The FOMC deceives itself

With all the talk about the economy being "in a good place" and being "strong". A couple of examples.

From **Jerome Powell**:

> Today I will focus on the Federal Reserve's ongoing efforts to promote maximum employment and stable prices. I am pleased to say that, by these measures, **the economy looks very good**.
>
> I am glad to be able to stand here and say that **the economy is strong**, unemployment is near 50-year lows, and inflation is roughly at our 2 percent objective.

Atlanta Fed´s Bostic "ups the ante" writing:

> **The economy is in a good place**. So good, in fact, that as I was sitting down to write this speech, I struggled to come up with **sufficient variations on the word "strong." Strong** has many definitions that can describe physical prowess, the intensity of an odor or flavor, and, in physics, a type of force between particles. **But one definition stands out to me as particularly apt to describe the economy at this moment: *strong*—able to withstand great force or pressure.**

Because what we have witnessed for the past nine years, not dispelled by the latest GDP release, does not describe a bona fide economic boom, the spin has focused on the length of the expansion. The longest in history lasted 120 months (30 quarters) from March 1991 to March 2001. This one, so far, has been going on for 110 months.

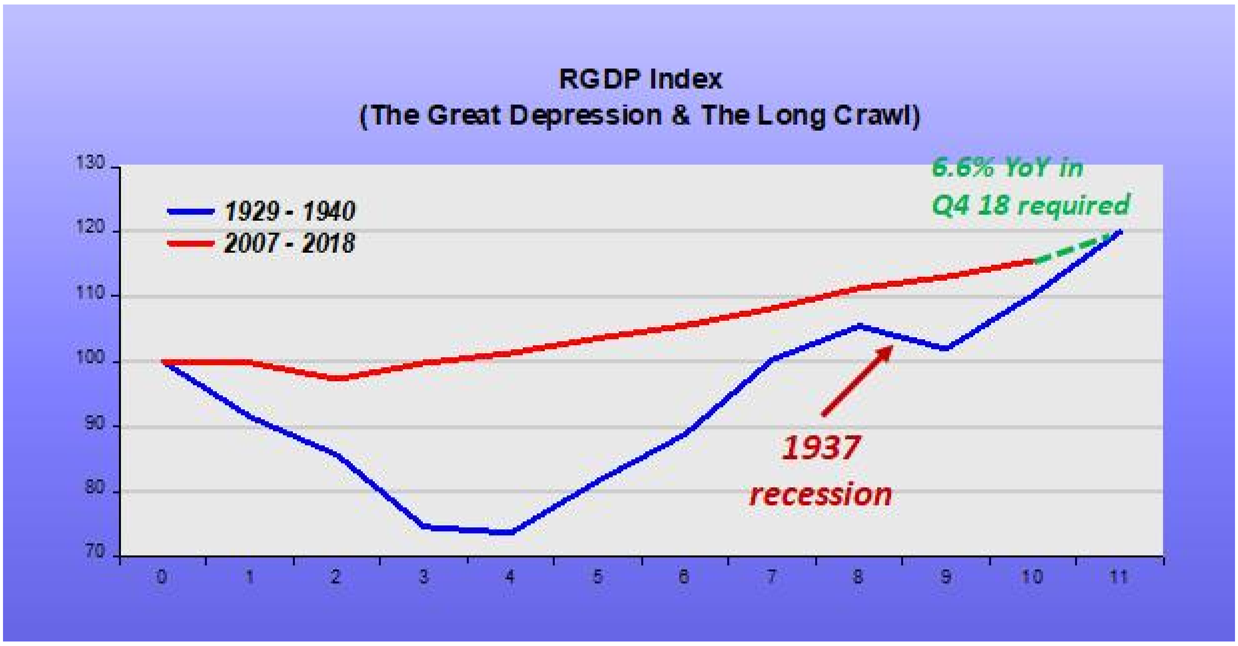
At the end of the 1990s expansion, unemployment was 3.9% and core PCE inflation was 1.8%, numbers that almost exactly match those seen at present. Therefore, given the comparable length of time and the similarity of the inflation and unemployment numbers, this must be a **boom**, with the economy **strong**!

The comparison with the 1990s is completely out of order. The only similarity is length of time, but that´s a completely arbitrary dimension, probably “made up” to make the FOMC feel vindicated!

