The sad state of the economy

Some “conflicting” comments:

> Federal Reserve Vice Chairman for Supervision **Randal Quarles** on Monday brushed off criticism of the central bank’s monetary policy choices and plans and said key remarks from the Fed’s leader last week didn’t signal a shift in the interest-rate outlook.
>
> According to him: “**The data show we are doing a pretty good job of meeting the employment and inflation goal laid out by Congress**”.

Vice Chairman **Richard Clarida** is more nuanced:

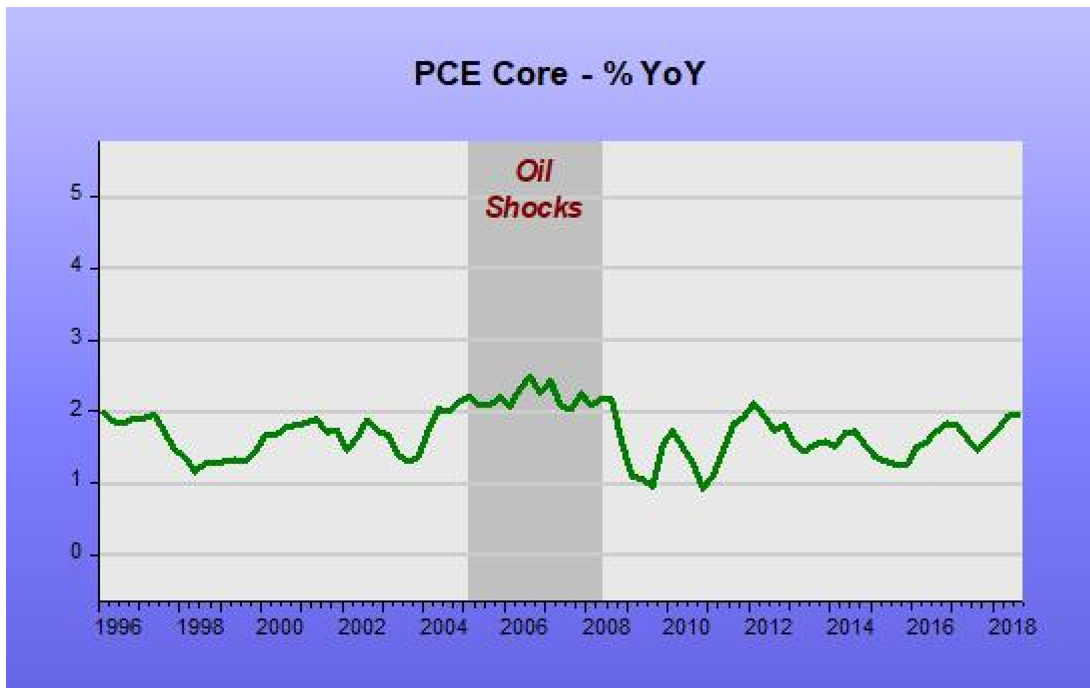
> “**In recent decades, the asymmetry has been toward disinflation forces**,” Vice Chairman Richard Clarida said in an interview with Bloomberg Television. Asked about the price impacts of globalization, he said, “we are in a world where central banks, including the Fed, are **focused on keeping inflation away from disinflation**.”
>
> Clarida’s comments came just after he expressed little concern about price pressures exceeding the Fed’s target.
>
> “**We have a symmetric objective around 2 percent**,” he said. “**Two percent is not meant to be a ceiling**. We’ve operated below 2 percent, we could operate somewhat above 2 percent, depending on the shocks.”

Others worry about the low wage puzzle in a “strong” economy:

> **One of the great puzzles of this economic expansion has been the tepid increase in wages, even as the unemployment rate has declined to 3.7 percent, its lowest point since 1969**.

