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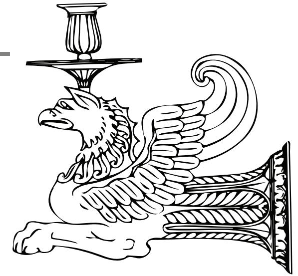

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- The Truth about Optimal Macroeconomic Policy -

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Why the Powell Fed is Dangerous

- The Truth about Optimal Macroeconomic Policy -

On Wednesday December 1, the front page of the New York Times proclaimed Jerome Powell "the most important policy maker in the country." The reality is that Powell has very little power, does not even recognize this, and misuses the power he has. He is the true emperor who wears no clothes.

Jerome Powell has been reappointed as Chairman of the Federal Reserve Board of Governors. His selection has been welcomed by most. To be sure, Powell is a very likeable person. He is middle-of-the-road politically. He is very well-rounded. And he appears to be very even-handed in his choice of policies. Everyone who works with him likes him.

Notwithstanding these points, we have been extremely critical of the Fed and its policies both under Janet Yellen and even more so under Jerome Powell. What exactly has Powell has done wrong in our opinion? To answer this question correctly, we must go far beyond a recitation of Powell's policy errors, and discuss widespread misunderstandings about macroeconomic policy as a whole (fiscal *and* monetary) by central bankers, investors, and market commentators. Only then can we appreciate where policy makers have gone wrong.

Part 1 discusses the true nature of macroeconomic policy. What exactly is "optimal macroeconomic policy" and what does this imply for monetary and fiscal policy jointly? Given this clarification, Part 2 then identifies widespread misunderstandings about macroeconomic policy – monetary policy in particular. Part 3 concludes with a discussion of the reckless and misguided policies of Jerome Powell.

Part 1: Optimal Macroeconomic Policy: What is It?

To understand what "optimal" macroeconomic policy is, we must first understand its goals. Thereafter we can assess whether and how it can achieve them. There are arguably three goals of macroeconomic policy: to achieve full employment, modest inflation, and economic stability. The third goal is rarely mentioned, crucial as it is. For now, simply suppose that price stability and full employment are the goals of policy. When government has the tools required to achieve these twin goals, we say that the economy is "controllable." Otherwise it is non-controllable.

But under what circumstances is it controllable? And how? The most fundamental of all theorems in macroeconomics answers this question rigorously. The "controllability" theorem states that when the number of *independent* policy tools is equal to or greater than the number of policy goals, then the economy is macro-controllable.[1] In today's world, the policy tools available to government for macroeconomic purposes are of two kinds: monetary policy tools, and fiscal policy tools. The former includes setting interest rates, changing the Fed funds rate, and outright bailouts if needed during emergencies.

Fiscal tools include tax rates (on income and on capital) and the degree of stimulus (size of the deficit) that are deemed necessary at any given time. It is currently thought that the number of independent policy tools available to policy makers *is* greater than the number of goals. Thus we do have a controllable economy, in principle. But this is not enough. For to achieve an *optimal* economy (with all goals met) in practice, it is necessary to determine the right *values* of the monetary and fiscal policies at hand. It is here that confusion begins. Two separate issues arise.

First, it is necessary that the two policies be "independent" of one another in the following and limited sense: the Fed must be *able* to set its policy values at whatever level is deemed optimal (e.g., increase the Funds rate from 2% to 4%) *regardless* of what is optimal for fiscal policy (e.g., decrease the fiscal deficit by 1.3%). There can be no impediments of the kind that "If monetary policy needs to be tightened, then fiscal policy must be eased." But this does not settle the issue of determining *which* fiscal and monetary policies are optimal.

Regarding this second issue, the only correct way to determine exactly which fiscal and monetary policies are optimal at a given point in time is to solve a set of equations for the optimal values of *both* policy variables *simultaneously*. There is no such thing as "optimal monetary policy" unless it is accompanied by "optimal fiscal policy," and vice versa for fiscal policy. They must be jointly determined. This is because it is their *joint* impact on the economy that matters in achieving the desired macroeconomic goals.

To sum up, while the two authorities must be *able* to turn their monetary and fiscal policy control knobs in any direction that is called for, the *correct* settings of these knobs must be jointly co-determined. The fact that this point is neither understood nor put into practice is one reason why our fiscal and monetary policies have been suboptimal for decades.[2]

While we shall not discuss the third goal (stability) of macro-policy at length since it is not recognized as a goal of its own, its importance should nonetheless be noted. There are two kinds of stability that citizens want. First, they want the levels of economic growth and inflation to be stable over time, and not to gyrate. No one wants to be regularly hired and then fired. Optimal

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[1] This was first proven for the case of a static economy by Jan Tinbergen in 1953. He would become the first person ever to receive the Nobel Prize in economics. His basic result was then made rigorous and extended to the dynamic case by Kenneth Arrow and Mordecai Kurz in their path-breaking book *Optimal Fiscal Policy* (1970).