The appropriate comparison appears to be with the 1930s. Then, the output drop was gigantic. Furthermore, midway through the expansion, the Fed (with an increase in required reserves and the Treasury (by sterilizing gold inflows) caused the significant 1937 recession.

With all that, you would think that 11 years from the respective peaks (1929 & 2007) the level of output today would be much higher than in 1940. You would be wrong!

The chart shows that the level of output at the end of this year will **match** the level in 1940 **only if** real output growth in the last quarter of this year climbs to 6.6% year-on-year, a feat last seen in the first quarter of 1984, at the tail end of the strong recovery from the 1981-82 deep recession.



What the chart indicates is that the economy has gone on the “longest crawl” in history, so slow that it will lose out to the outcome following the Great Depression!

Instead of saying, the economy is “strong” or “in a good place”, what the Fed should be asking is “why has this happened”.

Monetary policy has no place in explanations of the Great Recession & Long Crawl. In his latest presentation, Bernanke writes “Financial panic and credit disruptions in the 2007-09 crisis”:

> …I also provide new evidence that suggests that the

> severity of the Great Recession reflected in large part the adverse effects of the **financial panic** on the supply of credit. In particular, the housing bust alone can't explain why the Great Recession was as bad as it was.

Robert Hetzel does better (pp.15):

> Regardless of a final verdict on the role played by disruptions to financial intermediation, **there remains no way to explain the Great Recession without recourse to contractionary monetary policy**. The combination of disinflation and recession as well as the subsequent persistent decline in inflation required contractionary monetary policy.

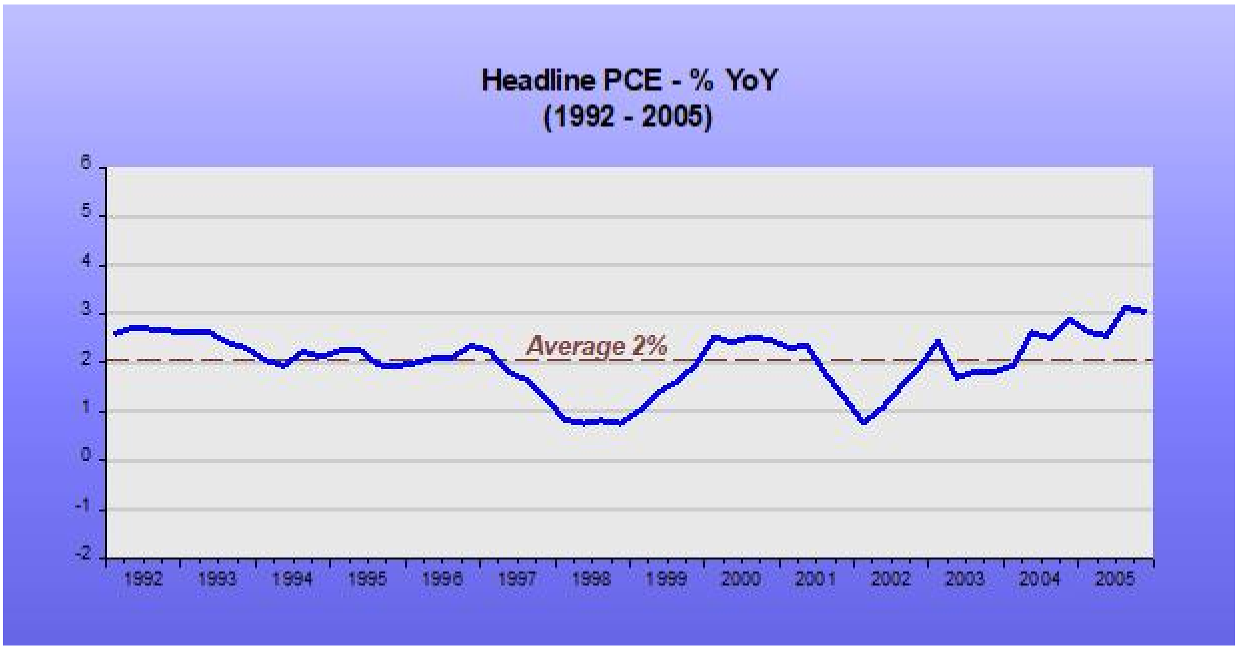
Why, then, did monetary policy become contractionary, leading to the "GR" followed by the "LC"?

