Guided by “potential”: How has that worked?

Here´s Tim Duy writing for Bloomberg:

> The Economy’s Too Robust for the Fed to Bow to Markets – Growth would need to slow to around 1.8 percent before the central bank considers slowing the pace of interest-rate hikes.
>
> But will growth slow enough to ease what the Fed believes are underlying inflationary pressures? In general, central bankers believe the economy currently operates at or beyond full employment… Policy makers are, however, **sufficiently concerned about the potential for overheating that they would prefer that unemployment didn’t drift much lower**.
>
> From the perspective of the Fed, that means growth needs to slow to something closer to 1.8 percent, **which happens to be the Fed’s estimate of the longer-run growth rate**. As of last month, the Fed forecast 2.5 percent growth for 2019, even with continued rate hikes. In other words, a slowdown to 2.5 percent leaves activity still too robust to ease the Fed’s concerns.

Let´s start at the beginning. Although the concept had been around for many years, Arthur Okun gave it meaning in the early sixties (“The Political Economy of Prosperity“):

> “[t]he strategy of economic Policy was reformulated in the sixties. The revised strategy emphasized, as the standard for judging economic performance, whether the economy was **living up to its potential** rather than **merely whether it was advancing…”**

James Tobin (1974) “The New Economics One Decade Older” (page 9):

> **Cyclical mentality** was a major **barrier to full employment policy**. To counter it, the Kennedy Council introduced the **concept of potential real GNP**, estimated at a constant rate of productive resources, taken to be 4% unemployment…

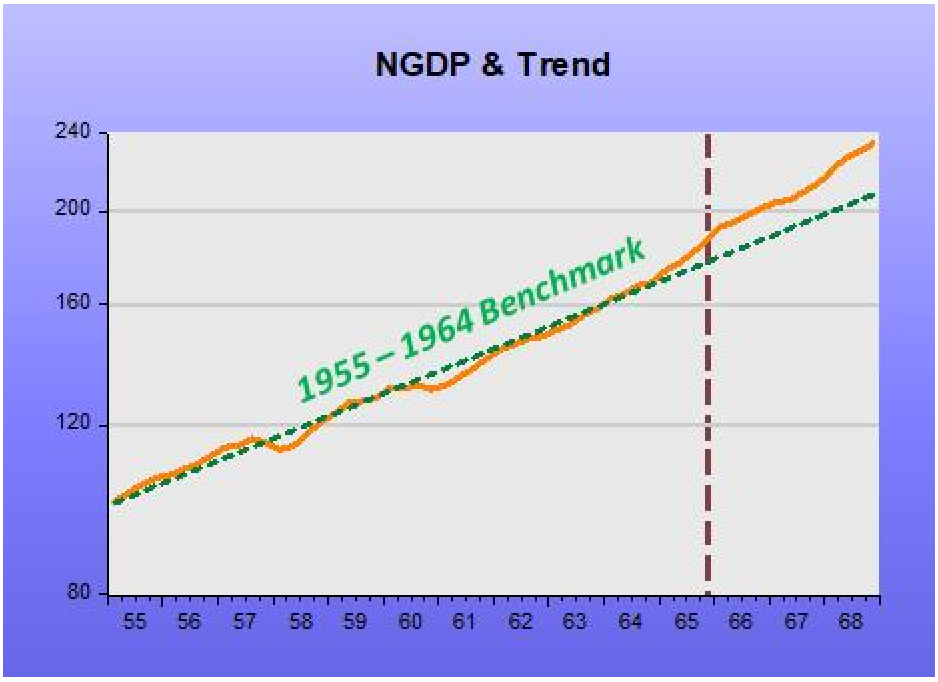
To the people at the President´s Council of Economic Advisers (CEA), it seems the concept was “aspirational”, not, as viewed later, as limiting economic performance.

The performance of the economy in the sixties, especially to 1966, was exceptional. For the five years between mid-1961 and mid-1966, real output growth averaged 5.6%. Those were the best five years of any five year period from the end of WWII to the present.

