Federal Reserve Chairman Powell Resets the Debate on Monetary Policy

RAPID RESPONSE ISSUE BRIEF* BY **J.W. MASON** | JULY 2019

Introduction

Before 2008 there was a clear consensus among both academic economists and policymakers about the appropriate role for monetary policy—what tools the Federal Reserve should use to steer the economy, and what economic outcomes they were responsible for, and what was beyond their control. After the financial crisis and Great Recession, that consensus began to break down, and over the past decade, the debate has continued to evolve. Fed chair Jay Powell's testimony before Congress earlier this month was one of the most dramatic examples to date of how far the monetary policy conversation has moved from the pre-2008 consensus.

While the Fed chair testifies before Congress regularly, his appearance on July 9 and 10 was an exceptionally noteworthy one. It's no exaggeration to say it signaled a sea change in the macroeconomic policy world. Powell's prepared testimony, and even more his responses to probing questions by several legislators, suggested a collapse of the consensus that guided policy for decades and a major victory for the alternative perspective being advanced at, among other places, the Roosevelt Institute over the past few years. In this brief report, I highlight several areas where his testimony made a clear break with the older conventional wisdom.

Before discussing Powell's departures conventional macroeconomic wisdom first need to review what that the conventional wisdom is.

The starting point for all macroeconomic policy discussions is the up-and-down fluctuations in production and employment in the economy, quarter to quarter, year to year and over longer periods. These fluctuations are driven by how much money households, businesses and government decide to spend. When people spend more, production and employment go up. When people spend less, production and employment go down. And since lower incomes in turn cause people to spend still less, this decline can turn into a self-reinforcing downward spiral we call a recession or depression. The flow of money into the real economy is also known as aggregate demand. Stabilizing demand is the core task of macroeconomic policy.

This fundamental vision—which goes back to Keynes— is not what's in question today. What is

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in question is what policy should do to affect demand—how it is carried out, and what it can and cannot achieve. The answers to these questions in most undergraduate textbooks, and most policy discussions until recently, were based on a set of strong assumptions.

- **Aggregate demand doesn't affect the productive potential of the economy.** In the orthodox view, there is a well-defined maximum level of production in the economy—a fixed capacity based on the country's available labor, natural resources, technology and so on. This is often referred to as potential output. As long as spending is below this level, more spending will call forth more employment and output. But above this level, more spending will just raise prices.

- **The unemployment rate is a good measure of how close current output is to potential.** In the orthodox view, the best guide to how close current output is to potential output is the unemployment rate. In the textbook world, there is a level of unemployment, called the "natural rate" or NAIRU (short for non-accelerating inflation rate of unemployment) that corresponds to output at potential. When unemployment falls below this level, inflation will rise, potentially without limit; when unemployment is above this level, inflation will fall. So the task of policy, in practice, is keeping unemployment near this target rate. Thanks to what economists without irony call "the divine coincidence", the rate of unemployment that stabilizes inflation is supposed to be the same as the one we consider equivalent to full employment. So while the Fed is supposed to have a dual mandate to achieve both maximum employment and price stability, thanks to the divine coincidence these two mandates are really one.

- **A single interest rate is the only tool required to keep output at potential.** The third pillar of orthodoxy is that only one tool is needed to achieve the combined goals of macroeconomic stability, stable inflation and full employment. The Federal Reserve can hit all three targets simply by setting a single interest rate at the right level. As long as the Fed follows the right rule for setting the interest rate, the economy will grow steadily with stable inflation and low unemployment. Neither fiscal policy nor other monetary tools are required. Fiscal policy is also limited by the need to limit government deficits.

- **In the short run money affects the level of output and income but not its distribution; in the long run it has no effects on the real economy at all**. Finally, the fourth pillar of policy orthodoxy says that monetary policy is "neutral." In the short run, it affects the overall level of output and employment but doesn't have important effects on *what* gets produced or on the distribution of income. In the longer term—typically understood to mean periods of more than a few years—monetary policy shouldn't affect the real economy at all. Long run growth and distribution depend on demographics, technology, institutions and other structural factors, not on money or aggregate demand.