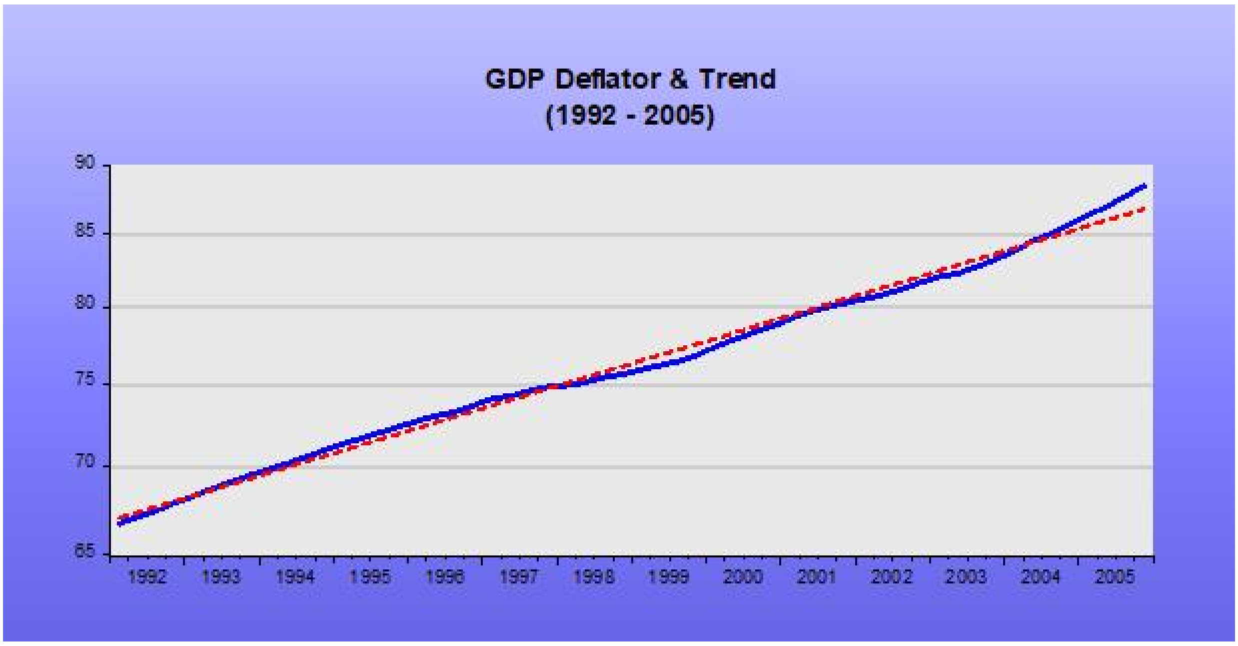
My conjecture: Because the Fed under Bernanke became an "Inflation targeting nutter." I´m not alone here. By saying that "false precisions can lead to dangerous policies", I believe Paul Volcker agrees.

