1. Focus on monetary policy
not because we are necessarily interested in monetary policy for its own sake
not because we imagine ourselves as central bankers
but because that’s the space in which macro discussions take place
it’s where the lack of congruence between economic theory and reality becomes most acute
(imagine fitting a flat map over a globe - it must crumple somewhere - today many of the crumples are clearly visible in this area)
economics as ideology: vision of self-regulating system of decentralized optimization
economic policy: economy as complex, unstable system that requires active management
reconciled with a set of ideas about monetary policy:
(a) monetary policy restores economy to “natural” state – quite explicit in some cases
(b) monetary policy operates as a “rule” that can be stated in objective form (3 equation model)
people expected revolution in macroeconomics 10 years ago – hasn’t happened, but the consensus was unstable and is beginning to fray

2. consensus of a decade ago
textbook story:
(a) sharp line between short run and long run - money neutral in long run
(b) goal of policy to stabilize output, employment around long run path
(c) divine coincidence
   i. stabilizing output necessary and sufficient condition for stabilizing price level
   ii. no tradeoff between employment and inflation
   iii. in some not always clear way achieving macro goals corresponds to restoring Walrasian world - famous Friedman quote
(d) strong, stable relationship between policy interest rate and output
   (often semi elasticity of -1)
(e) simple policy rule sufficient to achieve macro goals
(f) clean separation between monetary policy and other functions of central bank

consensus not as old as it’s made out to be - historically central banks have operated in lots of ways – but as of 2007 could be presented as just the way the world works

3. breakdown of consensus
   (a) crisis itself
      i. not as big as people thought
      ii. but the response to it
   (b) failure to achieve goals - persistent output gap even by conventional measures
   (c) confusion about goals
   (d) incoherence of larger conceptual framework

4. policy failure
   (a) obvious failure to stabilize activity
      i. output shortfall - cumulative 25 percent by official measure
      ii. (un)employment - gap looks bigger in retrospect, given low U today
      iii. price level

failure couched in terms of ZLB – assumes policy rate is tool to begin with

(b) three explanations
   i. “natural” or “neutral” rate lower than thought
   ii. larger fluctuations in private demand
   iii. policy rate has smaller effect on demand than thought
strangely discussions focuses only on first possibility, but not plausible on its own
   • if we assume standard parameters - multiplier of 1.5, semi-elasticity of -1 - and take into account big improvement in trade balance that implies fall in autonomous demand on order of 30 percent of GDP between 2000 and 2009
   • need to think about why private demand so unstable - not enough to say “shocks”

(c) clearly some breakdown in transmission mechanism
• failure to move policy rate - ZLB
• policy rate to risky rates
• policy rate to longer rates - Keynes and conventional long interest rate
• credit constraints
• marginal use of credit not real activity
• real activity not interest rate sensitive
  – both econometric and survey evidence suggests business investment not responsive to interest rates
  – only housing investment probably is
  – larger effects may be via interest costs when existing debt rolled over
• or Phillips curve (for non-output variables)

(d) have to think more substantively about financial system – not just “r”
  not enough to dump liquidity at top of system and hope it flows down
(e) recognition that credit markets partitioned, segmented in various ways - not “the” interest rate
(f) policy to be effective has to target specific segments where there are credit constraints – people like Adam Posen and (that BoE guy) recognize clearly
  • QE small step in this direction
  • much more in crisis

(g) yet paradoxically while past decade suggests that central bank’s ability to deliver macro outcomes is weaker than we thought, ability to set specific asset prices – if they choose to – is stronger
  • Mario Draghi’s “whatever it takes” in 2011 is about on a level with “let there be light”

5. policy goals

(a) divine coincidence
  i. never very convincing without proper theory of costs of inflation
  ii. required explicit notion of “central bank preferences” that lack either positive or normative grounding
iii. worked as approximation if we thought there was very sharp tradeoff between unemployment and inflation - but that is clearly not the case now if it ever was

iv. experience of past ten years gives strong reasons to doubt whether socially optimal – in any meaningful sense – levels of unemployment, inflation and output coincide

v. ... or whether stabilizing output around trend delivers them. tradeoffs! which are inherently political

vi. problem gets much worse with hysteresis

(b) hysteresis

i. literature going back to 1980s
   - original focus on labor market, now incorporates productivity as well
   - “anti-hysteresis” where positive output gap raises potential output, has also entered discussion

ii. raises profound questions of how we should even think of supply constraints

iii. makes job of policy harder
   - costs of missing on downside are larger
   - can no longer think of policy as stabilizing output etc. around given trend
     - trend a function of policy (money not neutral!)
     - instead of temporary employment gains for permanently higher inflation, it’s permanently higher employment for temporary higher inflation
     - tradeoffs again!
   - obviously no NAIRU or “natural rate” in this case

iv. another blow to effort to reconcile real-exchange theory with monetary-production reality

(c) relative prices

i. financial stability
   - Minsky’s two-price model

ii. distribution - labor and capital
   - still seems to be reasonably strong relationship between employment conditions and wage growth
• flattening of Phillips curve is at next step, wage growth to prices
• implies that by targeting U central bank is really targeting wage share, not price level
• ECB willing to go that step, talk about NAWRU, justify on grounds of competitiveness; Fed not yet
• weird disconnect in orthodox view where wage gains treated as sign of overheating, wage declines as supply-side

iii. more and less interest elastic (or credit dependent sectors of the economy) - doesn’t simply scale up output in proportion
• housing

6. conceptual

(a) throw out long term vs short term
(b) throw out neutrality of money
(c) blur distinction between monetary policy and other functions, like llr - either way cb is trying to direct flow of credit in order to get real economy into desired condition
(d) recasts independence of cb - makes it unambiguously political actor
   i. “Fed listens” events - “What Does Full Employment Look Like for Your Community or Constituency?” - pushing back against Trump but politicized either way
   ii. ECB’s extremely aggressive intervention in whole range of domestic policymaking
(e) going forward will need to think more about credit policy
   i. QE small step in that direction
   ii. crisis interventions much more so - thought of as short-term but sure to be revived
   iii. need to think about whether sectors supported now are socially desirable ones - green investment vs housing, e.g.
   iv. can’t just dump liquidity at top of system
   v. recognize that liquidity is real input, valuable, not just numeraire

7. conclusions - central banks and rule of money