Powell's testimony last week—and the larger conversation it reflects—strikes at the base of all four of these pillars. Here is my summary of some of the most important points that came out of the hearings.

1. The US economy is not operating at potential

The first question on which Powell gave a surprising answer was whether the US economy is in danger of overheating. Until recently, the conventional wisdom was yes, so Powell's answer is worth quoting at length:

> *We don't have any basis for calling this a hot labor market. We have wages moving up at a little above 3 percent and that … doesn't even cover productivity increases and inflation. … It's not a high enough wage increase to put any upward pressure on inflation. … 3.7 percent is a low unemployment rate but to call something hot you need to see some heat. We hear lots of reports of companies having a hard time finding qualified labor, but we don't see wages responding.*

This was a striking reversal from just a year or two ago, when the Fed was saying that the economy was at or above full employment. This is one of the comments that led Fed watchers to interpret the testimony as a sign that the Fed, after raising rates steadily for the past three years, is likely to move toward cutting them in the near future. It's also very relevant for any discussion of whether the economy is at full capacity, or whether there is still space for a substantial expansion of public spending. As Mark Paul, Anders Fremstad and I argue in a recent Roosevelt report, the fact that a decade into the official recovery we are still not seeing signs of a genuinely hot economy, is an important argument for a major expansion of public spending on decarbonization.

2. Low unemployment is not a sign of an overheating economy.

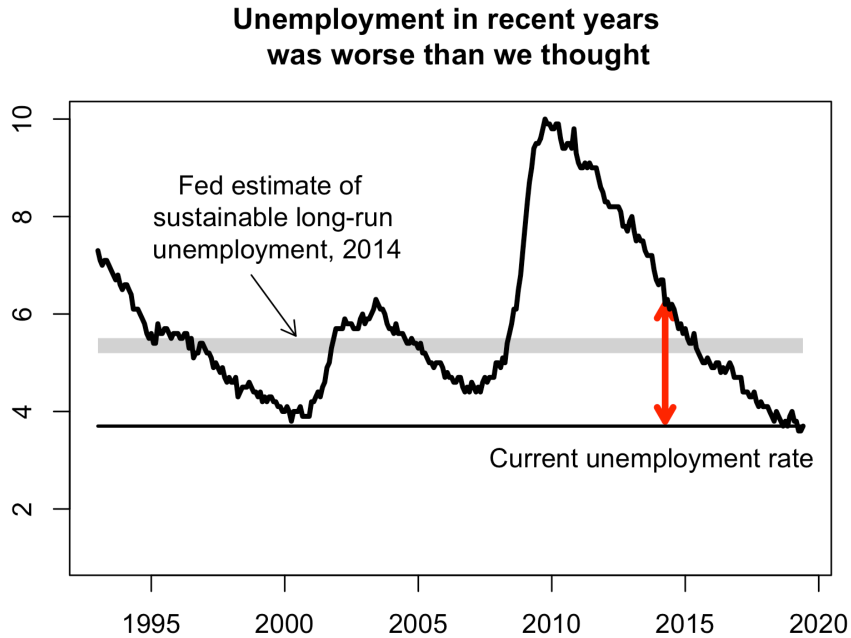
But Powell's testimony before the House went even further than this. He effectively repudiated the calculation that has underpinned macroeconomic policy making since the 1980s - that there is a clear floor that unemployment has to stay above in order to prevent runaway inflation. For decades, the Fed has moved to raise interest rates whenever unemployment fell too low. But if a 3.7 percent unemployment doesn't generate any more inflationary pressure than 4 or 5 or 6 percent, it's not clear why the Fed should be trying maintain a certain rate of unemployment at all.