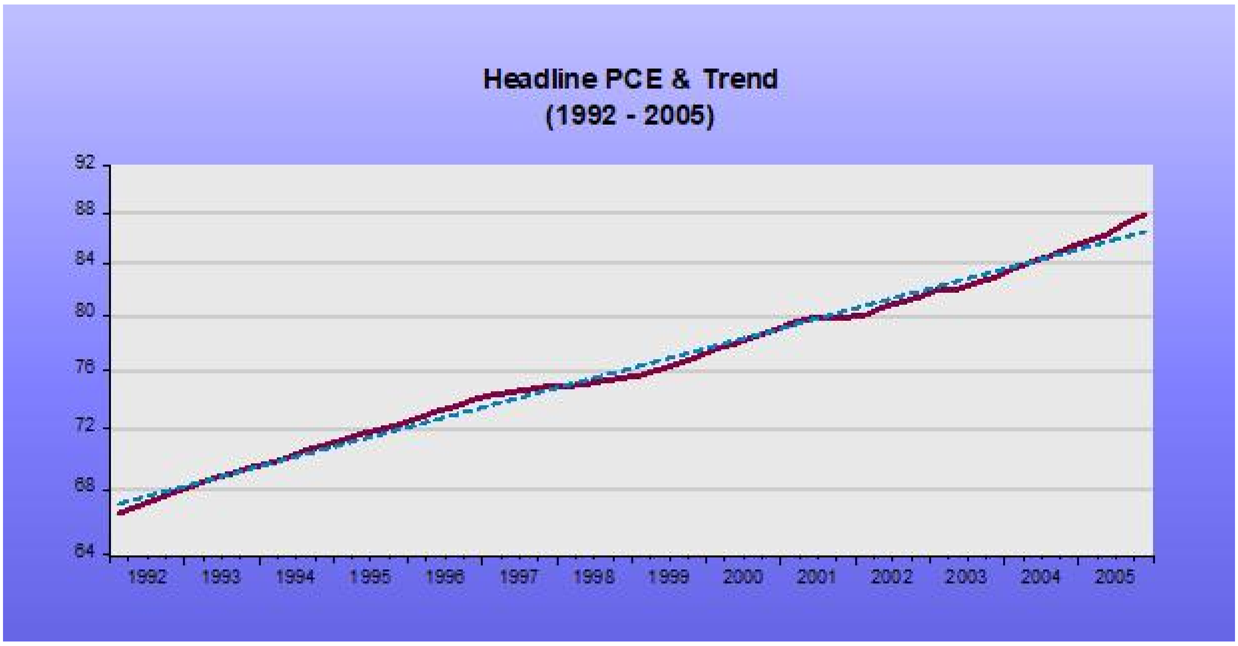
Maybe the Great Moderation came about because when, in 1996, Janet Yellen asked, "How do you define price stability"? Greenspan answered, "That state in which expected changes in the general price level do not effectively alter business or household decisions."

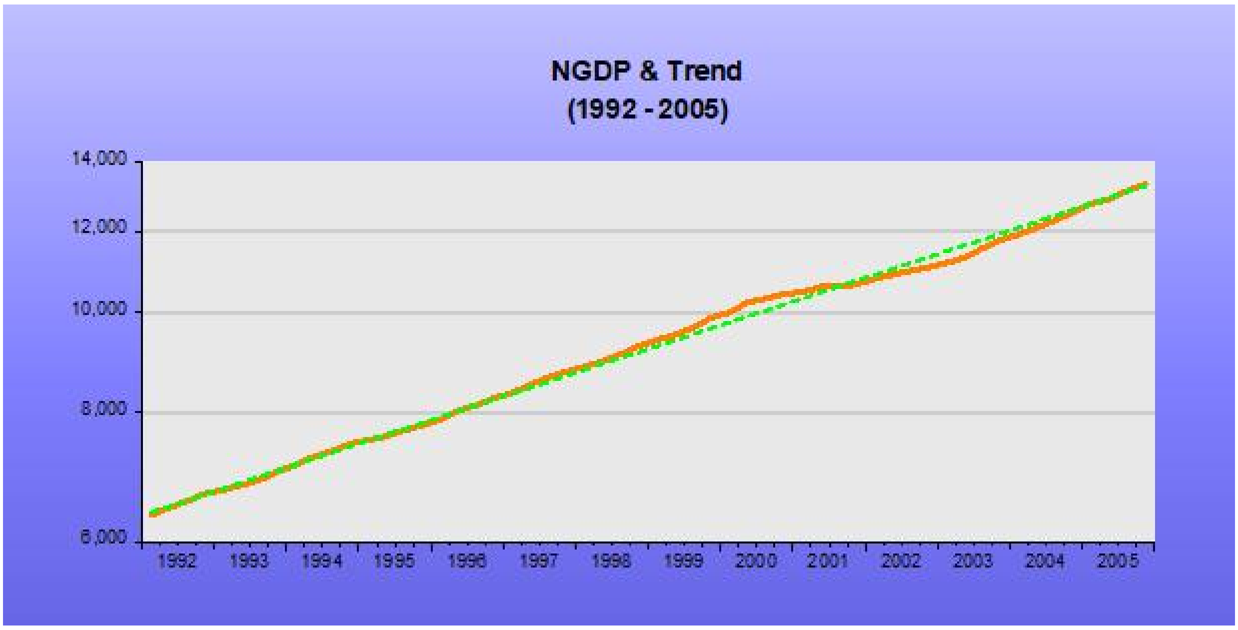
From 1992 to 2005, you could not be sure about what the Greenspan Fed was targeting. It could be inflation, in the Greenspan sense of not "altering business or household decisions", it could be the general price level (the GDP deflator) or the PCE deflator price level or, instead of the price level or inflation, the Fed could be level targeting NGDP.