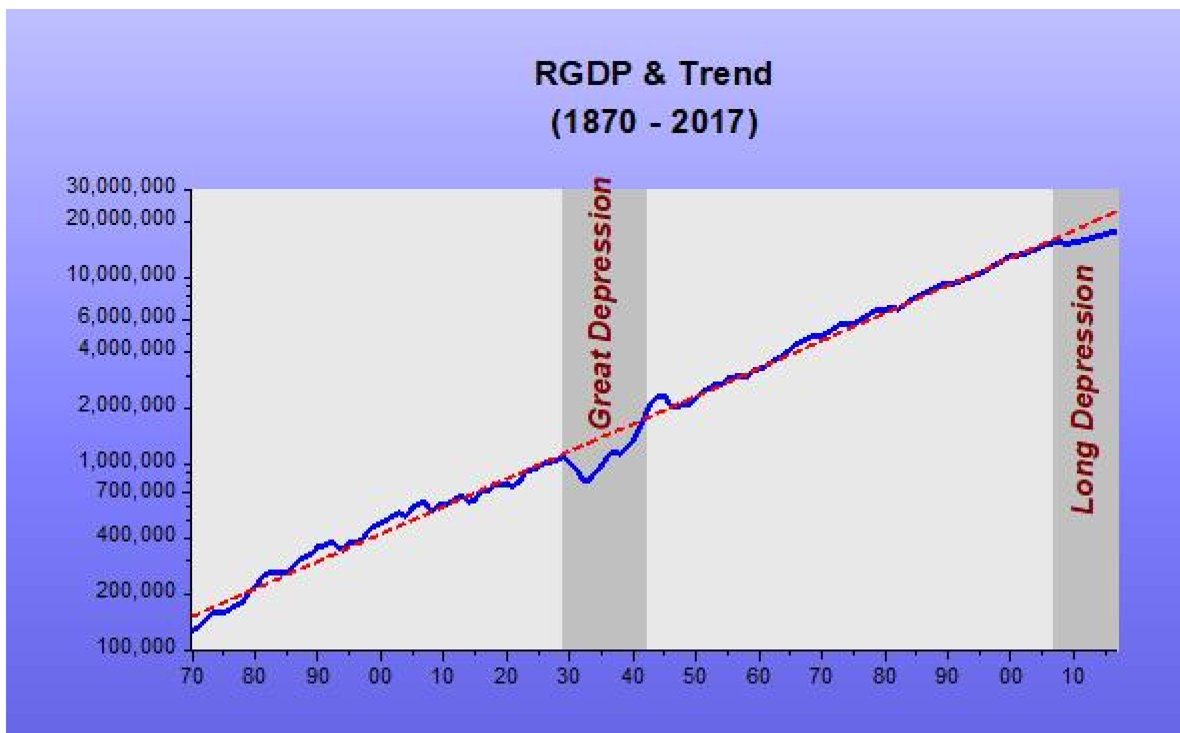
Clarida´s comment on “not a ceiling” is contested by the facts. The chart shows that for more than 20 years, core inflation clicked above 2% only during the strong oil shocks of 2005-08. De facto,

then, 2% looks very much like a ceiling! As I will show, that´s not important, mostly because inflation is the wrong target.