Under sharp questioning from Alexandria Ocasio-Cortez, Powell acknowledged this point explicitly. "In early 2014," Rep. Ocasio-Cortez noted,

> *the Federal Reserve believed the long-run unemployment rate was 5.4 percent; in early 2018, the Federal Reserve estimated that this was 4.5 percent. Now, the estimate is 4.2 percent. And unemployment is at 3.7 percent today, much lower than that earlier estime.*

Unemployment has fallen about three full points since 2014, but inflation is no higher than it was five years ago. Given these facts, do you think it's possible the Fed's estimate of the lowest sustainable unemployment rate was too high?

Powell replied, "Absolutely. I think we have learned that this is something you can't identify directly."



Powell: The Fed has "absolutely" been wrong about how low unemployment can go.

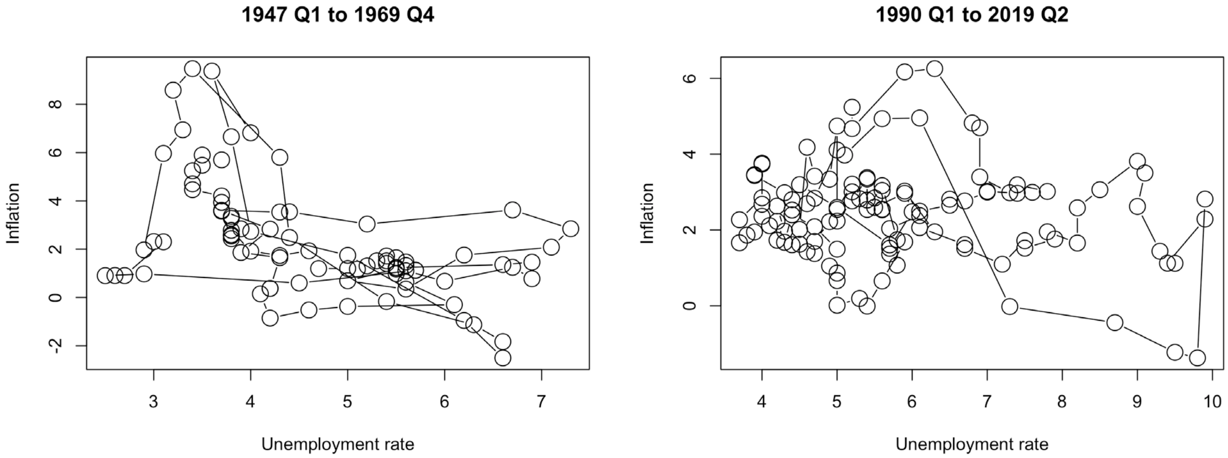
Ocasio-Cortez then asked him what this implies for the Phillips curve - the link from low unemployment to higher inflation. Does this no longer describe the real world? Again, Powell agreed:

The connection between the level of unemployment and inflation was very strong if you go back 50 years. It has gotten weaker to the point where it's a faint heartbeat. It's still there. But I think we have learned that the economy can sustain much lower unemployment than we thought without troubling levels of inflation. I would look at today's level of unemployment as well within the range of plausible estimates of the natural rate.

The "faint heartbeat" line got a lot of attention in the press, not surprisingly—it's a colorful way of saying barely there. Powell, it's true, doesn't want to completely give up the orthodox language. He still talks about a "natural" rate of unemployment that the Fed is trying to match. But in practice, the concept has been attenuated to the point of nonexistence.

If policy makers have no idea where the "natural rate" is, and if plausible estimates extend well below any unemployment rate seen historically, then operationally that is the same as saying there is no floor to unemployment at all. The only way to know if unemployment is too low for stable inflation is if inflation actually rises—which is the same as saying that low unemployment is not informative about future inflation at all.

This, to be clear, is a critique that a number of economists - mainstream as well as heterodox - have been making of the idea of a NAIRU since it came into vogue in the 1990s. But its embrace by the Fed chair is still a big deal.



In the 1950s and 1960s, there seemed to be a consistent "Phillips curve" linking low unemployment to high inflation. But in recent decades this relationship has largely disappeared.

