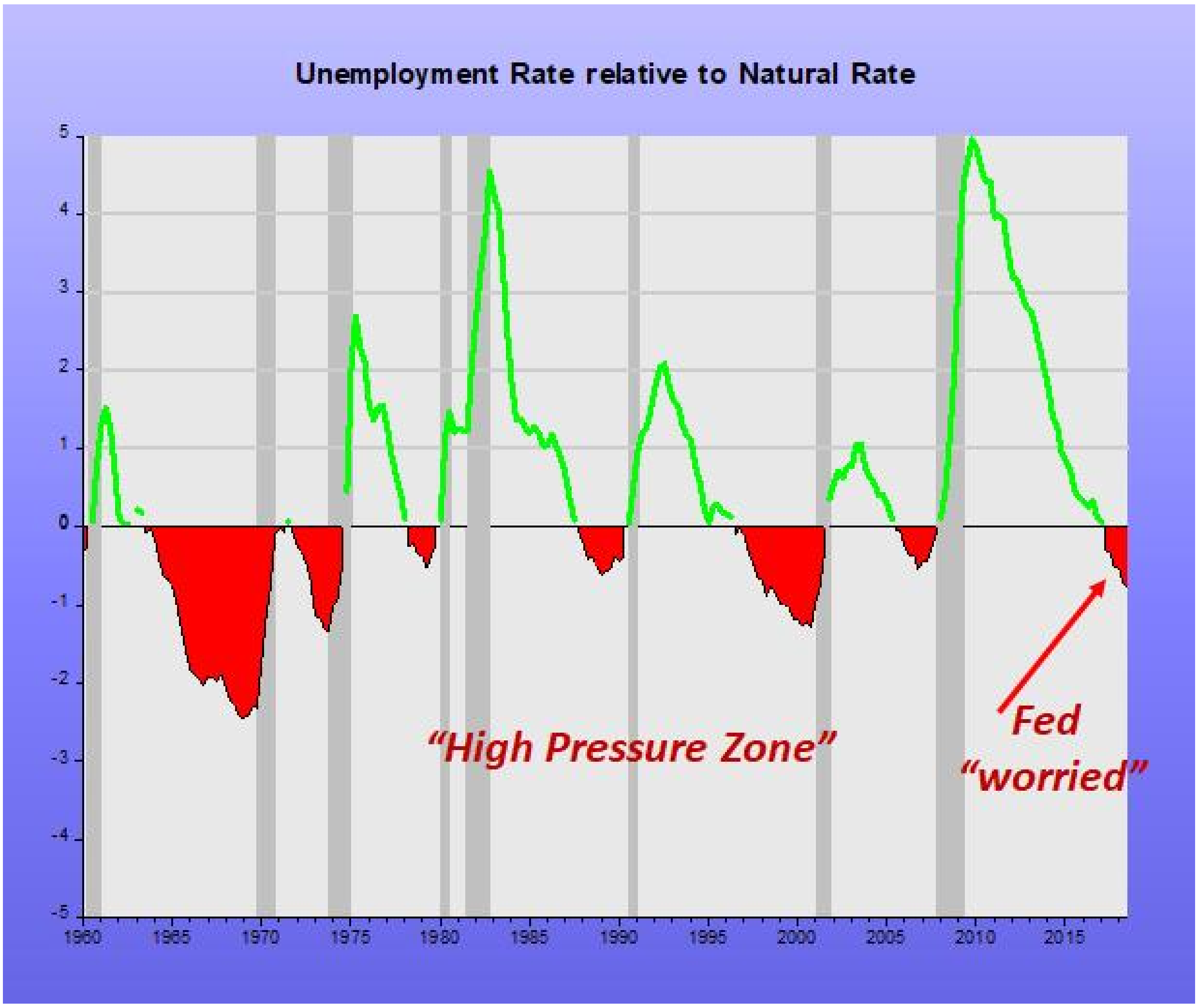
We don´t have a "high pressure" economy, but a "low pressure" one

Atlanta Fed Bostic writes "On Maximizing Employment, a Case for Caution":

> When the actual unemployment rate declines substantially below the natural rate—highlighted as the red areas in the following chart—the economy has moved into a "high-pressure period."