The charts show that all those "targets" were "reached".


Headline PCE - % YoY
(1992 - 2005)
Average 2%
6
5
4
3
2
1
0
-1
-2
1992
1993
1994
1995
1996
1997
1998
1999
2000
2001
2002
2003
2004
2005


GDP Deflator & Trend
(1992 - 2005)
90
85
80
75
70
65
1992
1993
1994
1995
1996
1997
1998
1999
2000
2001
2002
2003
2004
2005


Headline PCE & Trend
(1992 - 2005)
92
88
84
80
76
72
68
64
1992
1993
1994
1995
1996
1997
1998
1999
2000
2001
2002
2003
2004
2005



That´s the definition of "nominal stability". If you have nominal stability, you have stable inflation, a stable price level and stable aggregate nominal spending (NGDP).

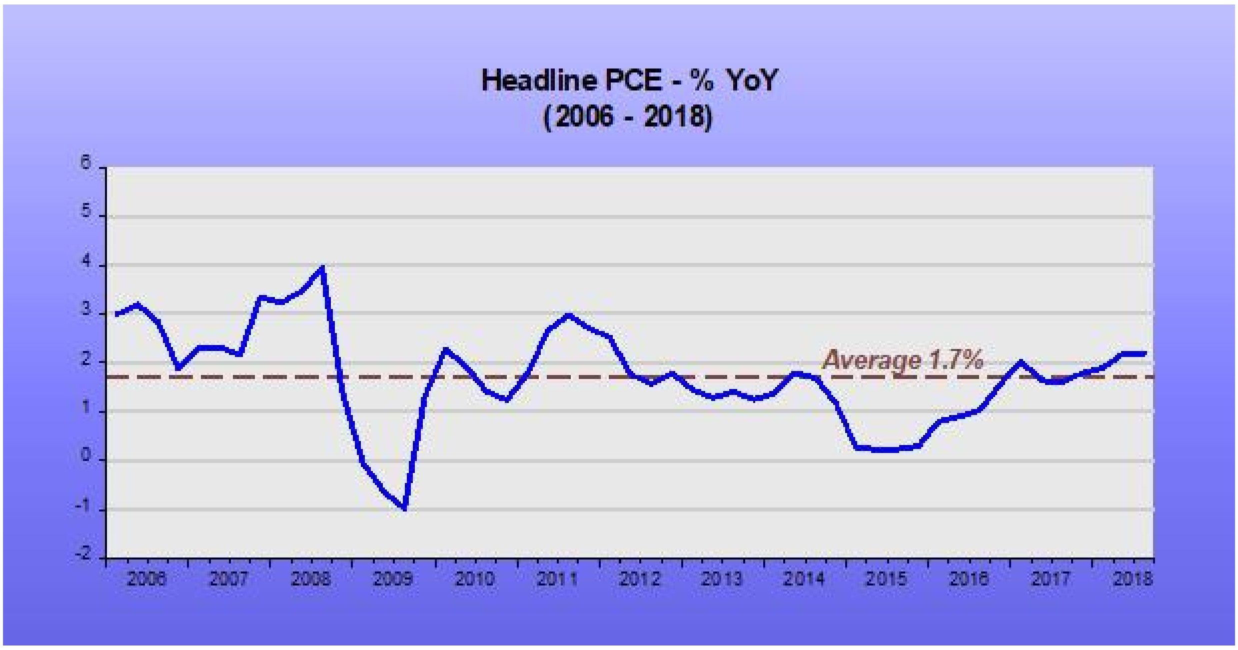
In January 2006, Bernanke comes along. His definition of "nominal stability" is much more "narrow", meaning stable inflation. Long before becoming a Fed Governor (2002), Bernanke wrote:

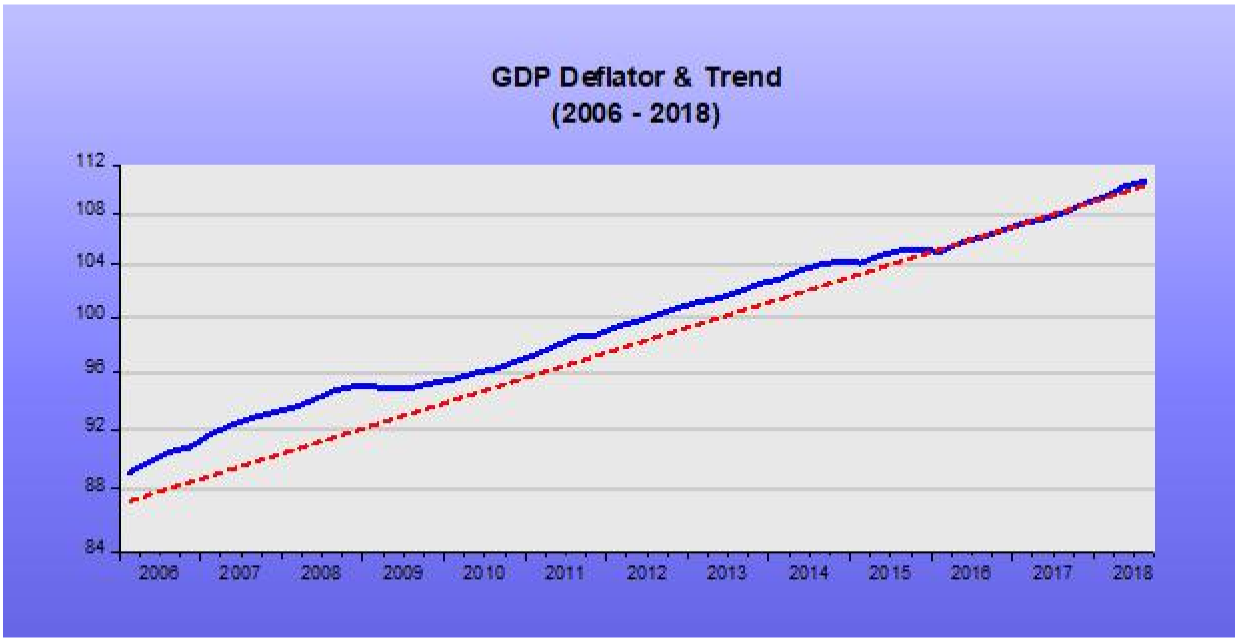
What Happens when Greenspan is gone? (Jan 2000):

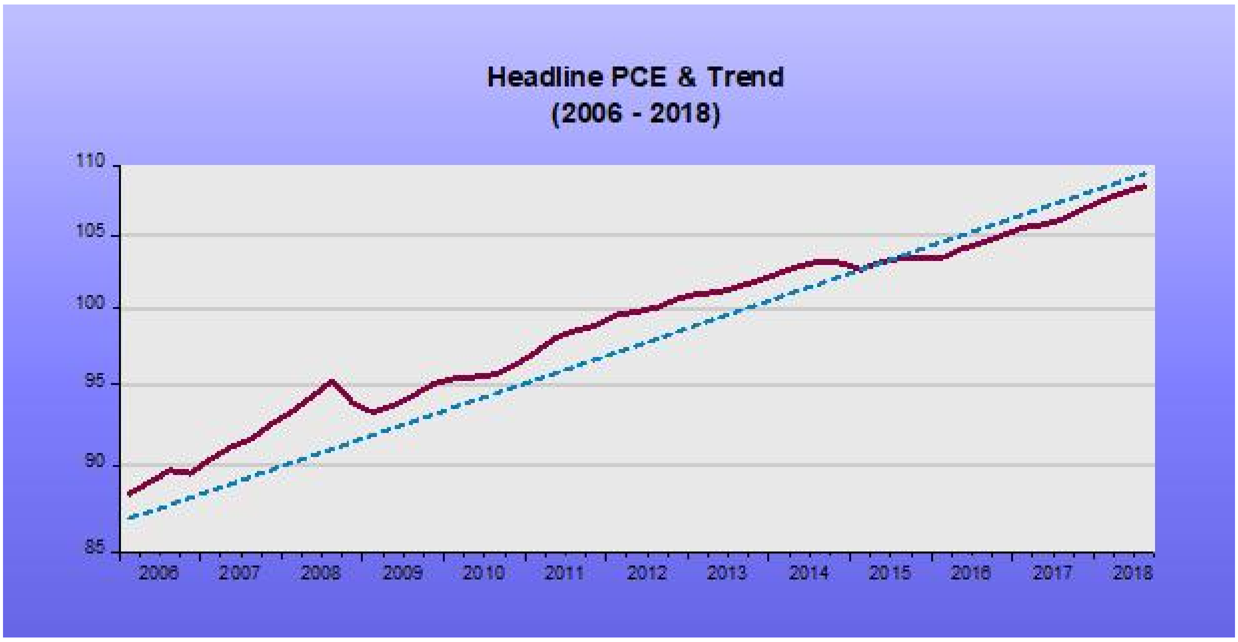
> U .S. monetary policy has been remarkably successful during Alan Greenspan's 121/2 years as Federal Reserve chairman. But although President Clinton yesterday reappointed the 73-year-old Mr. Greenspan to a new term ending in 2004, the chairman will not be around forever. To ensure that monetary policy stays on track after Mr. Greenspan, the Fed should be thinking through its approach to monetary policy now. The Fed needs an approach that consolidates the gains of the Greenspan years and ensures that those successful policies will continue; even if future Fed chairmen are less skillful or less committed to price stability than Mr. Greenspan has been.
>
> ***We think the best bet lies in a framework known as inflation targeting***, which has been employed with great success in recent years by most of the world's biggest economies, except for Japan. Inflation targeting is a monetary-policy framework that commits the central bank to a forward-looking pursuit of low inflation; the source of