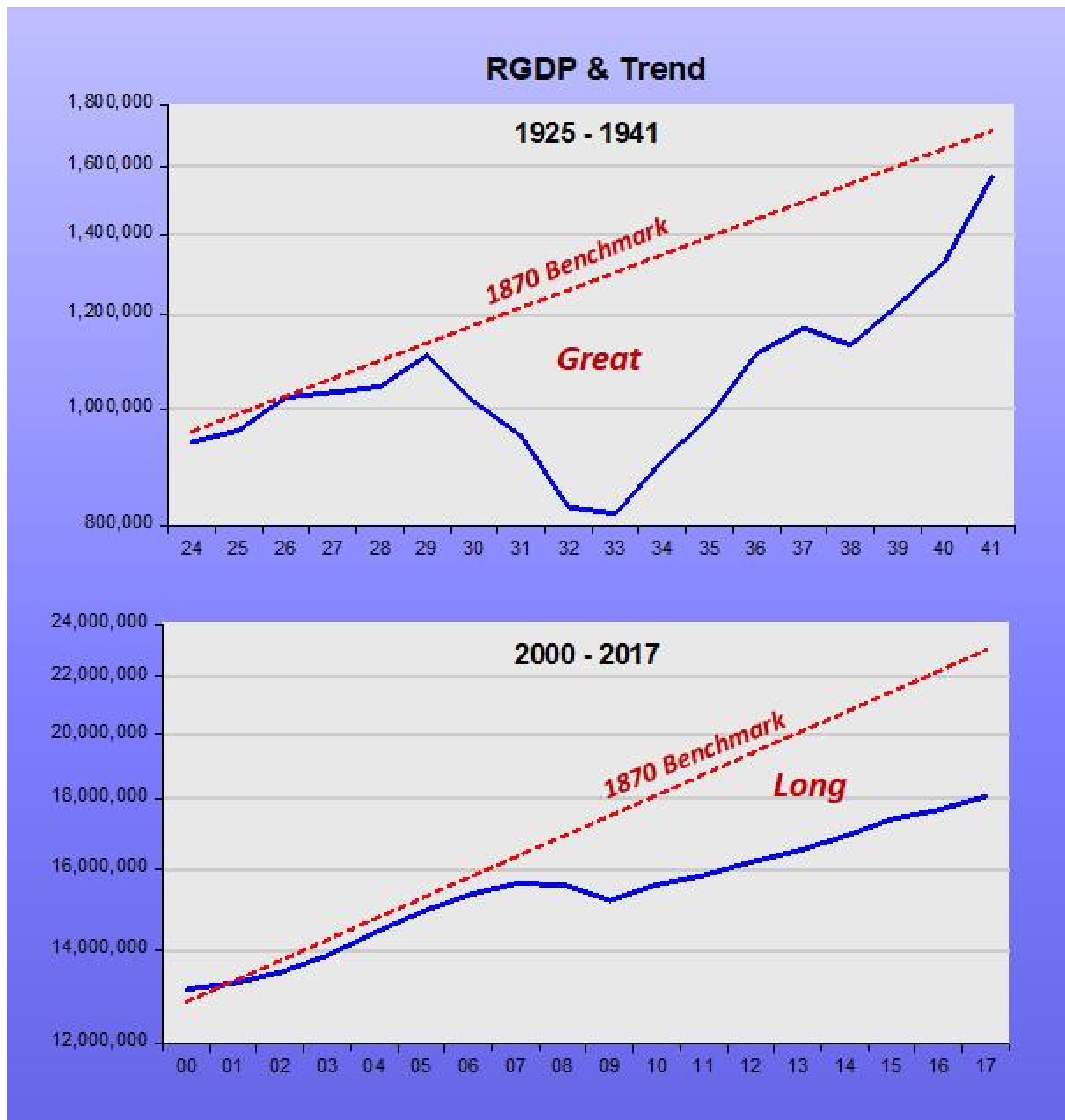


To reach my conclusion that the economy is in a “sad state”, I look at the last 150 years of real output (RGDP) data starting in 1870, five years after the end of the Civil War.

The chart shows that real output (RGDP) hugged the long-term trend very closely, with two noticeable “anomalies”, labeled “Great Depression” and “Long Depression”.



The next chart zooms in on those two instances. A little over 10 years after the start of the “Great Depression”, the anomaly had “dissipated”. The “Long Depression”, however, remains intact a decade after the crash!



How, then, can Quarles conclude that the Fed is doing “a good job”?

