The Fed *and the* Crisis *of* Capitalism

By Bernard Connolly

There needs to be not another FDR New Deal, but another Teddy Roosevelt Square Deal.

The first-quarter U.S. productivity numbers make an intriguing contribution to assessing U.S. President Donald Trump's badgering of the U.S. Federal Reserve to reduce interest rates. And they potentially have very significant implications for the global debate on the crisis of capitalism.

The numbers appear to suggest that the rate of growth of productivity in the United States may, for a time, have picked up to around 1.5 percent, miserable by most post-war standards but better than the truly awful performance of the middle of the present decade. There is an important caveat: productivity numbers are notoriously unreliable and are subject to revision many years into the future. But if the apparent pickup is confirmed, the rate of growth of potential output in the United States could, taking account of population growth, have recently been around 2 percent a year.

But how does that matter for Trump's agenda and for the way the Fed might—or should—react? In answering that, it is vital to distinguish between one-off improvements in the level of potential output and ongoing improvements in the rate of growth of potential. There can be little doubt that the Trump effect has increased the level of potential output in the United States. It appears that part of that effect has been an expansion of the labor force, with a significant increase in the participation rate, perhaps through an improvement in the profitability for employers of paying the

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"reservation wage" (the wage needed to attract people into employment).

The result has been that the economy, even beginning from what seemed in 2017 to be full employment, has been able to grow, over the past couple of years or so, substantially faster than its trend rate of growth. The quiescence of inflation in the face of very low levels of unemployment and above-trend rates of growth may appear to be testimony to such effects.

Suppose that was all that had happened. A period of two or three years in which firms, on the basis of Trump's tax and deregulatory plans and a general shift in the psycho-political climate as it affects business, seemingly expected—rightly, as it turned out—more output with an increased labor force and little effect on wages that will have increased the anticipated rate of return over that period. Such a state of affairs would typically trigger what I have long called a "super-Say's Law" effect, in which the prospect of future supply calls forth more than its own current demand, as business and consumer confidence and spending increases. The correct monetary policy response in that typical case would be to increase expected interest rates over a two-year or three-year horizon in order to defer some spending into a future in which additional supply would be available (it was the Fed's failure to respond in such a way in the mid-1990s which set in train the intertemporal disequilibrium which has produced violent boom-bust cycles and has been a major source of increasingly unacceptable inequality in wealth). The interpretation of the yield curve in such circumstances would be interesting. A inversion of 2s-10s would be appropriate. Rather than being a signal of impending recession, which such inversion is often taken as being, it would be a reflection of increased optimism about the future level of output.

For capitalism to work, there has to be an escape from the conveyor belt to ever-lower interest rates and/or ever-bigger, and ever more politically unacceptable, equity bubbles and, ultimately, to state control of both distribution and allocation.

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Does that mean that, contrary to Trump's assertions, the Fed should have acted to increase interest-rate expectations faster once the surge in confidence after Trump's election had become apparent? The answer is not straightforward. The increase in potential output over the past two years or so has—at least until recently—primarily been the result of increased availability of workers. Actual demand growth has certainly outstripped trend growth in potential output. But it has not led, so far, to rampant excess demand for U.S. output (the current account deficit has increased somewhat, but there is little evidence that U.S. demand has been sharply outstripping U.S. supply). An upward shift in the curve of labor supply really does have effects which are like, for a short period, those of the "manna from heaven" view of "disembodied" technological progress and potential growth (it was the misapplication of such a view to developments in the mid-1990s which so distorted Fed policy in that period).

How is the picture affected by the recent evidence—admittedly as yet very tenuous—that there may also have been a slight increase in the rate of growth of labor productivity—which may or not persist? It is far too early for any halfway-reliable decomposition of recent supply growth into changes in labor input, capital input, and total factor productivity. But it is not *prima facie* unreasonable to guess that the burst of growth in business investment in 2017 and the first half of 2018 was strong enough to do a bit more than just maintain average productivity levels as more people—probably less productive people—were drawn into the labor force. But that burst of investment seems to have faded. That probably has two implications.