CEA participants, Heller, Tobin, Okun, Ackley, among others may have been lucky. Just as they took over at the CEA, productivity experienced a boom, also unparalleled, growing at an average of almost four percent during that five-year period.

Then…unemployment fell below 4% and inflation began to rise.

This “4% lower bound” to unemployment has endured. However, when you look “deeper”, you see the reason for the rise in inflation. Just as the productivity shock was waning, NGDP growth began to increase, leading to the rise in inflation.



To Okun, however:

> From early 1961 to mid-1965, the main task was to invigorate the economy. The major problem could be simply and clearly diagnosed as inadequate total demand, and the equally simple remedy was stimulative fiscal and monetary policy. By mid-1965, that diagnosis had become accepted and much of the remedy had been applied.

And:

> The stimulus to the economy also reflected a unique partnership between fiscal and monetary policy. Basically, monetary policy was accommodative while **fiscal policy was the active partner**. The Federal Reserve allowed the demands for liquidity and credit generated by a rapidly expanding economy to be met at stable interest rates.

[Note: The chart for “potential” and actual output (see the **Economic Report of the President for 1969**, page 65) supports Okun´s conclusion.]

Okun continues:

> Thereafter, the assignment was to hold to a course of noninflationary prosperity, a problem for which the economist does not have a simple and satisfactory solution.

> It is inherently a much more difficult task, and it was made ever so much more difficult by **large increases in defense spending.**

Near the “breaking point”, in December 1965, Gardner Ackley, then Chairman of the CEA gave a talk “**The Contribution of Economists to Policy Formation**”:

> …The plain fact is that economists simply don´t know as much as we would like to know about the terms of trade between price increases and employment gains (i.e., the shape and stability of the Phillips Curve). We would all like the economy to tread the narrow path of balanced, parallel growth of demand and capacity utilization as is consistent with reasonable price stability, and without creating imbalances that could make continuing advance unsustainable.
>
> But the macroeconomics of a high employment economy is insufficiently known to allow us to map that path with a high degree of reliability…It is easy to prescribe expansionary policies in a period of slack. **Managing high-level prosperity is a vastly more difficult business and requires vastly superior knowledge**. The prestige that our profession has built up in the Government and around the country in recent **years could suffer if economists give incorrect policy advice based on inadequate knowledge. We need to improve that knowledge**.

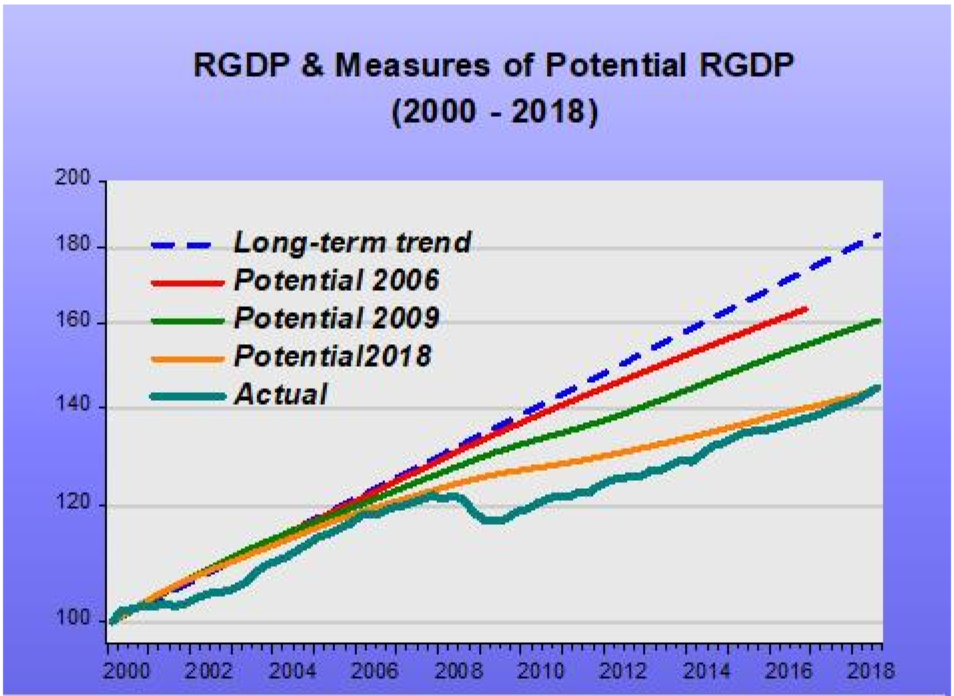
The set of charts above is consistent with a different story, one not so “uplifting” to the policymakers at the CEA. It wasn´t so much that “the stimulus to the economy reflected a unique partnership between fiscal and monetary policy”, but the fact that a productivity boom increased growth and reduced unemployment and inflation, with the Fed contributing by maintaining nominal stability (nominal spending evolving along a stable trend path).