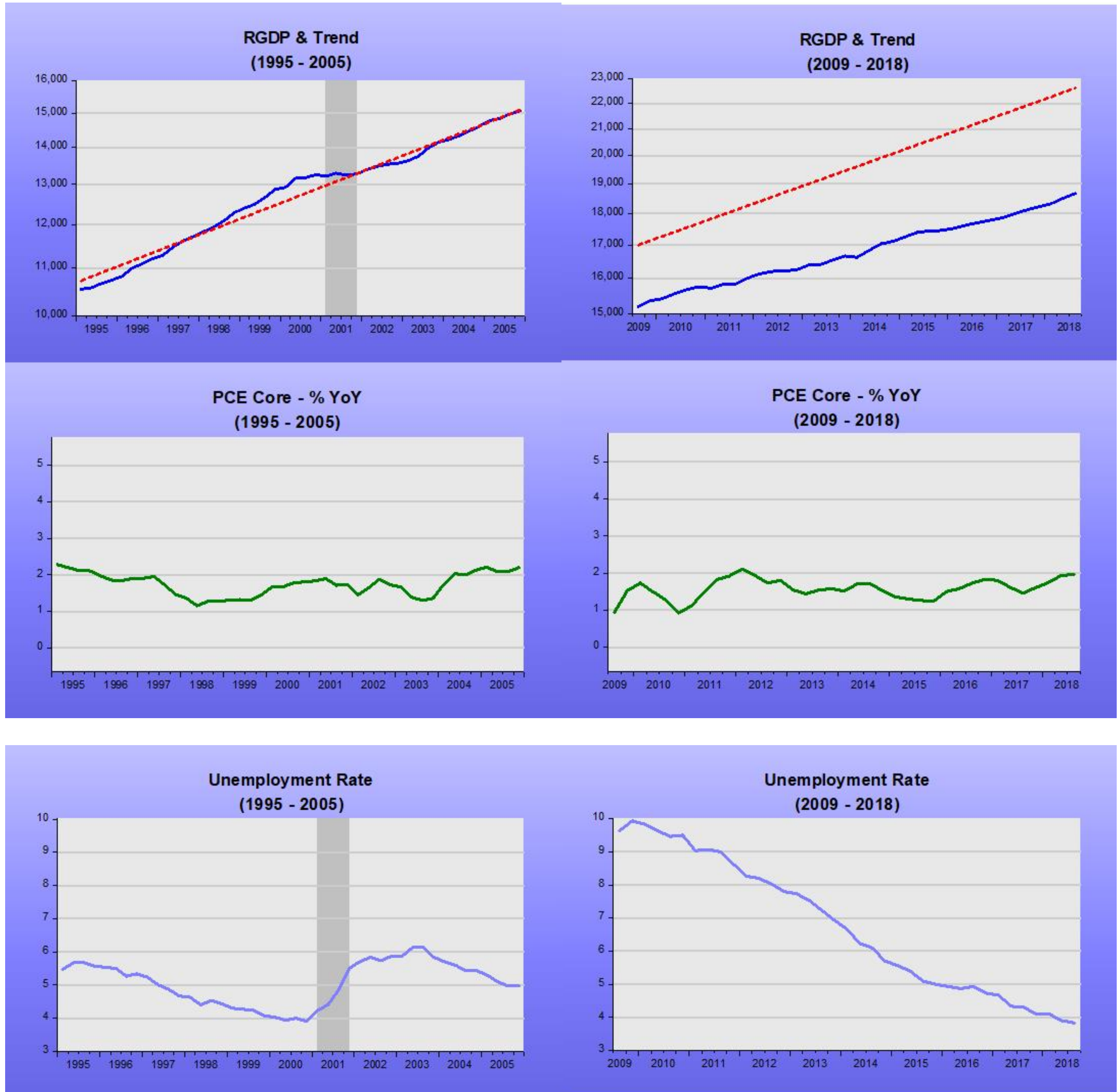
The logical conclusion is that satisfying the inflation and unemployment goals does ***not*** imply that the economy is in a good or “healthy” state.

The panel below illustrates.

From 1995 to 2005, RGDP hugged the long-term trend closely. Inflation was low & stable and barring the 2001 recession,

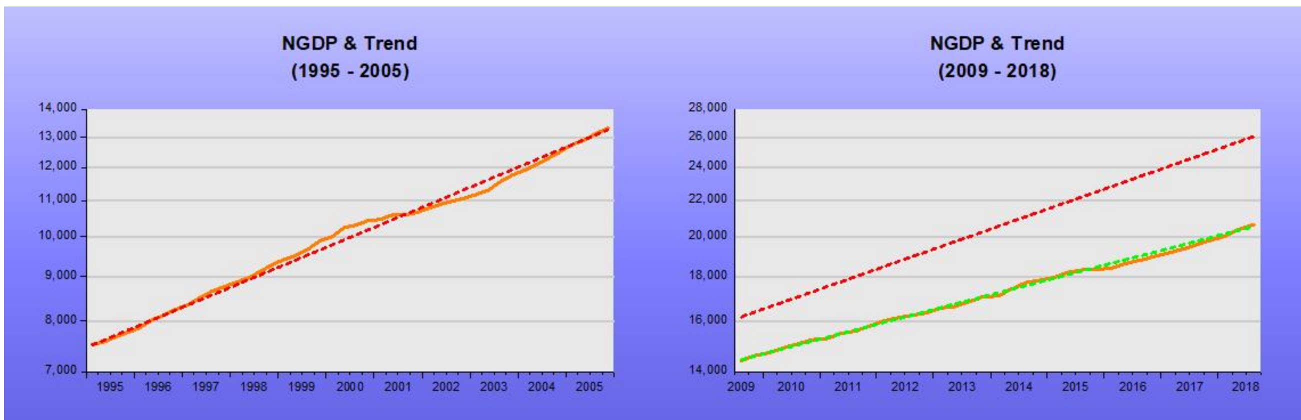
unemployment was also low, satisfying the mandated goals.

