product-price inflation and involuntary job loss. Chapter 6 of the website’s e-book demonstrates the rationality, in periods of weakening nominal demand, of large firms’ choice to emphasize reductions in employment/output rather than product prices.

Rational-behavior macro modeling reveals the New Keynesian single-objective policy advice to be flat-out wrong. That advice progressed from incorrect to appalling when mainstream NK theorists, with only a short pause following the acute instability and its millions of involuntary lost jobs in 2008-09, began to reassert the single-objective theorem. What follows is Woodford’s summary of his NBER Working Paper, “Inflation Targeting and Financial Stability,” written well after the Great Recession: “A number of commentators have argued that the desirability of inflation targeting as a framework for monetary policy analysis should be reconsidered in light of the global financial crisis, on the ground that it requires neglect of the implications of monetary policy for financial stability. This paper argues that monetary policy may indeed affect the severity of risks to financial stability, but that it is possible to generalize an inflation targeting framework to take account of financial stability concerns alongside traditional stabilization objectives. The resulting framework can still be viewed as a form of flexible inflation targeting; in particular, the paper proposes a target criterion that would still imply an invariant long-run price level, despite fluctuations over time in risks to financial stability or even the occurrence of occasional financial crises.” New Keynesians cannot adequately model unemployment and, as a result, doggedly pursue a Ptolemaic research agenda that ignores the obvious importance of joblessness as a primary monetary-policy objective.

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