An unspoken corollary of Powell's admission that the Fed was "absolutely" wrong about the lowest sustainable rate of unemployment, is that it was presumably also wrong to raise interest rates starting in 2016. The goal of the rate hikes was to move unemployment up, toward what the Fed believed was the natural rate. If they were successful at this, how many people have had to go without jobs because of that? If there were costs to the Fed's mistaken view of unemployment, they weren't borne by economists at the Fed, but by all the people who were out of work or didn't get raises thanks to the rate hikes of the past three years.

3. Monetary policy is not strong enough to stabilize demand.

One defense the Fed might make against this line of criticism is that the rate increases of the past few years probably didn't have much effect on the economy one way or another. This may well be true - there's little question that big increases in the policy-controlled interest rate can depress real activity, but it's less clear that small changes in either direction have much of an impact. Admitting that the central bank can't reliably control the level of activity with adjustments of the interest rate would exonerate the Fed from the charge of destroying jobs over the past three years. It would also be perhaps as radical a revision of the conventional wisdom as abandoning the Phillips curve. But Powell's testimony pointed in that direction as well.

This came out clearly in Powell's responses to another set of sharp question, these from Rashida Tlaib. As Rep. Tlaib noted, the recovery from the last recession was exceptionally slow and weak. Given its failure to restore demand after 2008, can the Fed be counted on to prevent another deep downturn? Powell's answer was an unambiguous no, it cannot. If there is another severe recession, he said, the Fed can't be expected to stabilize demand on its own, but "would hope for support from fiscal policy." He didn't offer specifics, but in response to a later question by Ocasio-Cortez he seemed to endorse an approach similar to the 2009 ARRA stimulus package.

To be sure, this is consistent with the broader reevaluation of fiscal policy we've seen over the past few years. But it was still departure from the textbook orthodoxy, which says that an appropriate monetary policy rule is the necessary and sufficient condition for macroeconomic stability. It is also, it's worth noting, a departure from much of the more recent conversation about macroeconomic policy reform, which has focused more on broadening the Fed's toolkit through measures like quantitative easing and forward guidance.

Again, this becomes an argument for talking about substantial expansions of the public sector today. One lesson of the ARRA is that "shovel-ready" public projects are harder to find than people imagined when the 2009 stimulus was passed. Public spending, especially on the infrastructure projects that are otherwise attractive stimulus candidates, must go through a number of administrative steps that makes it difficult to ramp them up quickly. So if fiscal policy is required to prevent a downturn from becoming a depression, better to have the spending in place today. Especially if the economy is still far from running hot—and as discussed below, wage gains are still too low to restore workers' share of output—there's a strong case that fiscal policy should be permanently more expansionary. If inflation does ever result, the Fed has the tools to deal with that. It doesn't have the tools to deal with deep recessions and jobless recoveries—as Powell acknowledged in his answer to Tlaib.

4. There is more space for higher government debt than we thought.

Active fiscal policy in a recession implies higher government deficits. Powell didn't only emphasize the need for fiscal policy; he also suggested that the costs of higher government debt are smaller than previously believed.

"We're the world's reserve currency. We keep being able to borrow. My predecessors who predicted more debt would lead to higher interest rates would be surprised that with the debt we have, we still borrow at very low interest rates, because we're the world's reserve currency. We just have not seen higher rates" on government debt. The admission that past warnings of the dangers of high government debt were wrong is important. So is the point that, in an international financial system based on dollars, the US is not subject to eh same kinds of financial constraints other countries might be. Indeed, as I've argued elsewhere, in today's world of dollar payments and unrestricted capital flows, financial stability probably calls for *more* US borrowing from abroad.