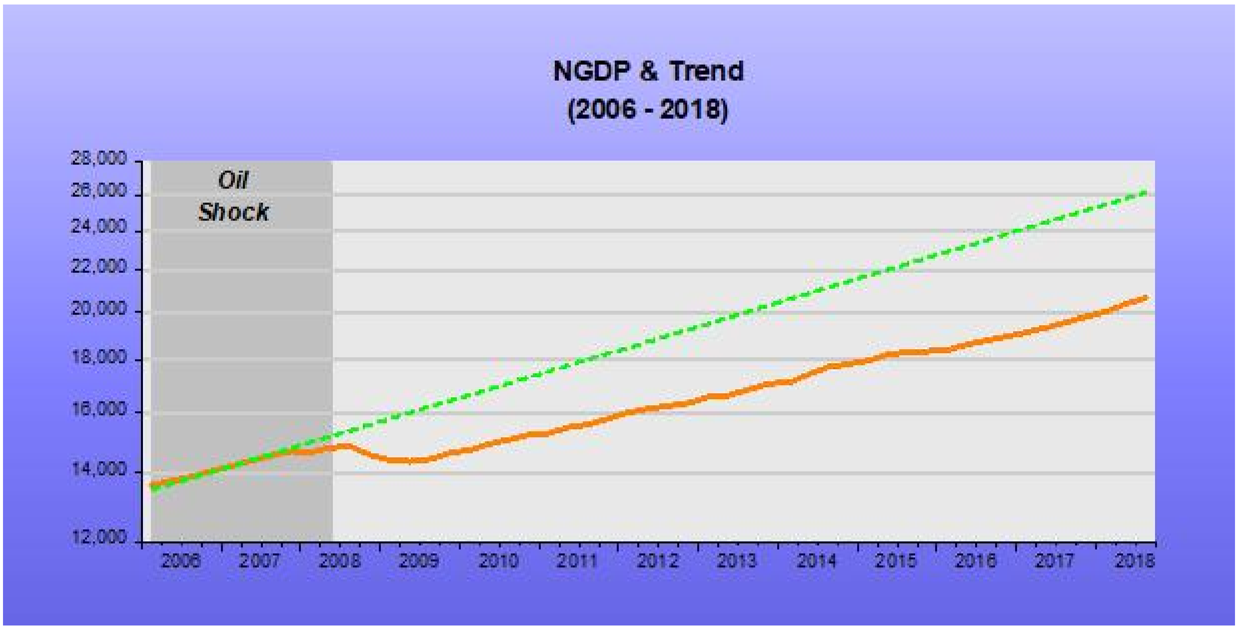
> the Fed’s current great performance; but also promotes a more open and accountable policy-making process. ***More transparency and accountability would help keep the Fed on track, and a more open Fed would be good for financial markets and more consistent with our democratic political system.***

In January 2006, he became the boss. How did things work out? The charts illustrate. (Keep in mind that his implicit (explicit after January 2012) inflation target was 2%.)





