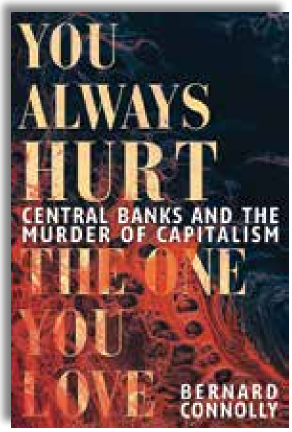
A Terrible Choice

The devil you know (central banks) versus the devil you don't (government controlling monetary policy).

BY BERNARD CONNOLLY



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A soft landing is a chimæra, and the U.S. Federal Reserve is damned if it does and damned if it doesn't. There will either be no landing of the U.S. economy, and hence inflation stubbornly above target, or a crash landing—or probably first one and then the other, involving a drastic slashing of rates.

Fed and commentariat faith in a soft landing puts one in mind of the 2007 attitude of Ben Bernanke, then the chairman of the Fed. As the March 2007 meeting of the Federal Open Market Committee (six months before the eruption of the financial crisis) drew towards its close, Bernanke was selling a prepared statement to the Committee. Its message was simple: "Things aren't quite perfect, but don't worry, they will be." The statement conceded that "Recent readings on core inflation have been somewhat elevated. Although inflation pressures seem likely to moderate over time, the high level of resource utilization has the potential to sustain those pressures." As for growth, "Recent indicators have been mixed and the adjustment in the housing sector is ongoing. Nevertheless, the economy seems likely to continue to expand at a moderate pace over coming quarters."

The transcript was to reveal, almost six years later, that Bernanke explained that "The notion here was to look at more fundamental factors that would be underlying the assumption of growth, such as income, which has grown rapidly, and supportive financial conditions" (and he added that favorable credit conditions were the main component of "supportive financial conditions"). That explanation was left out of the final statement but reappeared in the minutes, released a couple of weeks after the meeting. Yet Fed Vice Chair Don Kohn had argued in the meeting that "There's an act of faith here," since, "The income phrase always struck me as endogenous: 'We think that growth is going to be moderate and that income will go up with growth.'" Three or four other FOMC members

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declared themselves worried by Bernanke's argument. Then-Boston Fed President Cathy Minehan even said that "the whole statement is on faith." According to the transcript, that confession elicited laughter: faith in the consensus macroeconomic model was a joke, but a joke that could not be admitted.

Nothing has changed. Fed doctrine—and consensus macroeconomic doctrine—posits a kind of modified Say's Law, according to which income and employment grow in line with the economy's productive potential unless there is a stochastic disturbance, unpredictable beforehand and incapable of explanation afterwards. All that monetary policy has to do is to offset disturbances once they have become apparent. Once the disturbance has subsided (it is supposedly stochastic, remember), the monetary policy action can be reversed and the economy will carry on along its effectively supply-determined path until the next disturbance, independent of any previous disturbance and thus free of any taint of endogeneity, comes along. But now, as in March 2007, there is no Fed recognition that "financial conditions," not the growth of income, are the real "fundamental" and that the growth in employment and income is indeed, as Kohn posited, endogenous: a result of "supportive financial conditions"—a conjoined bubble in asset prices (now including an extremely dangerous and malignant bubble in crypto assets) and in credit (notably including public sector credit)—which are themselves endogenous, ultimately the result of, at least in part, past, present or expected future monetary policy.

As former U.S. Treasury Secretary Larry Summers said in the spring, if the Fed takes its mandate seriously (and, I would add, if it somehow still manages to believe the consensus macroeconomic model), it should have, with inflation still clearly above target, at least put the possibility of a rate hike into the market. But that would have risked crashing the "everything bubble" (including its massive public-finance element) that has been the primary reason for the much-praised "resilience" of U.S. growth. Take that bubble away, and the risk in the United States will soon be deflation.

A soft landing is a logical impossibility if the economy has been in a bubble.

As I argued in my recent book, a soft landing is a logical impossibility if the economy has been in a bubble. A bubble cannot "stabilize." It must either keep on swelling or collapse. For much of the past quarter-century, a bubble was necessary to produce, if only for a moment, full employment and inflation back to target. So the Fed could happily allow the bubble to grow. If a bubble was ever "wrong" as they retrospectively asserted of the bubble that burst in 2007, before blowing an even bigger one, they convinced themselves, the politicians and the public that they, the Fed, had clean hands, the only villains being "bankers." And they fooled themselves into thinking that the post-covid bubble, and the quantitative easing and fiscal incontinence that drove it, would never produce inflation. Now they find themselves faced with a choice of accepting an ever-bigger bubble, with devastating financial, social, and eventually political effects, or crashing the bubble and plunging the economy into severe recession.