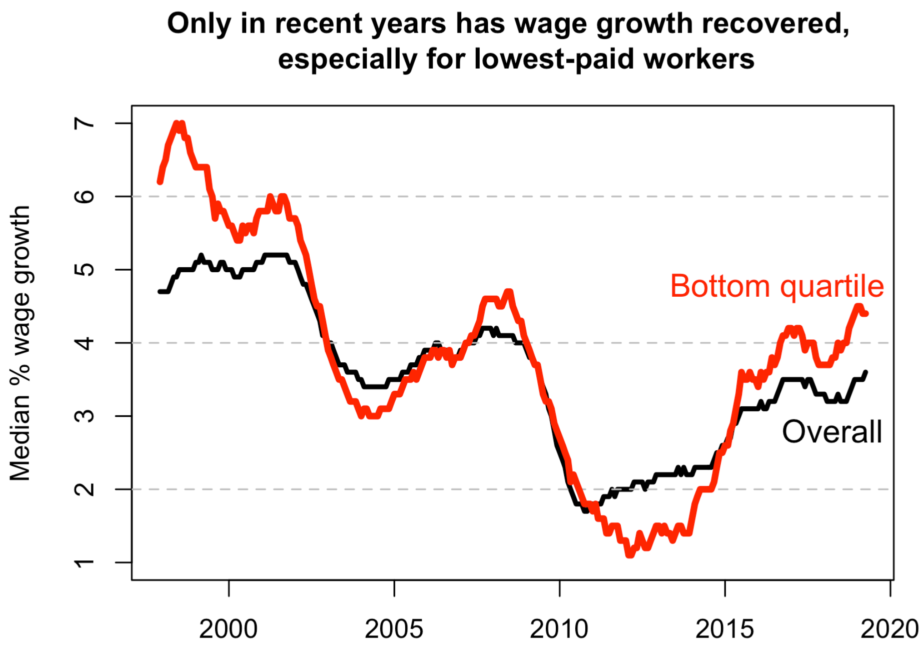
Powell, it's true, leaves some room for concerns about excessive debt, saying that "down the road, at some point ultimately there's a price to pay." But then without prompting from the committee he brings up the case of Japan: "Japan has a far higher debt to GDP ratio than we do and they lower interest rates." Indeed, Japan's debt ratio has passed 250 percent of GDP, triple the current US level, with no sign of rising interest rates, higher inflation or a depreciating currency - the supposed costs of excessive government debt. Powell doesn't let go of orthodoxy completely on this point, reiterating that "somewhere out there way in the future, there has to be in principle" a point where high debt imposes economic costs. But — as Powell , a practical central banker, surely understands — considerations that only apply somewhere out in the indefinite distance, are not important for decisions today. The fact that the foundation of your house is not strong enough to bear the weight of thousands of bathrooms is not something you worry about when deciding whether it should have two bathrooms or three.

5. Macroeconomic policy affects the distribution of income.

Powell did not just agree that the Fed had been wrong about how close the economy was to potential. He also suggested that this error might have farther reaching consequences than conventional wisdom allows. The orthodox view, again, is that monetary policy and aggregate demand in general affect only short run, and that even there they affect only the overall level of spending. They shouldn't have any effects on "real" outcomes like the mix of activity in the economy or the distribution of income. So it was quite striking when Powell on more than one occasion brought up income distribution as something the Fed should be concerned with.

"It's very gratifying that for the past two years the greater part of wage gains have gone to people at the lower end of the wage spectrum and education spectrum," he said early in his testimony. Later, in response to a question about wage growth, he zeroed in on the labor share, the fraction of national income going to compensation of workers, as a key variable of concern:

"Go back to the turn of the century, and what you see is a decline in the labor share, that has not been reversed. We're focusing on the change in wages, but [if you look at] the level, wages are missing ten years of growth. That's really the underlying problem. We're getting reasonable wage growth, but we missed all of those years at the beginning of this century. I think that's a very serious problem, and we [i.e. the Fed] should do a better job of calling it out."