> For the purposes of this discussion, the important thing about high-pressure economies is that, virtually without exception, they are followed by a recession. Why? Well, as I described in a recent speech:
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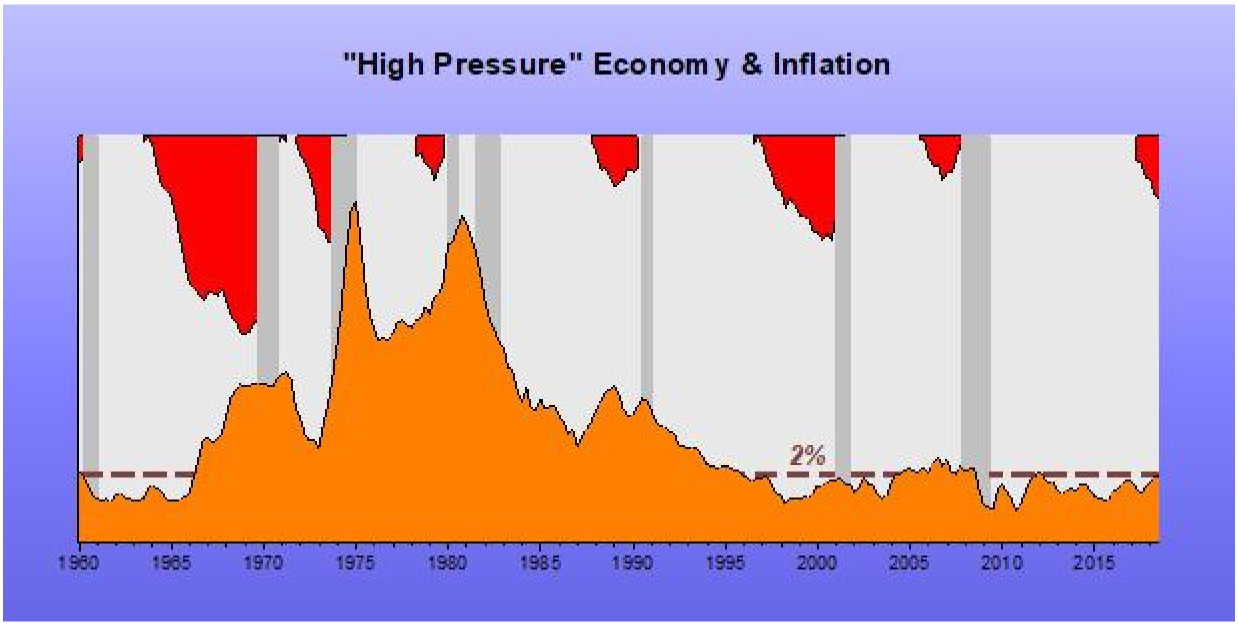
> "One view is that it is because monetary policy tends to take on a much more 'muscular' stance—some might say too muscular—**at the end of these high-pressure periods to**

combat rising nominal pressures.

"The other alternative is that the economy destabilizes when it pushes beyond its natural potential. These high-pressure periods lead to a buildup of competitive excesses, misdirected investment, and an inefficient allocation of societal resources. **A recession naturally results and is needed to undo all the inefficiencies that have built up during the high-pressure period**.

The first alternative is the correct one. The second is not independent, being the outcome of the first. Once the Fed´s "muscular stance" increases, investments will become "misdirected" and resource allocations will become "inefficient".

Indeed, the monetary stance becomes more "muscular" to combat inflation pressures. That may have been true from the mid-1960s to 1980. From then on, there´s no inflation pressure following a "high pressure" period.



The concept of a "high pressure" economy, or one where the unemployment rate is below the "natural" rate, is meaningless. Unfortunately, it determines the stance of monetary policy.

Let us look at the last 25 years. The first chart shows that over this period, on a monthly basis, the unemployment rate fluctuated widely, from less than 4% to 10%. Inflation, however, barely budged.

Now, let us look at the behavior of monetary policy, the stance of which is given, not by the level and change in the policy rate, but by the behavior of nominal spending (NGD) growth. [Note: the monthly NGDP data is from Macroeconomic Advisers].

Look at the green bars. In those instances, the unemployment rate rises. Those are moments in which monetary policy "tightens", signaled by the drop in NGDP growth. When, as in 2008-09 the drop in NGDP growth is massive, the increase in the unemployment rate is "immoral".

It seems that by focusing on a misguided view of a "high pressure" economy, determined by a low level of unemployment, monetary policy reacts. Even more recently (blue bar), when monetary policy only "slightly tightened" (a small reduction in NGDP growth relative to the recent trend), the fall in the unemployment rate "paused".

We can conjecture about what would have happened to the rate of unemployment in the late 1990s if NGDP growth had not fallen. Could the rate of unemployment continue to fall? Very likely yes, but the Fed´s anxiety with what they consider a "high pressure" economy led to monetary tightening, a recession (2001) and an increase in the rate of unemployment.

In 2008, a drastic tightening of monetary policy led to a deep recession and a huge rise in the unemployment rate. In this case, even inflation, despite the credibility of the 2% "target", was temporarily affected.

In fact, many show surprise that inflation fell so little despite the big increase in unemployment. The answer: Despite the big monetary policy mistake to the downside, inflation expectations were "well anchored".

For the past eight years, since coming (partly) back from the great recession, monetary policy has been "stable". Stability of monetary policy, even at the low trend level ("low pressure"), is enough to permit a drown-out drop in the rate of unemployment and the maintenance of low and stable inflation.

If monetary policy remains on the stable trend, unemployment will likely continue to fall and inflation will remain calm. Given its "bias", it is unlikely the Fed will pursue that strategy…

Now, let us "dream" and imagine the Fed not only does not "tighten" policy (bringing NGDP growth down from current levels) but also, in effect, decides that the spending **level** should be higher.

If it can make that clear, maybe by saying, it will allow the economy to run "hot" while inflation does not rise, what could happen? (It is beyond imagination that it would change the monetary policy framework to one based on NGDP level targeting!)

If economic prospects rise, unemployment would also temporarily increase due to a rise in labor force participation. Employment would with a lag increase, bringing the unemployment rate back down. Once the economy reaches the new spending level, NGDP growth would continue at an "appropriate" rate (maybe somewhat higher than the present one).

After all the adjustments, unemployment would remain low (or falling), inflation would be stable and real GDP growth would proceed at a new higher level.

Just like measures of “potential” output have been revised down (converging to actual), we would observe, as in the 1990s, “potential” being revised up!