First, the Trump effect, although undoubtedly favorable, has been mostly one-off. By raising the level of potential output, it has gone some little way to validating, *ex post,* previously inflated expectations. It has thus

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made the stock-market valuations which obtained before Trump's election less over-inflated at anything like hypothetical "normal" interest rates. In turn, that meant that the increases in short rates since that election have been less damaging to stocks and to aggregate demand than would otherwise have been the case. Candidate Trump accurately stated in 2016 that there was "a big, fat, ugly bubble" in stock prices and that "bad things will happen" if the Fed raised rates without there being the changes in other policies that he advocated. There can be little doubt that had Hillary Clinton been elected, the 2016 slump in business confidence would have been aggravated and the Fed would not have been able to raise rates as it did without crashing stock prices and pushing the economy into recession. But Trump has far from resolved the underlying disequilibrium in the U.S. economy, and the sharp rise in equity prices over the past two-and-a-half years probably means, at present levels of interest rates, that, despite an increase in the level of potential output, equity prices again embody over-optimistic expectations of future incomes, especially if trade wars escalate.

A second probable implication of the fading investment surge is that the bringing-forward of spending from the future (exacerbated by the macro effects of fiscal policy) which has already happened will mean that growth in aggregate demand will hereafter tend to fall short of growth in aggregate supply. Unemployment will tend to rise again, making it even clearer that equities are overvalued. An adverse feedback loop between falling equity prices and an emerging output gap will tend to develop.

In these circumstances, the Fed is going to have to respond to Trump's demand for lower rates. But contrary to Trump's tweeting, lower rates will not push U.S. growth up from 3 percent to 4 percent and ensure that the United States "wins hands down" in trade wars. Rather, they will be necessary just to prevent a sharp fall in stock prices and a return to rising unemployment—developments which could lead to a left-wing victory in November 2020 and a reversal of those favorable economic impacts which Trump has undoubtedly had.

And the underlying problem remains. For capitalism to work, there has to be an escape from the conveyor belt to ever-lower interest rates and/or ever-bigger, and ever more politically unacceptable, equity bubbles and, ultimately, to state control of both distribution and allocation. For that escape to happen without creating a deep recession, there has to be a climate in which innovation, and its commercial implementation, flourishes. In turn, that will require deep economic and sociocultural changes. There must be a move away from rigged markets and crony capitalism towards competitive markets and entrepreneurial capitalism. That is, there needs to be not another Franklin Roosevelt "New Deal," but another Teddy Roosevelt "Square Deal." And there must be a single-minded effort to defeat the totalitarian political correctness which has transformed so many universities from centers of learning, free expression, and innovative thinking into fanatically anti-capitalist, quasi-Maoist "re-education" camps of stifling obscurantism.

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Such a "re-capitalismization" of the economy and society, if it happens at all, will take decades, perhaps generations. It is highly unlikely that such a process will have any chance even of beginning if a near-term recession brings a left-wing victory in 2020. Thus, in an example of what former Bank of England Governor Mervyn King has called "the paradox of policy," the Fed, if it wants there to be any chance of restoring normal rates of interest in the long term, is probably, in the near term, going to have to begin reversing the attempted interest-rate "normalization" of the past few years. And if that maintains equity prices at overvalued levels or increases them even further, then, as I argued in the Winter 2019 issue of this magazine, there will have to be countervailing tax measures to make the resulting wealth distribution effects less politically explosive.

So two cheers for Donald Trump: he has at least deferred the existential crisis of capitalism. But the list of requirements for a successful escape from the trap in which capitalist societies across the world now find themselves is daunting. It is hard to be optimistic, even without mentioning the risk of further protectionism in the United States, China, and the European Union. ◆