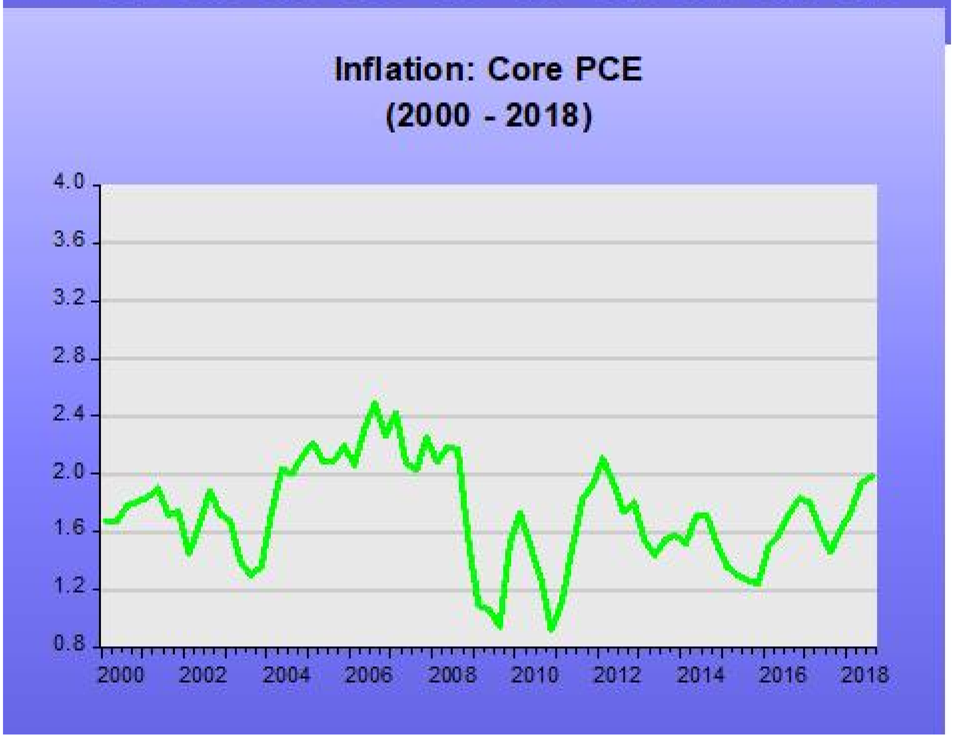
It was when monetary policy “partnered” with fiscal policy, with nominal spending growth rising above trend that inflation began to “bloom”, with the next 15 years witnessing high and rising inflation!

I think the “lesson to be learned” is that “Business cycle patterns are largely determined by monetary policy.”

Skipping to the present, Tim Duy argues, “growth would need to slow to around 1.8 percent before the central bank considers slowing the pace of interest-rate hikes.”