Since the Great Recession ended, RGDP has remained far below the long-term trend, but nevertheless, inflation has remained low & stable and unemployment has fallen substantially, with the mandated goals being at present fully satisfied.



How can the goals continue to be satisfied if the economy is so much “poorer”?

The reason becomes clear in the next two charts. Both for the 1995 – 2005 and 2009 – 2018 periods, the economy is characterized by ***nominal stability***, a stable level path of nominal spending (NGDP) growth.

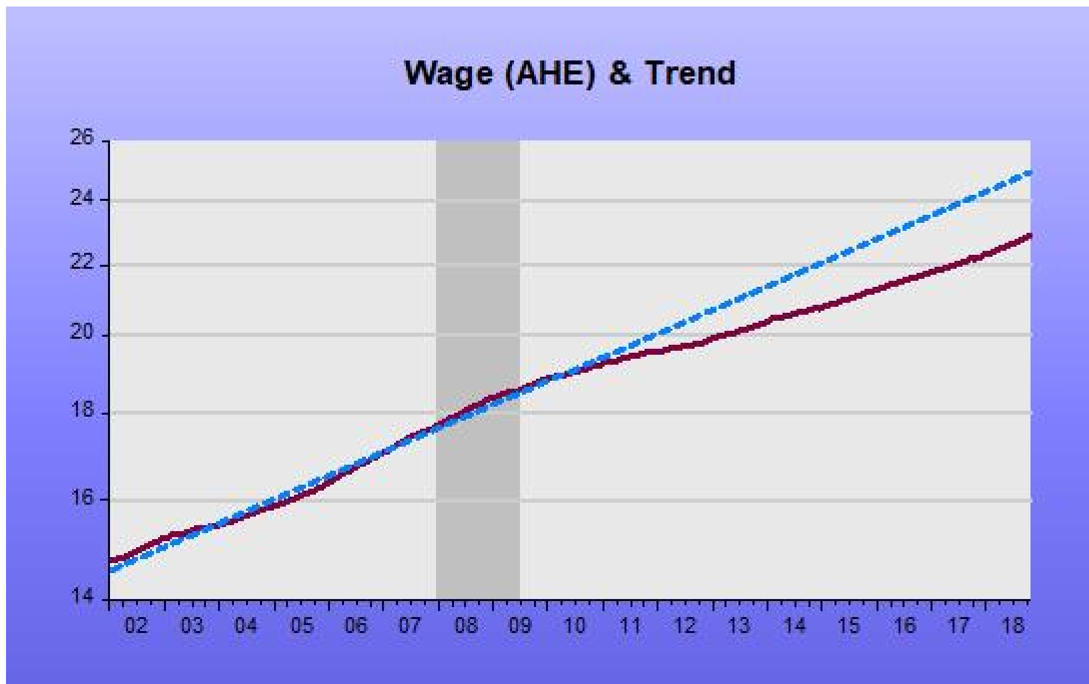


The implication is that the ***level*** of nominal spending is the most important factor, with that being the reason behind the proposal of targeting the level of nominal spending, or NGDP level targeting.

The "low wage growth puzzle" is also "solved". Given sticky wages, a sudden fall in NGDP as happened in 2008-09, the wage/NGDP ratio will markedly increase and the unemployment rate balloons.

Thereafter, with NGDP growing, even at a lower rate, the wage/NGDP ratio begins to fall and so does the unemployment rate.

The next chart shows the adjustment process. Initially, given sticky wages, the wage growth path does not change. After a time the wage growth path adjusts down and unemployment falls.



Therefore, if you want a higher pace of wage growth, increase the level path of NGDP! A new and higher level path will, after the adaptations are complete, continue to be compatible with the goals of low & stable inflation and “low unemployment”. The economy, however, will be “richer”.

Bottom Line: If the Fed continues to worry about (non-existent) inflation implications of “too low” unemployment, the outcome will be, even if not explicitly pursued, a “kink” in the NGDP growth path, which in the short-run will increase unemployment and reduce inflation. The economy, however, will become even “poorer”.