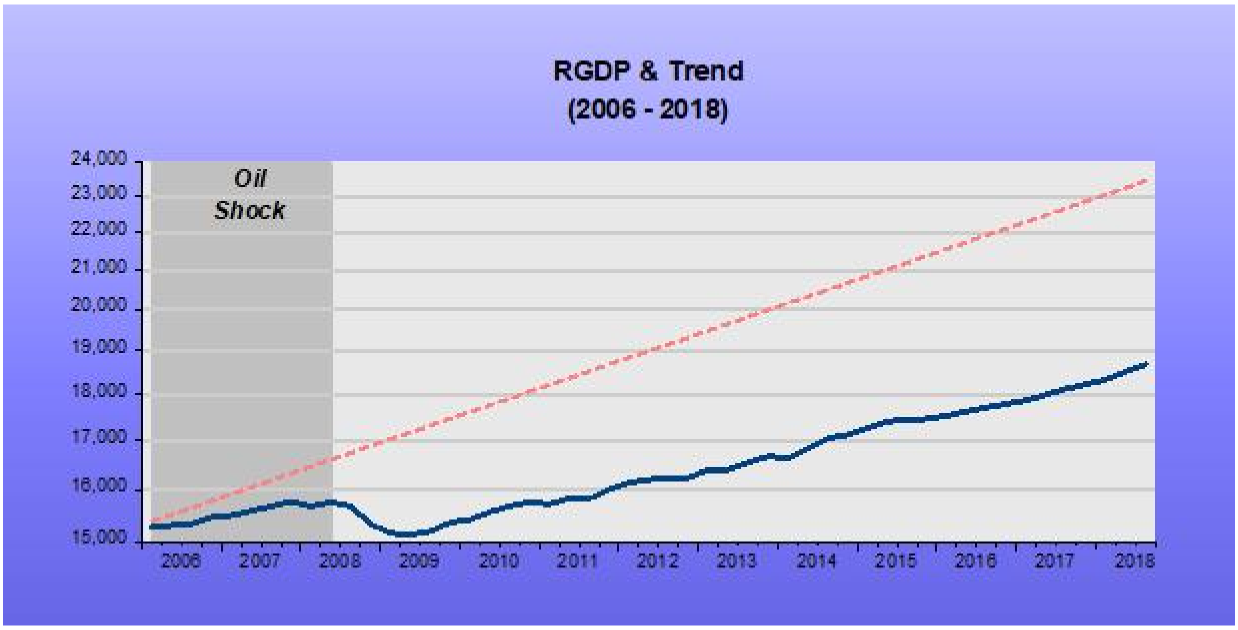




Note that when Bernanke became Fed chair, the occurrence of an oil shock (a supply shock) increased headline PCE inflation and both measures of the price level relative to trend.

When the economy is hit by a negative supply shock, inflation (and the price level relative to trend) rise and real output growth falls.

The fall in RGDP growth or, what amounts to the same thing, a drop in the level of RGDP relative to trend, is visible in the chart below.



In order for nominal stability to prevail, according to the workhorse Dynamic AS-AD model, nominal spending (NGDP) growth has to remain stable. In other words, NGDP has to remain on trend.

Unfortunately, Bernanke´s narrow view of nominal stability led him to “viciously” restrain nominal spending growth, or bring down the level of nominal spending. When that happened, real output tanked and the economy fell into the Great Recession.

With that, headline inflation falls and the alternative measures of the price level slowly converge to trend. Nominal spending, however, remains far below trend and the economy begins to “crawl”, never recovering.

Interestingly, the economy has regained overall nominal stability (stable inflation, stable price level, and stable nominal spending). But what does society prefer: a “low level” of income or a “high level” of income? What are the welfare costs of having a “low level” of income (spending)?

What´s worse, with “stability” of inflation (and the price level) regained, the Fed is worried that the “strength” of the economy will take inflation (and the price level) above target. The outcome of the 2% “inflation phobia” can well be another recession!