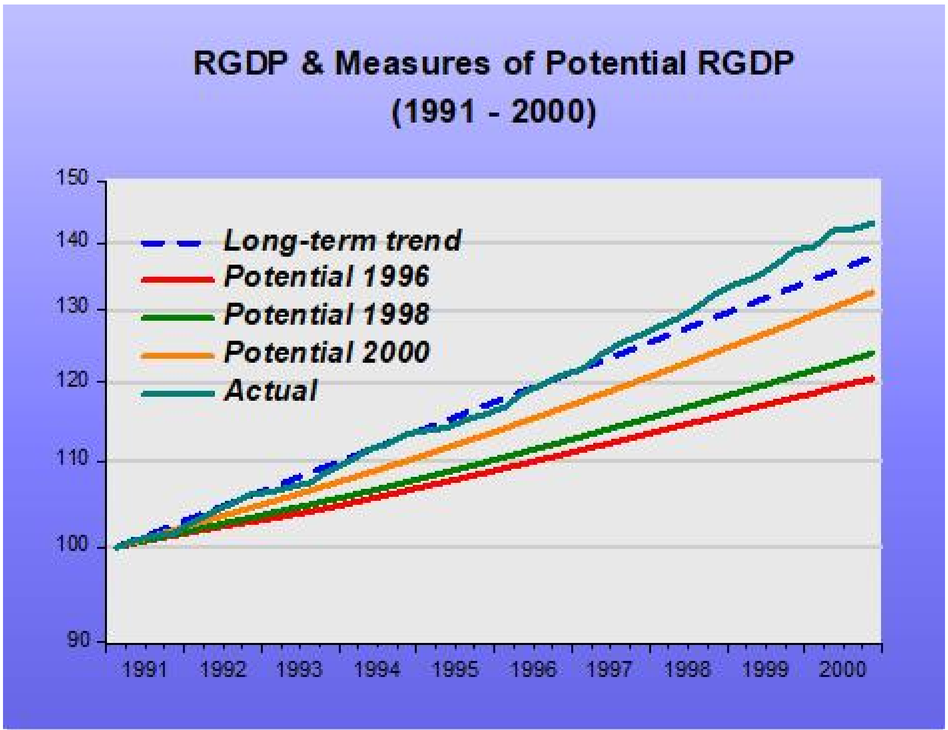
The chart below indicates that´s the growth rate compatible with the most recent measure of “potential”. Note, however, that since the crash, “potential” has been systematically revised down, and all the while, inflation has remained low and stable!

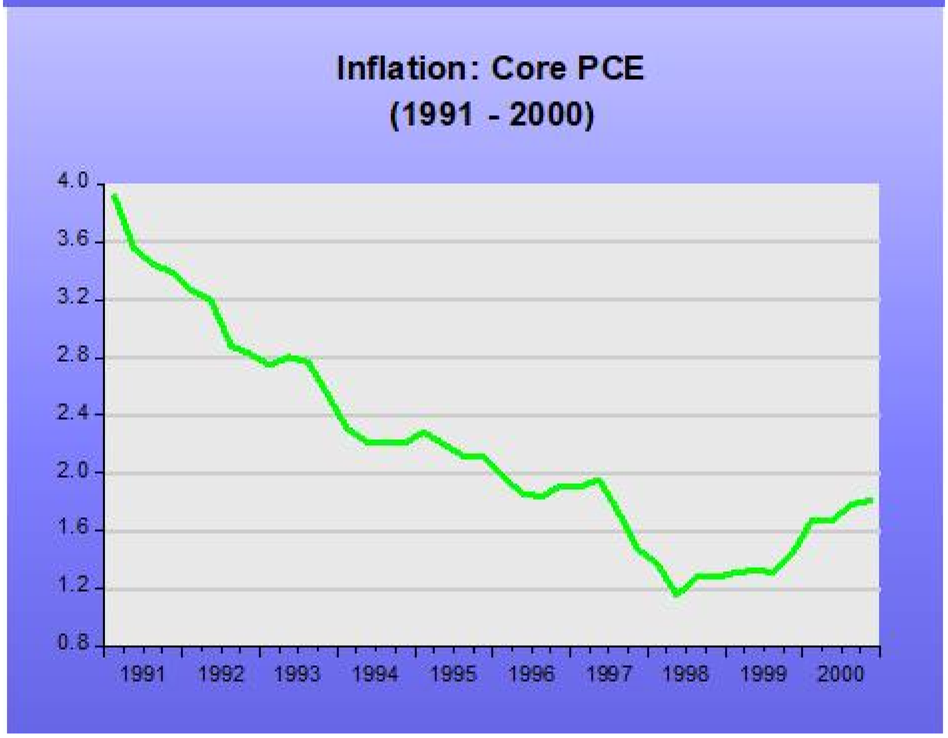




Why should we believe that the most recent measure of “potential” is the “true measure”, justifying the Fed “keeping up the pace of interest rate hikes?”