Fed Vice Chair **Don Kohn** *had argued in the March 2007 FOMC meeting that "There's an act of faith here."*

The Fed is indeed damned if it does and damned if it doesn't. And there could hardly be a worse electoral backdrop in prospect for the Democratic presidential candidate. Come what may, Donald Trump will give Fed Chair Jerome Powell a hard time even if turns out that the chairman's mistakes (or perhaps the mistakes urged on him by President Biden's packing of the Fed) help him back into the White House. Trump, were he to win in November, would have to face—or perhaps take advantage of—the worst consequences of those mistakes, not least of which would be an increased politically perceived need for fiscal dominance.

So do those mistakes suggest that the case for central bank independence has been severely weakened? In my book, I argued that behind the mistakes made by the Fed and other central banks lies a wholly inadequate consensus macroeconomic model, one that radically misrepresents the nature of a capitalist society. The familiar maxim "Make a better mousetrap and the world will beat a path to your door," has a corollary: the resources required for production of the improved mousetrap have to come from reducing other demand. In a real-world intertemporal setting, a technological improvement usually requires investment ahead of output. The resources required for that have to come, except in wholly open economy, from a holding-back of consumption and of investment in other areas.

While the modified Say's Law implicit in the Fed's underlying model is false, at least once something has gone wrong in monetary policy, there certainly can be a "super-Say's Law" effect in which the prospect of future supply calls forth more than its own current demand. In the

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mid-1990s, as soon as an investment boom created by the potential of new technologies became apparent, the Fed should have raised real longish rates sufficiently to do the job of holding back other areas of spending until new supply from the improved technologies came onstream and investment in those technologies fell back. Instead, the Fed allowed a massive stock market boom such that demand threatened to further exceed supply. Finally worried about inflation, the Fed raised rates at just the wrong time, as new supply was coming onstream and other areas of demand, rather than coming in as aggregate supply increased and interest rates fell back, were themselves weakening as interest rates rose—real *ex ante* ten-year yields appear to have exceeded 4 percent by early 2000—and expectations of an everlastingly bountiful "New Economy" were falsified.

My book explains how that sequence of events set the U.S. economy and Fed policy on a course in which the choice between bubbles and recessions (perhaps one should say a choice between crashes now and bigger crashes in the future) is inescapable. In 2007, the choice made by the Fed—unconsciously, no doubt, but far from innocently—produced the financial crisis. Monetary policy had then, and continues to have now, through the blowing of bubbles, enormously important distributional effects which are weakening popular understanding of and support for capitalism—for free-market capitalism, at least.

Monetary policy is necessary given the absence of Arrow-Debreu complete markets. A coordinating mechanism for the expectations of savers and investors is required. The awful problem is when, in what is otherwise a more or less free-market capitalist economy, the most important intertemporal coordinating variable, the *ex ante* real interest rate, is set by the authorities—whether a central bank or a government—without an understanding that such coordination, not hitting an arbitrary inflation target, is what the interest rate is for. The true role of monetary policy should not be that of offsetting supposedly stochastic disturbances, but that of mimicking what would happen if there were complete markets. In the all-too-obvious absence of that understanding, monetary policy has operated in a way such that the creative destruction that made capitalism so successful and beneficial is stymied and capitalism becomes politically unviable. And it has involved central banks, not least the Fed, in actions whose tremendously important distributional implications should really be taken by the market or, if they are to be modified, then at least by democratically-elected governments.

Once monetary policy has gone seriously wrong for an extended period, as it has, it matters less who sets monetary policy (or rather, the reason why it matters changes). Monetary policy cannot keep things right, still less put them right. It cannot get economies out of the choice between bubbles and deep recessions. The only thing that could perform that trick would be a genuinely important and economically and politically practicable leap in productive potential. Might artificial intelligence be the answer? Who knows? Monetary policy would have to understand that a prospective leap in productive potential could validate after the fact, so to speak, at least some of what are currently bubbles; it should not allow the general level of asset prices (or, rather, what one might call the economy-wide price-to-earnings ratio) to rise still further; the prices of most stocks would still need to fall as AI stocks rose. Unless there is an even bigger leap in understanding of monetary policy in a capitalist society—and there is no sign of that—one cannot be optimistic even about the macroeconomic implications of AI.

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What central banks do mostly understand is that fiscal incontinence—fiscal stimulus going beyond anything needed as substitute for interest rate reductions that might or might not be required to avoid recession—is simply not consistent with a bounded outcome for inflation or for government debt. That is the conventional and strongest argument for central bank independence. But there is equally no bounded outcome for bubbles short of a crash. Perhaps one has to resort to folk wisdom: better the devil you know (central banks) than the devil you don't (governments controlling monetary policy). What a terrible choice—here as in so many other areas of modern life. ◆