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The idea that the state of labor market affects the share of income going to workers, and that this is something the Fed should be concerned with, may not sound so radical. But it is a major departure from the orthodox view of just a few years ago. Here for example is what Powell's predecessor, former FOMC chair Ben Bernanke, said about income distribution in 2015:

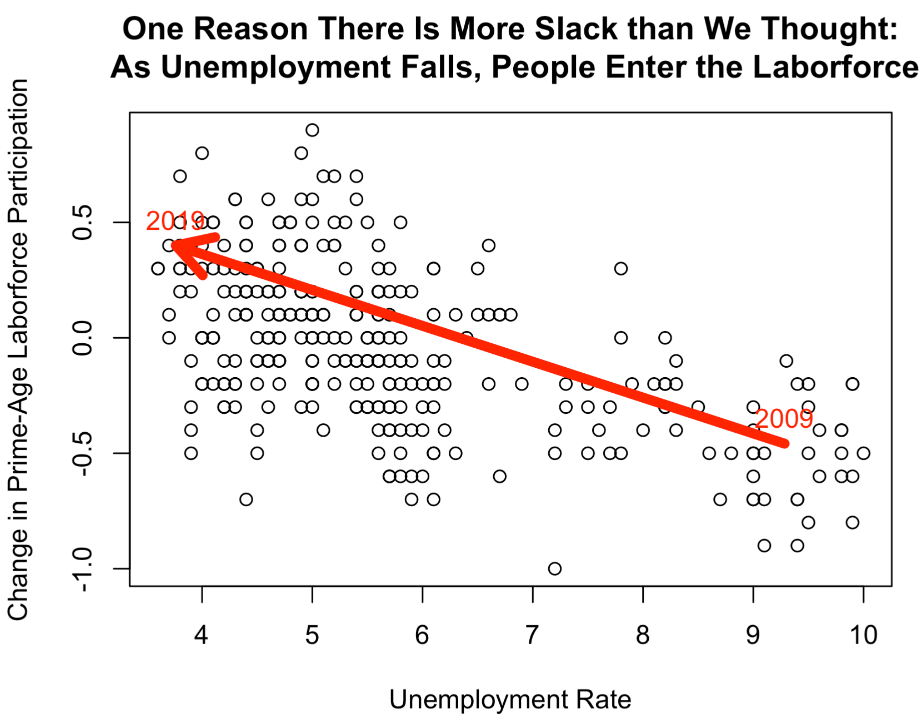
> *Widening inequality is a very long-term trend, one that has been decades in the making. The degree of inequality we see today is primarily the result of deep structural changes in our economy that have taken place over many years, including globalization, technological progress, demographic trends, and institutional change in the labor market and elsewhere. By comparison to the influence of these long-term factors, the effects of monetary policy on inequality are almost certainly modest and transient. Most economists would agree that monetary policy is "neutral" or nearly so in the longer term, meaning that it has limited long-term effects on "real" outcomes like the distribution of income and wealth.*

Note the key elements of the orthodox view here: income distribution is all about "structural" factors like demographics, trade and technology; and monetary policy has little or no effect on real economic activity beyond the short run. Bernanke is quite right that most economists would have agreed with this, and with the corollary — also expressed by Bernanke's successor Janet Yellen — that income distribution doesn't fall within the responsibilities of the Federal Reserve. So it's major departure to see Powell here linking the fall in the wage share to macroeconomic conditions, and explicitly agreeing that it's something the Fed does need to worry about.

6. The labor force isn't fixed, but depends on employment conditions.

Another important aspect of the testimony was how much Powell pushed back against the idea that lack of qualified labor is an economic constraint. He noted, as others have, that in an economy really suffering from labor shortages, we should see rising wages, at least on some industries and occupations; but so far this hasn't been the case. At one point he responded to this point in a way that might seem subtle but was quite striking to those of us who have been debating macroeconomic policy these past few years. Pushed by one of the members to agree that "workers are scarce" and that the problem is "having enough able workforce is key," Powell pushed back, saying that "a tight labor market is pushing all kinds of communities into the laborforce", a point he reiterated later in the testimony.

The idea that the size of the labor force depends on employment conditions might seem obvious. But it has far-reaching implications. The orthodox approach to macroeconomics makes a strict separation between the demand side—which is what macroeconomic policy affects—and the supply side. Supply depends on "structural" factors including, importantly, the available labor supply. Since aggregate demand has no effect on these structural factors, there's no way for it to affect the long-run path of the economy; the only thing it can do is stabilize the short-run path around this given long-run given trajectory.