In the 1990s, we experienced the opposite. “Potential” was systematically revised up, but inflation fell and remained low!



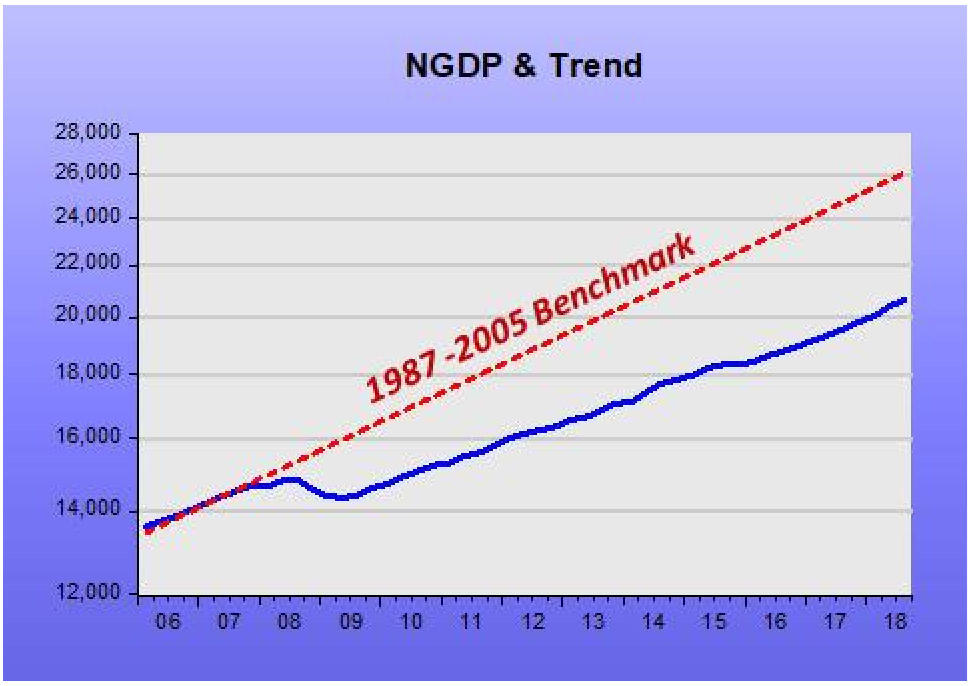


It´s time to heed Okun´s observation, “[t]he strategy of economic Policy was reformulated in the sixties. The revised strategy emphasized, as the standard for judging economic performance, whether the economy was **living up to its potential** rather than

merely whether it was advancing…"

The economy has surely been advancing (expanding), but has it been living up to its potential? **Maybe so, but as the result of "potential" being drastically downgraded!**

How did this state of affairs come by? As the chart illustrates, after the monumental monetary error of 2008-09, the Fed never bothered to promote a recovery, keeping the economy expanding in a "depressed" state.



As J W Mason puts in a recent post, "**For Economics, a Demystifying Decade**":

> …On the other hand, it has become increasingly clear that the productive capacity of the economy is not something **separate** from current demand and production levels, but dependent on them in various ways.
>
> Unemployed workers stop looking for work; businesses operating below capacity don't invest in new plant and equipment or develop new technology. This has manifested itself most clearly in the fall in labor force participation over the past decade, which has been considerably greater than can be explained on the basis of the aging population or other demographic factors.
>
> **The bottom line is that an economy that spends several**

> **years producing less than it is capable of, will be capable of producing less in the future**.

The sad part is that the Fed thinks the economy is “**in a good place**”, implying that it is more likely that we will regress further!