

I want to draw your attention today to what I perceive as a cultural lag in thinking about the objectives of economic policy. Why are we still so focused on fighting inflation? Why are so many people in this room devoting so much time and attention to guessing when the Federal Reserve will start raising short-term interest rates and get back to its “normal” job of protecting us from inflation? Is inflation an important threat to our economic well-being? Is when to raise interest rates the most urgent question facing the Fed at the moment? Or are we suffering from cultural lag?

Collecting linguistic evidence of cultural lags is a minor hobby of mine. I smile when I catch myself referring to the refrigerator as the “ice box,” because that was what my mother called it, although she didn’t actually own one. I am amused when young people tell me their phones are “ringing off the hook.” Have they ever used a phone with a receiver on a hook? When bureaucrats say they are eager to break out of their silos, I wonder if they if they have ever lived on a farm or anywhere close to a silo. So when politicians and financial journalists ask me earnestly, as they do, whether the Federal Reserve isn’t risking devastating “run-away” inflation by buying all those bonds, I suspect cultural lag. What Inflation? We should be so lucky! Central banks have amply proved that they know how to stop inflation—Paul Volcker showed that. They have been much less successful in getting little inflation going.

A lecture in honor of Paul Volcker is the perfect occasion for raising the fundamental question: are the major advanced economies (US, Europe, Japan) facing a new normal for which current tools of monetary, fiscal, and regulatory policy need to be restructured? In the Volcker era of central banking, inflation was the principal threat to sustainable growth—and central bankers had to be brave enough to raise interest rates to tame the beast and steadfast in communicating their determination to do so. Paul Volcker demonstrated that he was a brave man.

But after Volcker slayed the dragon over three decades ago, inflation gradually drifted down, and the beast has hardly wiggled its tail for a long time. The last time the core PCE hit 3.0 percent was 1992. The surprise of the second half of the 1990s was the co-existence of strong job growth, low unemployment—with the unemployment rate even dipping briefly below four percent—and no worrisome rise in inflation. The surprise of the current long recovery is that, even with decent economic growth and persistently impressive job creation, we still have wages barely budging and inflation below two percent and recently falling. Just possibly, destructive inflation is an oh-so-last-century threat that should be moved down our list of macro-economic concerns to make room for others. In any case, it is threat we know how to deal with, so we should focus on the ones for which we are less equipped.

Yet many economists worry about that elusive animal, the NAIRU. The rhetoric of many politicians and much the financial press implies that we face a dangerous inflation-prone world. Recent Fed statements talk a lot about “normalization” of monetary policy.[1] That means getting back to a situation in which the role of a central bank is guarding against inflation by raising short-term interest rates.

Fed statements assure us that our central bank is actively planning how to get back to “normal,” and will start raising short-term rates as soon as it can appropriately do so. They explain that the central bank has to be “patient” while the economy returns to normal wage and price growth, which they expect it will soon. But six years into recovery with inflation still falling the words sound a bit plaintive, as though our central bank were saying, “Please be patient with us; we want to get back to normal but economic conditions won’t let us.”

But suppose that the major advanced economies actually face a new “normal,” in which inflation is low on the list of threats. In this new world the top-of-the-list threats to prosperity in large advanced economies are financial instability, slow growth with tendencies to deflation, and the concentration of income, wealth and political power in the hands of a small number of people.

I am not asking you to buy a hypothesis that inflation is dead forever or that we are stuck in secular stagnation. Larry Summers has made a strong case for stagnation worries in NABE speech last year,[2] but I am older than Larry--old enough to remember the last round of stagnation theories. I was in Alvin Hansen’s last class. I am skeptical of secular stagnation, indeed, secular anything; the real world has a tendency to upend economists’ long run expectations with disturbing reliability.

Nevertheless, if wages don’t pick up significantly in the next few months or weakness in the global economy saps our recovery’s strength, down-side risks might plague policy makers for quite a while. And you don’t have to believe in secular stagnation to appreciate the importance of reexamining the tools of economic policy to deal with a world in which worrisome inflation is at most a low level threat and other problems loom a lot larger.

Over-coming cultural lag in order to prosper in a post-inflation world will take significant shifts in the mind-set of economists, economic policy-makers, politicians and the public. I see four major challenges to current thinking:

We have to recognize that the main job of central banks is avoiding financial crisis.

We will have to get used to central banks operating at quite low interest rates much of the time and managing big balance sheets without apologies.

We have to rehabilitate budget policy to make it useable again and move to a sustainable debt track at the same time

We have to find constitutional ways of reducing the power of big money in politics and economic policy—or change the Constitution.

I will get back to these four challenges, but first a very quick tour through the macro-policy landscape of the last five or six decades.

