Our Uncertain Economy

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In recent times, most economists have pretended that the economy is essentially predictable and understandable. Economic decision- and policy-making in the private and public sectors, the thinking goes, can be reduced to a science. Today we are seeing consequences of this conceit in the financial industries and central banking. "Financial engineering" and "rule-based" monetary policy, by considering uncertain knowledge to be certain knowledge, are taking us in a hazardous direction.

Predictability was not always the economic fashion. In the 1920s, Frank Knight at the University of Chicago viewed the capitalist economy as shot through with "unmeasurable" risks, which he called "uncertainty." John Maynard Keynes wrote of the consequences of Knightian uncertainty for rational action.

Friedrich Hayek began a movement to bring key points of uncertainty theory into the macroeconomics of employment -- a modernist movement later resumed when Milton Friedman and I started the "micro foundations of macro" in the 1960s.

In the 1970s, though, a new school of neo-neoclassical economists proposed that the market economy, though noisy, was basically predictable. All the risks in the economy, it was claimed, are driven by purely random shocks -- like coin throws -- subject to known probabilities, and not by innovations whose uncertain effects cannot be predicted.

This model took hold in American economics and soon practitioners sought to apply it. Quantitative finance theory became a tool relied on by most banks and hedge funds. Policy rules based on this model were adopted at the Federal Reserve and other central banks.

The neo-neoclassicals claimed big benefits from these changes. They boasted that their statistical approach to risk made the financial sector much more effective in matching lenders with borrowers, with vast savings in labor and increases in profits. They asserted a decline in "volatility" in the U.S. economy and credited it to the monetary policy rules at the Fed.

Current experience is putting these claims to the test.

Subprime lending and the securitization of debt was an innovation that, it was believed, offered the prospect of increasing homeownership. But "risk management" was out of its depth here: It had no past data from which to estimate needed valuations on the novel assets, it did not allow for possible macroeconomic dynamics, and it took inadequate account of the system effects of unknown numbers of entrants into the new business all at nearly the same.

The claim for rule-based monetary policy is weak on its face. In deciding on the short-term interest rate it controls (the Fed funds rate) the Federal Reserve thinks about the "natural" interest rate -- the rate needed if inflation is neither to rise nor fall. Then the Fed asks whether the expected inflation rate is above or below the target. The Fed also asks whether the unemployment rate is above or below the medium-run "natural" unemployment level -- the level to which sooner or later the actual rate will return.

But the medium-run natural unemployment rate and the natural interest rate are anything but certain. About the natural unemployment rate, Friedman and I used to say at every chance that it is not like the speed of light; it is always shifting, temporarily or permanently, with new developments. We know many of its determinants by now -- but not with any precision and, for sure, not all of them. It is uncertain. More than one view about it is tenable.

The Fed's view seems to be that the medium-term natural unemployment rate is stable. Thus the rise of actual unemployment in the past year is wholly or largely temporary -- a result of passing forces such as the surge in the price of energy, the time home prices are taking to get to down to their new equilibrium path, and the financial market tangle yet to be unwound.

Accordingly, the Fed has cut the Fed funds rate with each increase of unemployment. This "cushions" the fall of employment, as Fed governor Donald Kohn put it, until the contractionary forces pass and unemployment retracts to its former level.

What if inflation -- and thus inflation expectations -- move up? Tighter money can deal with it in the future from a position of strength -- i.e., when employment is high again.

Yet there are good reasons why the medium-term natural unemployment rate may be a lot higher now than before. The permanent decrease in house prices will permanently decrease the jobs in residential investment activity. Share prices, which give some indication of how firms would value additions to their stock of business assets, have fallen markedly in the past year -- more so if we remove the rising value of overseas operations from share prices. That portends fewer jobs in domestic capital goods industries. Absent a great deal of luck, these job losses will not be offset by job gains in export industries.

Keynes, in my reading, had a radical thought here: that the natural rate of unemployment cannot be fully determined by economists. Entrepreneurs' willingness to innovate or just to invest -- and thus create new jobs -- is driven by their "animal spirits" as they decide whether to leap into the void. Central bankers, he implied, can try to guess which way entrepreneurs are going to jump, but some wide swings in employment are inevitable.

The Fed's view seems to be that the natural interest rate has decreased with the business downturn. But this too is uncertain.

We should consider Hayek's argument that the upheavals in a boom may change the natural rate of interest. If the boom left it elevated, failure by the central bank to raise its interest rate correspondingly would cause inflation to begin rising. Something like that may be happening now.

I would add another possibility. Consider the sharp decline over the past year in Americans' stock market wealth. This means, at unchanged interest rates, a decrease in their income from wealth.

For households to be willing in such straitened circumstances to save as much as before -- cutting their consumption by the whole amount of the drop in their income from wealth -- they would have to be compensated with a higher interest rate. At unchanged interest rates, people will not want to leave consumption in the present so pinched. So natural interest rates are driven up.

There may be other mechanisms at work. Uncertainty reigns. But if the above scenario comes to pass, the Fed cannot keep interest rates as low as now for very long. We may see in the near future higher interest rates and higher unemployment than have prevailed in the recent past.

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