[2] This point is formally proven and is discussed in the last three chapters of the Arrow-Kurz book.

fiscal and monetary policy can go a long way in achieving this kind of stability assuming that these policies are correctly determined - a strong assumption. But more is needed: the regulation of debt and leverage. This is because the *cause* of instability is often excess leverage. This has been true throughout economic history, which is pockmarked with “debt cycles.” For example, the Global Financial Crisis of 2008-2010 was caused solely by record levels of leverage in the American housing market. This led to a collapse in US housing prices that in turn caused two New York investment banks to go under. The rest is history.

In the last decade, both monetary and fiscal policy makers have not only condoned the arresting explosion of debt and leverage we have witnessed but have encouraged it, as we see below. For this reason, just as independent monetary and fiscal policies are needed in their own domains, debt and leverage policies are needed in their domain as well. Moreover, such policies should be determined by a third and independent authority charged with preventing instability due to reckless increases in debt and leverage, and to the commonplace misuse of “derivatives.”

With these very basic points in mind, we can now discuss in Part 2 some widespread misunderstandings about optimal macroeconomic policy as it is currently conceived. Then in Part 3 we can zero-in on Powell’s own mistakes and why he should not have been reappointed as Chairman of the Fed’s Board of Governors.

Part 2: Real-World Misunderstandings about of Macroeconomic Policy

Confusion #1 - Monetary Policy: In 1979, Congress “mandated” the Fed to target both price stability and full employment. Via elementary controllability theory, it is clear that it could never achieve both of these goals on its own. It does not have enough independent policy tools to do so. Thus the mandate was a self-contradiction. Congress is clearly responsible for fiscal policy, and its Fed mandate did nothing more than to ask the Fed do its own dirty work. [Imposing fiscal duress can cost votes.] All this being obvious, it is surprising how post-Volcker Fed chairpersons have talked *as if* the Fed were capable of controlling the economy and inflation regardless of what Congress does.

What the Tinbergen-Arrow-Kurz theory makes clear is that the Fed should use its own tools (e.g., setting interest rates) to manage monetary policy at the same time as Congress uses its tools to manage fiscal policy. And the particular fiscal and monetary policies that should be implemented (e.g. a rate hike of 2.1% and a deficit reduction of 1.3% of GDP) must be jointly optimal in that they have been simultaneously co-determined as within the Arrow-Kurz theory.

An additional confusion – one encouraged by the Fed – is its claim to be able to control not only the Fed funds rate, but longer-term rates as well. It claims to be able to do so by QE, that is, by buying up lots of bonds of longer maturities. This artificial increase in the demand for bonds is

thought to raise bond prices and lower yields. Other things being equal, this assertion is correct. The problem is that other things never are equal. And "other things" usually swamp the ability of the Fed to regulate longer-term rates, as Fed Chairman Volcker explained decades ago.

For example, when the Fed was claiming that QE was driving down longer-term rates after the the Global Crisis of 2010, the real story was that a global flight to quality was driving down the yields of *all* developed-nation bonds – even in the case of Canada and other nations where there was no QE at all. As the Nobel Laureate James Tobin pointed out back in 1948, controlling long-rates is a game of David versus Goliath. In this game, whereas the Fed can only muster the funds to buy a few trillion dollars of bonds in a given year, private investors in the bond market can muster 10 times as much money with which to impact bond prices by buying or selling their bonds regardless of the wishes or activities of the Fed.

A case in point may help here. Suppose the Fed wishes to lower bonds yields by 1% and plans to do so by buying up two trillion dollars of bonds. Then, if for reasons of their own, investors as a whole seek higher yields to compensate for higher inflation, they will dump as many bonds as are needed to drive up yields to the level where they receive a proper inflation premium. And investors worldwide hold a huge number of bonds that they can dump compared to the relatively few bonds that the Fed can afford to buy. The *net* result: bond prices fall and yields rise. David versus Goliath.

Confusion #2 - Fiscal Policy: In the case of monetary policy, there is a real-live person in charge, even if this emperor wears few clothes. The fact that there is "someone in charge" means that all eyes are upon him and his every utterance. Contrast this situation to that of fiscal policy. There is no one in charge. There is little understanding of what fiscal tools are real and legitimate – and not mere fiscal gimmicks that are illegitimate. For example, what does tax policy now amount to given today's gridlock in Washington? Every proposal to raise taxes to pay for trillions of new "benefits" is opposed, thus dimming any prospect for significantly increased tax revenues.