Taming the inflation beast

The second half of the 20th century was a good time for the advanced economies. Economic policy, both monetary and fiscal, got a lot of the credit, probably more than it

deserved. The consensus goal of economic policy was to keep the good times rolling by smoothing out the ups and downs of the business cycle. At least at the beginning of the period fiscal policy was thought to be useful in stimulating aggregate demand and job creation in recovery; central bankers were thought to be useful in the boom part of the cycle when the problem was how to stop inflation before it became unstoppable.

Central banks warmed to the task and got increasingly explicit about their mandates to moderate inflation. They set numerical targets for inflation and emphasized their commitment to achieving them, in hopes that credible intentions could make painful policy measures less necessary. Even the Federal Reserve, with its dual responsibility for price stability and maximum employment, concentrated on moderating inflation on the grounds that inflation was the biggest threat to sustainable growth and employment. The challenge was to find the right moment for removing the proverbial punch bowl as the boom phase of the cycle gathered steam.

Timing was everything. Tightening too soon could slow growth, throw people out of work, and undermine prosperity; waiting too long was dangerous because inflation was so hard to stop once it got started. Inflation was perceived as a lurking predator that had to be stopped in its tracks before it took off in a self-perpetuating upward spiral. Fear of inflation had institutionalized mechanisms to protect the public from its ravages. Escalator clauses in multi-year union contracts and indexing of public pensions served this purpose, but perpetuated inflation once it accelerated. Even more worrisome were inflationary expectations that became self-fulfilling prophecies. Once inflation got out of control, the only remedy was hard monetary tightening that risked sending the economy into a tailspin. Examples of over-tightening that precipitated recession included the actions of the Volcker Fed.

Back in the 20th century, adults in the US and Europe had personal experience of inflation in their lifetimes and had heard about the chaos of hyper-inflation when grocery-shopping required wheel-barrels full of cash and savings and pensions became worthless. Germans relived the runaway inflation of the 1920s for decades as tales of that desperate period imbedded fear of inflation in their culture. Developing countries provided proof that hyperinflation was not just a scary tale from a bygone era.

But by the turn of the century economists were talking about “The Great Moderation.”[3] Recessions were shorter and shallower; inflation was more contained. Central banks got—or took--much of the credit for the Great Moderation, although the stabilizing effect of welfare spending and progressive taxation may well have played a role. Markets hung on the words of central bankers; the financial press perceived them as endowed with magical powers. Politicians understood that the unpopular action of raising interest rates at the critical moment was necessary to moderate inflation. They didn’t want to take unpopular actions themselves, so they respected central bank independence. In the United States there were still vocal critics of the Federal Reserve, who thought the central bank focused too much on inflation. They carried the populist banner of opposition to money and power, but did not seriously threaten Fed independence.

But even as the prestige of inflation-fighting central banks soared, other threats appeared. After 1989, Japan was battling deflation and other countries realized deflation could happen to them.[4] Monetary authorities began to talk about minimum, as well as maximum targets for inflation. Zero inflation seemed risky in a down-turn, because it could so easily lead to deflation, and undesirable in a recovery because the downward stickiness of money wages made it hard to move labor into more productive uses.[5] The prospect that inflation could start suddenly and get out of control quickly also became increasingly remote. The self-perpetuating mechanisms, such as escalator clause in labor contracts, were disappearing. Internet communication, outsourcing, and increasingly competitive wage and price markets were reducing upward pressure on prices. Above all, the longer inflation remained quiescent the less people expected it to flare up. These days, when I give my students a monetary policy exercise, I can't get them to regard inflation as a serious threat.

The decline of fiscal policy

During the Great Moderation discretionary fiscal policy fell out of favor. Using “public works,” as we called infrastructure then, and public employment to counteract recession was a legacy of the New Deal. Both were featured in the policy response to the deep recession of 1973-74, but were less prominent in subsequent recessions. Economists pointed out that getting major infrastructure projects up and running was too slow a process. By the time the shovels hit the ground, the recession was over and public infrastructure projects were only adding to the inflationary pressures of the next boom. The mantra that fiscal stimulus should be “timely, targeted, and temporary” excluded major public works. Tax cuts (especially fast rebates) were still a favorite anti-recessionary tool of politicians, although many economists warned that such tax windfalls tended to be saved, not spent.

Rising distrust of government also curbed the use of budget policy. Hostility to government, especially the federal government, is a deeply ingrained American attitude that has risen to fever pitch in recent years. Rising anger at government may have been fueled more by the growth of regulation (environmental, safety, employment) than spending, but it merged into widespread antagonism to “big government” and suspicion of bureaucrats and politicians. Railing against government spending became standard campaign rhetoric even on the left and led to surprising, often counter-productive political moves like getting rid of earmarks.

