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The Conscience of a Liberal

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The Moral Equivalent of Stagflation

Martin Fackler and Steve Lohr have a good article this morning on parallels between the United States and Japan; regular readers know that I've been on this for more than two years. And the possibility of such a parallel was the main theme of the original version of The Return of Depression Economics, which I wrote way back in 1999. Domo arigato, Bernanke-san.

What I don't think is fully appreciated yet — and may never be, for reasons I'll explain in a bit — is what this American remake of The Bad Sleep Well should be telling us about economic theory and policy.

Let me offer a parallel: the stagflation of the 1970s.

Stagflation had a huge impact on economic thinking. Why? Mainly because it was *predicted*: the Friedman-Phelps natural rate hypothesis said that the apparent positive tradeoff between inflation and unemployment would prove only temporary, and that once inflation had gone on for a while, disinflation would involve a period of both high inflation and high unemployment.

So when that condition actually materialized, it gave huge prestige to the whole program of grounding macroeconomic models in microeconomic foundations. When I was in graduate school, which was just when the saltwater-freshwater divide was beginning to widen, I remember some of my classmates arguing that we should believe what the Chicago guys were saying — after all, they'd been right so far.

Of course, stagflation also gave a boost to the political right, although with much less justification; to this day, right-wingers basically wave the bloody shirt of stagflation to justify any and all opposition to government programs.

So what's the parallel with the Nipponization of the U.S. economy? Well, like the stagflation of the 1970s, our current predicament was predicted well in advance. Liquidity-trap theorists — yes, with me playing a large and early role — told you what would happen if the economy suffered a sufficiently severe negative shock, one that pushed us up against the zero lower bound. We predicted, specifically, that:

1. Increases in the monetary base would fail to increase broad monetary aggregates, let alone boost the economy
2. Despite large monetary base expansion, the economy would slide toward deflation, not inflation
3. Despite large budget deficits, interest rates would stay low, because short-term rates would stay pinned at zero

All of this was, like the natural rate hypothesis, grounded in a basic theoretical approach, embodied in simple models.

Everything that has happened these past two years has fit that basic model; meanwhile, those who failed to accept the implications of the liquidity trap have been wrong over and over again.

But here's the thing: I see no signs of a rethink among most players. The slide toward deflation despite huge increases in the monetary base hasn't shaken either the paleomonetarists who still predict hyperinflation or the it's-all-the-Fed's-fault crowd. The failure of interest rates to soar hasn't shaken the deficit hawks. Instead, the usual suspects have taken the failure of an inadequate stimulus to produce a solid improvement in employment — a failure I, among others, predicted! — as proof that they were right.

It's disheartening, to say the least. You really have to wonder if economics has become completely unmoored from evidence, whether anything can ever convince anyone that they were wrong.