Analogously, there is no agreement as to how big deficits should be, much less whether soaring national debt even matters in today's era of Modern Monetary Theory. Even worse, taxpayers rightly believe that the tax rates and deficit size that emerge from Congress are not the result of rational analysis, but rather of highly politicized sausage-making. "At least the Fed has someone in charge, is independent of Congress, and knows what it is doing."

The irony here is that the power of a supposedly rational Fed to impact the economy pales compared to the power Congress has when setting fiscal policy. For example, during the Covid crisis of the past two years, the Fed has done almost nothing to bail out the economy except to buy in assets in an ongoing manner. But as most everyone now agrees, it was fiscal largesse that mattered and that restored GDP to its pre-Covid level: trillions of dollars of handouts to almost everyone. Yet the large outward shift in the demand curve due to fiscal policy when combined with totally predictable supply-side shortages guaranteed that inflation would result. It has.

Accordingly tighter monetary policy should have come into play, offsetting excessive fiscal stimulus. But it never did. The Powell Fed simply maintained the most dovish policy in modern history as if it had no responsibility to do anything proactive to forestall inflation. And it still has not done anything. Despite a near tripling of inflation, Powell simply talks on and on about reducing asset purchases "soon" but has failed to do so as of this writing, and has likewise not increased interest rates at all.

Confusion #3 – Enhancing Economic Stability: As noted above, this third goal of macroeconomic policy has for decades been largely ignored as a goal of its own, supported by a designated set of control variables targeting stability. More specifically, both the Fed and Congress have completely dropped the ball in controlling the ongoing explosion of excess leverage we all witness. Indeed, monetary policy and fiscal policy have arguably *driven* this increase in potential instability. First, Powell's "zero-rates-forever" policy has made stunning levels of borrowing *irresistible* to the housing and corporate sectors. Second, Powell's ongoing deregulation of the banking system (see Part 3 just below) has further stimulated borrowing and leverage.

Many of us worry that our over-leveraged real and financial economies pose a very grave threat to future stability. This being true, it is astonishing that policymakers have encouraged rather than opposed recent developments. It is hard not to conclude - as many have - that Wall Street has bought Washington hook, line, and sinker. The denizens of Wall Street just love leverage. It permits incomes to increases from a mere $5 million per year, to $50 million per year.

Confusion #4 – Overestimating the Impact of Piecemeal Changes in Macro-Variables: The main point of Part 1 above was to stress that it is meaningless to talk about either optimal monetary policy or optimal fiscal policy *on its ow*n. For the only thing that can be "optimized" is the *doublet* of optimal fiscal *and* monetary policy. Optimal policies can be determined by solving the simultaneous equations of controllability theory for the values of all the control variables. These cannot be determined in a piecemeal and uncoordinated manner.

Nonetheless, current Fed policy is discussed as if it were completely independent of fiscal policy. Thus we read that "by reducing QE asset purchases, and by raising rates by 1%, the Fed will be able to quell inflation." Or we read that "Congress can both increase growth and reduce inflation by passing the President's 'Build Back Better' proposal." Incredibly, Biden claimed exactly this on December 1. The reality is that changes in either monetary or fiscal variables on their own will typically have a much smaller-than-expected impact on the economy than is commonly supposed.

In today's context, does anyone really believe that inflation would be brought back under control were the Fed to raise the Fed Funds rate from 0.6% today to 1% or even 1.5%? The reality is that such modest increases will do virtually nothing to curb inflation, especially since such changes in Fed policy will be implemented at least a year after inflation took off, thus causing inflationary *expectations* to rise in the interim. In this regard, former Fed Chairman Paul Volcker back in 1981 found himself forced to raise the Fed Funds rate from 7% in 1978 to 21% in order to quell

inflation. He told me that he never expected he would have to raise rates higher than 15%. It is also noteworthy that vastly higher interest rates in and of themselves did *not* bring down inflation. Rather it was the collapse of the financial markets along with two back-to-back recessions due to sky-high rates that *caused* inflation to fall significantly.

Contrast these earlier Volcker Era policies with those contemplated by the Powell Fed. Just prior to the advent of the new Omicron virus, Powell talked about raising the funds rate by some 30 basis points in 2022. Is this a bad joke given that an increase of some 1600 basis points was required between 1978-1981? Yet with the new mutant virus, it is now doubtful that Powell will actually raise rates – indeed he may lower them.