As faith in discretionary fiscal stimulus waned, monetary policy emerged as the major tool of economic stabilization in both directions. When the economy tipped into recession (2001, 2007) the Fed brought short-term interest rates down rapidly to unprecedented levels. The rationale was not so much to stimulate investment, which was unlikely to be successful in the absence of a turn-around in demand, but to energize the “interest-sensitive sectors” of the consumer economy--housing, automobiles, and consumer durables. Unfortunately, this tactic (on top of lax regulation and an accelerating appetite for risk) contributed to the housing bubble and the credit explosion that fueled the financial crisis. It also contributed to the reaching for yield that made risky behavior so inviting until it all came crashing down.

What have we learned?

This is not the place to go into the multiple causes of the Financial Crisis. There has been plenty of analysis and blame assessment and will be more. I still find it amazing in retrospect that so many smart economists—including this one—failed to see the disaster coming, although we all thought we were keeping pretty close tabs on the economy. But it happened and the monetary and fiscal authorities—the first responders of financial catastrophes—did a remarkable job of containing the damage and averting total meltdown. Still the costs of the crisis were enormous and cannot be recouped.

The most important lesson is that we must not let a major financial crisis happen again. In an inter-connected world economy where finance is so dominant, the cost in human suffering, in lost livelihoods and lifetime savings, and hopes derailed is too high to repeat. This is no time for complacency, for pretending that not much happened because the stock market is back or the bailout was paid for. It wasn't the bail out that was costly; it was the world-wide devastation of the crisis itself.

Crises can have various sources, but that is no excuse of not learning the lessons of this one. We learned the hard way about the dangers of allowing lending standards in mortgage and other consumer finance to deteriorate drastically, about the risks of undercapitalization and over-leveraging of financial institutions, about excessive reliance on short-term financing, lack of transparency in derivatives markets, misleading bond ratings, and a bunch of let's-not-do-that-again rules that must not be forgotten. We learned we needed better tools for closing down a troubled financial institution without infecting the rest.

So come back to my four challenges for economic policy in a post-inflation world. What can we do to overcome the cultural lag?

Recognizing that the main job of a central bank is avoiding another 2008

First, we have to get used to the idea that the primary job of a central bank (together with other regulators) is to reduce the risk of financial collapse that could throw the country and the world into another deep and prolonged recession. Financial instability in the advanced economies is a far greater threat to world prosperity than the risk that inflation could get out of control. Unfortunately, if central banks keep interest rates low enough for a slow growth world, they risk creating asset price bubbles based on cheap credit that can end in financial catastrophe. Raising rates is not the right response to containing asset price bubbles or avoiding financial meltdown. An array of sharper tools is needed. Dodd-Frank was an attempt to create those sharper tools, but, like all major legislation, it was an elaborate compromise among multiple stakeholders. We are still a long way from agreement on how the tools should work and how to use them. The hydra-headed financial regulation structure that survived the crisis has not demonstrated an ability to work effectively together.[6]

Avoidance of systemic risk or macro-prudential supervision, as the ugly phrase has it, is a much harder assignment than monetary policy. The authorities have to strive for smart,

effective regulations and flexibility without undue burden. Opponents will argue that regulation could reduce financial sector profits or even cut a sliver off economic growth, but this argument should not be a conversation stopper. The cost of another 2008 is so high that such trade-offs must be weighed and debated.

Actions to reduce systemic risk arouse hostility in the financial services industry, which can threaten the independence of the central bank and other regulators if backed by big money and political influence. Brave central bankers—the Paul Volckers of the future—will have to have the courage to raise capital ratios and lower leverage ratios when instability threatens and use selective credit controls to contain asset price bubbles. In the past, threats to the independence of the Fed were diffuse populist reactions to the high interest rates and limited political clout. But recent critics of monetary policy have come from the right, not the left. An alliance of proponents of tighter money with critics of systemic risk regulation could be a well-financed coalition.

Monetary accommodation as a normal state

It would surely be nice to get back to the hoped-for “normal” in which wages rise with employment and measured inflation comes back in the more comfortable range of slightly above two percent. Then the Fed could raise short-term rates and use its newer tools of interest on reserves and overnight reverse repos to keep inflation moderate and manage the balance sheet. With any luck, the recovery will strengthen, but when recession eventually threatens again, the monetary authorities will have plenty of room to be accommodative.