Powell: A strong labor market is pulling more people into the laborforce.

In the orthodox view, the country has a given supply of labor. Once all those workers have jobs, more spending can't call forth any more labor. Further increases in demand will only bid up wages and, eventually, prices. This is the whole premise behind focusing on the unemployment rate: Workers who don't fit the definition of unemployment - which depends on taking active steps to find work - aren't available for employers. They are assumed to be out of the labor force for reasons that have nothing to do with monetary policy or demand - age, domestic responsibilities, health problems, etc.

An alternative view is that there is no sharp line between in and out of the labor force. Yes, people who are actively looking for work are more likely to be hired. But if demand for labor is strong, people who previously were not looking may well re-enter the laborforce. This is one reason the unemployment rate is no longer a good measure for labor-market conditions - in fact most new hires today come from people counted as not in the labor force, rather than people counted as unemployed.

The fact that a relatively strong labor market draws more people into the labor force, is one reason there has been relatively little wage growth despite the low measured unemployment rate. Despite the complains of employers, labor is not really scarce. It's also relevant for debates about potential output in recent years. While many economists have argued that the decline in labor force participation is due to structural factors outside the reach of policy, a number of others—including the Roosevelt Institute—have argued that much of the decline in labor force reflects chronically weak demand, and could be reversed if demand ever picked up. The fact that a stronger demand is pulling labor force participation up suggests that much of the decline in labor force participation after 2008 was indeed due to weak demand.

The fact that the labor force depends on current demand conditions—is endogenous, in economists' jargon—has more far-reaching implications as well. If the pool of people available for work depends on how much work there is to be found, then we can't think about policy simply in terms of reaching the economy's given potential. Because that potential itself depends on how successful we are in reaching it. Monetary policy, and anything else that affects demand conditions, doesn't just determine how many of the economy's available workers are employed, but how many workers are available in the first place. This phenomenon is referred to by economists as hysteresis. It means that the costs of weak demand are much greater than previously believed, since we miss out not just on jobs and production today, but jobs and production into the indefinite future, as weak labor markets lead to a smaller labor force. This, it is true, is a point that economists at the Fed have noted before. But its larger implication has yet to be taken on board by most macroeconomists - that you can't neatly separate a long run supply side from a short run demand side.

Takeaway: The end of the apolitical Fed?

Ideas like the Phillips curve and a fixed labor supply are not simply theories about how the economy works. They are what allows monetary policy to be thought of as a technical, apolitical question. They are not just ideas which might be more or less true; they *have* to be true for the logic of central bank independence to work.

Without a determinate relationship between unemployment and inflation, there's no reason to think that achieving price stability will also deliver full employment; macroeconomic policy may be forced to choose which of these goals to prioritize. If the growth of the labor force depends on demand conditions, then we can no longer think of monetary policy as being "neutral" even in the long run. Policy is not just stabilizing the economy around a given long-run path, but choosing what that path is going to look like.

Similarly, if policy has important effects on the distribution of income, then it doesn't make any sense for the Fed to say they don't want to pick winners and losers; they are always doing so. All the issues raised in Powell's hearing suggest that monetary policy involves real tradeoffs and conflicting interests. Which means it can't be left to apolitical technocrats. The Fed can't be seen as outside or "independent" of politics, but has to be a subject for democratic debate—in fact one of the most important ones.

The orthodox view of monetary policy—technical, apolitical, neutral—is deeply rooted in American political discourse. So it is probably no coincidence that the most interesting exchanges at the hearings were with newly elected representatives like Ocasio-Cortez, Tlaib, and Ayanna Pressley. When new questions are called for, it often takes new voices to ask them.

At the Roosevelt Institute, we have argued that lack of demand is a bigger problem than structural constraints, and that the Fed needs to broaden both its goals and its tools. These arguments have been taken up by an increasing number of people in recent years. Powell's comments suggest that we may be getting somewhere.