> *The bottom line to date is that, despite the triad of strong employment growth, a labor shortage, and rising inflationary expectations, the Chairman has not raised rates by one single basis point.*

A final point should be made in this regard. The “risk” that raising rates will adversely impact growth and/or tame inflation on Main Street is much less today than it used to be. This is because the economy is now completely dominated by service industries where changes in interest rates matter much less than they did in the past. Businesses in the service sector do not build large plants where “interest rate hurdles” matter. Nor do they need to build inventories in our age of “just in time” inventory management. In the past, the Fed could manage the inventory cycle just by changing rates. Finally, today’s fastest growing new firms raise needed funds through various forms of venture capital, and are largely interest rate insensitive. We refer the reader to the excellent 2018 book *Capitalism Without Capital* by Jonathan Haskel and Stian Westlake. The title speaks for itself.

The fact that the economy is much less interest rate sensitive than it used to be should have emboldened the Fed to proactively forestall inflation much *more* than it used to do – not less. But the decline in sensitivity of the economy to rates was never once mentioned. To be sure, there is one sector of the economy that hangs on every word about the prospects for interest rates, the Fed funds rate in particular. This is the financial sector - Wall Street and the markets. But while the markets are rightly fearful that higher interest rates will depress asset prices, this should not matter to the Fed at all – just as it never mattered to Volcker. For the mandate of the Fed is to manage goods and services inflation on Main Street, and not asset price inflation on Wall Street.

The same exaggeration of the impact monetary policy will have on the economy is also true of fiscal policy. Traditionally, it was gospel that increased deficits will boost the economy and thus inflation. But as we have stressed in many essays, the *degree* to which a fiscal boost impacts the economy depends largely on *how* the additional funds are spent. In particular, if additional money goes directly into the pockets of consumers on Main Street, both economic growth and inflation will be driven upwards. For the resulting outward shift in the demand curve will increase both GDP and inflation. This is axiomatically true.

In recent years, the first time that inflation increased was during 2020-2022. This was partly due to Congressional fiscal largesse that went directly into the pockets of consumers. Even newspaper commentators talk about the excess demand shock we have experienced – and experienced during a time of shortages. Conversely, a trillion dollar increase in the deficit due to a large infrastructure bill will have a negligible impact on the economy to the extent that **(i)** the investments end up raising productivity, and **(ii)** the funds will be dispersed over 15 years, not in one year. The same is true when increased funds are spent on bailouts which do not impact GDP or inflation but simply keep mismanaged firms afloat for longer than they should be.

> *As a general rule, whenever you hear that a given macroeconomic policy variable will be changed by the authorities, assume that the impact of the change will be 1/3 of what the consensus predicts. You will end up correct most of the time.*

Part 3. Governor Powell's Mistakes

Given this background, we can now assess the damage to date that is attributable to Powell's leadership. We find fault not only with his policy errors *per se*, but with his overall failure to understand the nature of optimal macroeconomic policy as discussed above. To be fair, Powell himself is not a trained economist. In this regard, it is understandable that he may not understand the all-important point about macro-controllability that we have stressed. But the economists advising him *should* have understood this, though there is nothing to suggest that they did. Monetary policy was carried out without regard for the impact of fiscal policy.

Failure #1 – Not recognizing the danger of his zero-rates-forever policy: Did Powell not realize that, when the economy smartly recovered during 2021, it was high time to tighten policy and raise rates? The unemployment rate tumbled over ten months to levels lower than anyone expected. And there was a widespread shortage of labor. Was this not enough of a signal? Furthermore, Powell has kept reassuring the financial markets that the economy will soon return to the "new normal" of very low inflation and zero-rates-forever. There is nothing whatsoever in financial market history to suggest this happy outcome. To the contrary, history is replete with examples of how structural changes of one kind or another can cause well established trends in inflation and interest rates to *reverse*. We believe this is now happening on several fronts, as discussed in recent essays. Powell for his part has failed to give any serious justification for his Pollyanna views about the future – views he finally is being forced to revise, as signaled by his dropping the adjective "transitory" in describing today's inflation.

But there are other problems more serious than Powell's interest rate policies. Consider that most citizens' money is invested in insurance companies or else in pension funds of various kinds. For these institutions to fulfill their longer-run fiduciary obligations, they were for decades required to invest "prudently" and accordingly held a significant number of government-guaranteed obligations. However, Powell's extremely low rates have forced them to go way out

on the risk curve. They now hold assets such as securitized corporate debt which, while deemed "investment grade" by the rating agencies, are anything but. Remember those extremely "safe" securitized mortgage-backed obligations whose values collapsed in 2008?

