Munk Advisory Services
ECOMENTARY™

MAS031104

Which Economic Tool is Best: snowstorms or potholes

Morgan Stanley's economics department is headed by Steve Roach, and it is rightly celebrated as a 'great shop." The department's most obvious characteristic is its lack of homogeneity. That is to be applauded because Wall Street bankers have a tendency to herd toward a 'group view.' Choosing the 'right take' is usually the art of economics and for that reason it has led to all sorts of jokes about "using hands" in the practice of giving economic advice. Of course, the classic line was President Truman's remark that he was looking for a 'one handed economist,' by which he meant to put a stop to the "on the one hand," and "on the other hand," advice that was hardly helpful.

Unfortunately, however, there are reasons to think that even if there are many points of view on any given economic problem, it doesn't mean that each view is correct. Some views are simply thoughtless or just plain wrong, either from a theoretical point of view or because there exists evidence that clearly contradicts the asserted view. What is crucial in my view is to make readers aware of the distinction between 'macro economic theory' (which some will argue is an oxymoron) and micro economic theory (optimizing behavior on the part of economic agents), which lies at the foundation of economics as a whole. And it is critical that the right tools be applied to a given problem.

Take the issue by which Roach is becoming widely known, to wit: the Fed is a 'serial bubble blower,' in that it is keeping the real short rate of interest too low, inducing asset bubbles in housing, bonds etc. Sooner or later this policy must end because otherwise some asset prices will be come just plain unreasonably high and a collapse is 'just around the corner.' Roach feels that it is a failing of macro policy (and in particular, easy monetary policies) that accounts for the puzzling behavior of employment in this business cycle. Unlike other cycles, GDP has expanded vigorously, but employment has shrunk. Given that low real rates have not been able to stimulate suitable job growth, and the prices of assets such as bonds and houses are soaring beyond reasonable levels, the Fed should "prick the bubble!" Better now than later when more air has been sucked into these asset prices!

In our view, this is confusion over the goals and effects of monetary policy. When one thinks about the jobs issue, one is invariably drawn to the conclusion that the typical relationship observed in past business cycles between GDP growth and employment growth has broken down. But that is a "real" problem, not a "monetary one." How can it be that the paths of employment and GDP growth not be parallel? The obvious answer is that the relationship between labor and output has been altered in a significant way. For whatever the reason, the U.S. is experiencing a gigantic "productivity boom."

Concurrent with this productivity boom, it is also notable that some jobs, particularly in sectors heretofore thought to be beyond the pale of comparative advantage, can in fact 'move.' They move because the Internet makes it possible to move these activities. Even if we don't know how much further this process can go, it is clear that the policy problem is not a "macro policy problem." It is a micro problem, coming from a change in the relative value of certain types of labor in the U.S. If the 'lower skilled fragments' are moving offshore, it means that for some occupations, 'real wages' in the U.S. are too high.

When we say that real wages are too high, we are not staking out an ethical position. Those positions that can be "moved offshore," will be moved. Assuming that employment in the 'outsourced sector' was receiving a market determined wage, it must mean that employees who have lost jobs have lower 'alternative opportunities,' or high 'transfer costs' or that they need to acquire 'new skills' in order to take jobs that are still in demand in the U.S.

ECOMENTARY? is published for clients of **Munk Advisory Services, LLC**
955 Mt. Moro Road, Villanova, PA 19085. tel (610) 527 5368 fax (610) 527 5068

Website www.ecomentary.com. Contact: munkb@ecomentary.com

Stripped from its ethical underpinning, it is rudimentary to see that this kind of problem, changing the skill basis of the newly unemployed is not addressable by monetary policy. Nor is it, in our view, properly addressed by most, broadly based fiscal measures. Rather, it must be addressed by 'micro policy' measures that go to the skill-acquisition and location issues that lie at the root of the problem. Judged by these standards, the current Presidential debate is an exercise of economic mugging. The proper analytical framework and the relevant policy prescriptions are being deliberately distorted by one or more of the candidates.

The claim is made that this President (Bush) is unique, or nearly so, in that while the economy has grown, jobs have not. Of course, the implication is that the President has failed to do something about the shift in comparative advantage. When an economist whose professional reputation came largely in the field of "pure trade theory" (which is completely micro in its foundations) adopts a similar slant, the profession of economics is in deep trouble. (See the recent 'rants,' by Professor Paul Krugman).

Conventional 'macro policy' tools were never designed to work on micro problems such as these and using these micro criteria to judge macro policy is like doing acupuncture with a fork. Macro policies are far too blunt an instrument, and most economists ought to make the distinction clear to the public. Monetary policy is also a blunt instrument whose principal effect in the long run is on prices. In the short run, monetary policy can stimulate or retard spending, but it is 'blunt' with respect to issues of changing comparative advantage. The same goes for macro fiscal tools such as changes in income tax rates or the level of the budget deficit. It serves no useful purpose to recommend that monetary policy be made tighter because it has failed to do a job it is not designed to do.

It is ironic that Roach should create a macro need out of micro failing, but he is not singular in this regard. Robert Feldman, Morgan Stanley's very able economist in Tokyo, has recently criticized the Bank of Japan and other Japanese financial policy makers for not focusing on the "structural issues" in Japan, while leaning only on the BoJ's macro tool: interest rates or quantitative easing measures. In our view, this is another example of an inappropriate choice between macro and micro policies.

As we have argued elsewhere, a clear case can be made that the Bank of Japan waited far too long to ease and when it eased, it was tentative and insufficiently aggressive for much of the last part of the Bust. (See **MAS030604 Reinventing Central Banking**). By commission and omission, the financial implosion in Japan certainly weakened the monetary transmission mechanism. However, while the repair of the banking system was and is on its own a laudable objective of Japanese financial officials, and arguably would improve the ability of the BoJ to effect its monetary policy changes in a more traditional manner, the 'structural argument' is fundamentally "micro." At the early stages of the Bust, the remedy was plain, old and admittedly blunt, macro policy---in particular, unrelentingly aggressive monetary policy.

The distinction between a "macro problem" and a "micro problem" is not hard and fast, but is rather a timing judgment. After a big snowstorm, the bigger the snow plow, the better. But for doing road repair, it is one pothole at a time! Economists can disagree as to which 'micro policy' measure is likely to work best to address a change in relative wages or relative prices seen to be 'undesirable,' or having large social consequences. What they ought to be able to agree upon, however, is the efficacy of an institution that can be the 'hostess with the mostest.' When there is a demonstrable lack of aggregate demand, monetary policy is a snowplow and in a big snow, the rule should be, 'start early and keep at it' until the traffic can move again. When the issue is one of road quality, you need to fix the potholes and that is a one-at-a-time procedure. We should all agree to keep these distinctions well in mind when we opine on public policy!