But suppose it doesn't happen and slow growth with low inflation persists. Then monetary authorities will have to stick with low interest rates and maybe even opt for more QE. After recent experience, this should not be scary. Monetary authorities, at least at the Fed, have actually proved that they can operate effectively in this world—they just feel terribly uncomfortable being there. The current balance sheet is more of a political problem than an economic one, but it is certainly is that. The political problem is exacerbated by the perception that QE is “printing money,” which suggests that this money might suddenly be spent on rent and groceries and drive up the price of everything. It is hard to get across that what is created is bank reserves that no one is currently eager to borrow and that the Fed has tools to control that borrowing if (we should be so lucky) the demand builds up. In any case, the economy is not as inflation prone as it used to be, and the beast won't jump suddenly out of its cage and run away. Unfortunately, cultural lag makes it hard to grasp the remoteness of a serious inflationary threat.

Making Budget Policy Useful Again

Budgetary actions could spur growth and avert deflation, but fiscal institutions no longer have the credibility or track record associated with monetary authorities. Fiscal policy has been derailed by ideological wars about the size, role and effectiveness of government and grounded by legitimate concern about long-run increases in debt. An economy with a debt/GDP ratio of 75 percent and an exploding retiree population has more limited options than one with a 35 percent ratio and more remote entitlement pressures. If that is

‘Simpson-Bowlesism,’ as Paul Krugman disparagingly called long-term debt concerns, so be it.[7]

Political polarization has led to angry confrontations over the budget for the last several years complete with threats to shut down the government or default on the national debt and bizarre budget decision processes, such as the Super Committee, the fiscal cliff, and sequestration. These shenanigans are unworthy of a mature democracy and horrendously destructive of confidence in rational economic governance. The result has been worse than gridlock. It has been insanely counterproductive budget policy at a time when the federal budget could have been contributing both to faster recovery and to longer run productivity growth.

I believe the Great Recession would have been longer and deeper without the stimulus package of 2009.[8] If the stimulus had been larger and lasted longer, recovery would have been more robust and the Fed might not have found it necessary to do so much quantitative easing. Indeed, it is pretty crazy economics for a country trying to climb out of a deep recession to put the burden of accelerating a recovery on the monetary authorities—a job they have never been great at—in the face of sharply declining federal deficits that made the task of stimulating recovery with monetary tools a lot more challenging. But that is what we did.

I also believe that the United States has been dangerously under-investing in public infrastructure, scientific research, and the skills of our future labor force. Doing everything we can to nudge productivity growth back up again is essential to future prosperity. With the private investment awaiting more demand and confidence, the public sector should be moving strongly into the breach with well-structured investment in everything from roads to technical training to basic research. Instead, our bizarre budget process has been squeezed the very budget accounts that contain most opportunity for public investment. Discretionary spending is at record lows in relation to the size of the economy and headed lower while the highway trust fund is running dry. How crazy is that?

Making budget policy useful again will take major shifts in political thinking, and here I think economists can help if they use arguments the public and politicians can relate to. First, I would recommend not pushing the argument that unspecified government spending would add to aggregate demand and accelerate the recovery without adverse consequences to the long-run debt. Ball, Summers and DeLong may well be right that hysteresis is so serious a consequence of recession that spending now would juice recovery enough to bring down long run debt.[9] But they are never going to sell that argument. Unspecified spending and near-term debt increase are what the public and elected officials fear, and they are skeptical of fee lunches.

Instead, we have to make the case for very specific public investments that can be shown to have positive impacts on productivity growth and future prosperity. This should not be an argument for larger government, but for shifting from less to more effective government spending and from consumption-oriented spending (including spending in

the tax code) to growth oriented spending over time. And, oh yes, that means making the tax code more progressive, more pro-growth, and raising additional revenue, as well as restructuring entitlement programs. There is plenty of such an agenda for both liberals and conservatives to like—if only they could be persuaded to talk about it.

Reining in the Big Bucks

We didn't really need a talented French economist to draw our attention to the rapid increase in concentration of income and wealth, although he did it effectively.[10] But unfortunately, reducing income and wealth concentration is not even a widely accepted goal of our society. The tools for achieving it are tangled in ideological controversy, and I don't propose to tackle them here.

Nevertheless, whether or not we figure out how to reduce the concentration itself, we need to guard against financial institutions and the very affluent using their political power to prevent regulatory actions needed to reduce the risk of financial crisis. The parallel danger is that similar interests, waving the banner of freedom from government interference, will derail fiscal and tax policies needed to promote higher productivity and growth.

In sum, the proverbial Punch Bowl is still there and the party-goers never want it taken away. It is a different Punch Bowl at a different party than it used to be— now related to systemic risk-taking rather than run-away inflation, but it still faces us with the same fundamental question. Do we have collectively and individually the intelligence and the Volcker-style courage to move this great economy of ours toward lasting shared prosperity? I'm a born optimist, and I'm hopeful.