Consider also the millions of individual citizens who wish to invest in safe assets each year for their retirement. As traditional 5% yields dropped to 0.5%, they too were forced to go out on the risk curve – or else to reduce their savings rates. Without a compounding rate of return that is positive, what is the value of saving for the long term? Related to this point is the fact that Powell has kept *real* interest rates very negative. He did not have to.

Then there is the adverse impact of ever lower rates in boosting housing prices. There are few observers today who deny that the housing market is in a bubble, due to low rates and to reduced down payments. It is *incredible* that the leverage in housing now exceeds that of 2007 when the 2008 crash in American house prices precipitated the Global Financial Crisis of 2008-2010.

Failure #2 – Powell's deregulation of the banking system: Elizabeth Warren and I agree on very few matters. However she was quite on the mark when she said in October that "Chairman Powell is a dangerous man who should not be reappointed." She said that for four straight years he undermined the stability of the US banking system by significantly deregulating it. The Fed's actions have moved the nation ever closer to future financial crises and bailouts to be funded by taxpayers, as happened in 2008-2010.

To paraphrase Dennis Kelleher in the October 28 edition of the *Financial Times,* Powell has sabotaged the most important banking reforms imposed after the 2008 financial crisis in five areas: **(1)** the stringent new capital requirements on banks; **(2)** the improved supervision of banks; **(3)** the curtailing of proprietary trading by banks; **(4)** the creation of "living wills" allowing stricken banks to be safely unwound; and **(5)** increasing the requirement that banks increase their holdings of truly liquid assets. Kelleher claims that "each of these financial protections was significantly weakened by the Fed under Powell, leaving the overall structure of the regulatory framework impaired and materially reducing the resilience of banks." He goes on and convincingly explains his views in his column.

Interestingly, both Fed governor Lael Brainard and FDIC director Martin Gruenberg strongly dissented from Powell's deregulatory policies. [Brainard was the alternative candidate for the new Fed chairmanship.] All in all, Powell gave the big banks everything they wanted to be able to indulge in ever riskier behavior when the US asset markets were already in a dangerous bubble. Again to paraphrase Keller:

> *"Not only did Powell's Fed permit banks to engage directly in activities rendered verboten after the 2008 crash, but they were also enabled to do more of these activities indirectly through investments in venture capital and loan funds, some of which have already been shown to be unstable and unsafe. The Fed's deregulations have weakened the financial reform legislation meant to protect Main Street families' jobs, homes, savings and so much more."*

Failure #3 – Ignoring the requirements of macro-controllability: For over five years, nothing suggested that Powell or his advisors understood the requirements of macro-controllability. The result was disjointed, seat-of-the-pants macroeconomic mismanagement. For example, the *huge* fiscal stimulus by Congress ensured economic recovery regardless of whether interest rates had been raised to, say, 3% today. [Recall why an increase of rates to 3% or even 5% would have little impact on Main Street in today's service economy.] But Powell never considered raising rates to offset unprecedented fiscal stimulus. He acted as if monetary policy existed in a world of its own – *his* world. And he evinced no understanding of the damage that zero-rates were wreaking on Main Street where risk averse investors were forced further out the risk curve. Such tradeoffs caused by zero rates were never identified as tradeoffs. Incredible!

Failure #4 – Powell's disregard of excess leverage, and his creation of a "casino economy": Perhaps the most egregious error of Powell's was to remain silent about the staggering increase in leverage that took place on his watch. Leverage in housing and throughout the corporate sector has risen to an all-time high, according to many statistical measures. Only in the last two months has the Fed itself finally expressed concern over "excessive debt." But not only did Powell fail to identify excess debt as the problem it is, or to oppose it, but his policies generated ever greater debt and leverage. They did so by making money "free" and irresistible to investors keen to make yet another deal. Even worse, Powell was personally responsible for supporting the deregulation of the banking system as detailed above.

In this regard, the contrast between Powell and the late Paul Volcker is stark. Volcker saw excess leverage to be the scourge it is, and fought it, whether by his proclamations or by his "Volcker Rule" aimed at reining in the reckless behavior of banks. Powell on the other hand has acted as if leverage were irrelevant, and has undone much of what Volcker achieved.

Our case rests. Wall Street won. Main Street lost. Powell's Fed has acted imprudently in the extreme. His reappointment was a mistake.

December 7, 2021

H. Woody Brock

"Twin Quarries"

Gloucester, Massachusetts