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For More Jobs and Stability, Set the Economy Free

By John P. Cochran

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The headline in the print edition of the *Denver Post* of an associated press story on the nomination of Janet Yellen highlights a quote from President Obama, "She understands the human cost when people can't find a job." This statement about then-new Fed Chair Yellen, which emphasizes Yellen's Keynesian-based commitment to the unemployment prong of the Fed's dual mandate, underlies why some economists feared that no matter how bad policy might have been during Bernanke's tenure, policy is likely to get worse rather than get better from a sound money perspective during a Yellen reign. Her empathy for the unemployed was clearly present in her remarks following her first official policy meeting which as reported by the Wall Street Journal "were a notable affirmation of her commitment to low rates until the economy is much stronger." She emphasized, "The recovery still feels like a recession to many Americans, and it also looks that way in some economic statistics." She then chose to support her remarks not with usual econ jargon and statistics, but "Ms. Yellen instead exhibited a personal touch … by coloring her comments with experiences of three people who had struggled to gain full-time work."

Unfortunately Yellen's strong compassion for the plight of the unemployed comes tied to a faulty understanding of the cause of unemployment. With Yellen's ascendency to the Chair of the Fed, the Wall Street Journal notes the "Tobin Keynesians are back in charge at the Federal Reserve." The last time this group's Phillips Curve-based ideas dominated Fed policy, the Fed engineered the stagflation of the 1970s. Exhibiting a lack of historical understanding, sympathetic cheerleaders such as Justin Wolfers see Yellen's commitment to the dual mandate as a plus.

"Yellen's appointment should be viewed as an investment in the Fed's dual mandate, which emphasizes the central bank's role in taming both unemployment and inflation. The unemployed should rejoice that they have a powerful advocate willing to battle the hard-money types willing to consign them to the economic scrap heap."

Wolfers goes so far as to argue that failure to heed savior Yellen's advice has left Fed policy less effective and the "recovery" weaker than it might have been. He claims, "If Yellen had been in charge of the Fed over the past few years, millions fewer would be jobless, and we would be less concerned about the danger of deflation."

This return of the Keynesian understanding of unemployment, accompanied as it is too often and uncritically by an even more fallacious doctrine, the Foster-Catchings underconsumption theory of depression, and its high-wage theory of prosperity,[1] is misguided. The best one can hope for from a policy driven by this worldview is it will leave the crippled economy hobbling forward. Continuing the policy has the potential to run a significant risk of trading slightly more employment now for a significant risk of greater instability and higher unemployment later, as recognized by Kevin Warsh ("*Finding Out Where Janet Yellen Stands*"):

"The most pronounced risk of QE is not an outbreak of hyperinflation. Rather, long periods of free money and subsidized credit are associated with significant capital misallocation and malinvestment — which do not augur well for long-term growth or financial stability."

Failure, which is highly likely, to unwind the massive increase in the Fed's balance sheet, runs a risk of hyperinflation or a crack-up boom.

Better policy and a genuine recovery require, not a faulty understanding of labor markets, but must be built on a Misesian-classical view of labor markets.[2] Gallaway and Vedder explain (and provide empirical support):

"Von Mises, and others like him, were correct in rejecting the "progressive" view that the level of money wage rates does not matter [the view of Keynesian and Foster-Catchings theories]. Not only is it important but, in conjunction with the levels of prices and productivity, it is the key to understanding patterns of variation in aggregate levels of employment and output. With the aid of the von Misesian-classical analysis, such disparate phenomena as high unemployment rates, low unemployment rates, high unemployment accompanied by inflation (stagflation), low unemployment in unison with inflation, swift economic recoveries, and aborted economic recoveries can be understood in an intelligent fashion. No special economics are needed for each situation. What other theoretical apparatus can make the same claim?"

Hayek explains further this "true theory of unemployment":

"The true, though untestable, explanation for extensive unemployment ascribes it to a discrepancy between the distribution of labor (and other factors of production) among industries (and localities) and the distribution of demand among their products. This discrepancy is caused by a distortion of the system of *relative prices* and wages. And it can be *corrected only* [emphasis added] by a change in these relations …"[3]

Earlier in the work,[4] Hayek provided a warning, recently echoed by Warsh (above), "a new inflationary push may temporarily succeed and make the eventual breakdown worse."

A first step to better policy is found in the conclusion of Gallaway's and Vedder's important but too-often-neglected — not only by mainstream economists but also by Austrians — *The Fraud of Macroeconomic Stabilization Policy*:

"To place these technical conclusions in perspective, we point out that the overall interpretation of short-run economic phenomena presented here is quite consistent with the Austrian

conception of a world that is seeking to attain an underlying equilibrium state but is being buffeted continually by exogenous shocks of an unpredictable nature. As a consequence, entrepreneurs and workers continuously must adjust their behavior to take into account these changing circumstances. The best they can hope for from government policymakers is, in the spirit of Hippocrates advising future doctors, that they do no harm. Given that the phenomena that policymakers confront in the short-run are essentially unpredictable and given that even their best efforts are the equivalent of medieval doctors *bleeding* their patients, the most appropriate short-run macroeconomic stabilization policy is to give the aforementioned entrepreneurs and workers maximum freedom to adjust to potentially discoordinating shocks to the macroeconomy. Clearly, the conventional wisdom proposition suggested by Galbraith that there is endemic instability in a market-based economy that can be remedied only by government policy interventions is inappropriate. Also, it is clear that Mises's vision of the nature of the macroeconomy is substantiated by our findings. *The notion that deliberate contracyclical macroeconomic policy can stabilize the economy is a fiction*." [emphasis added][5]

Notes:

[1] See Gallaway's and Vedder's "Wages, Prices, and Unemployment: Von Mises and the Progressives," Review of Austrian Economics 1, no. 1 (1987).

[2] Ibid., pp. 66-67. Salerno uses the framework in a devastating critique of Krugman.

[3] See Unemployment and Monetary Policy: Government as Generator of the "Business Cycle". San Francisco: Cato Institute, p. 8. PDF on request.

[4] Ibid., p. 3

[5] Printed in the Quarterly Journal of Austrian Economics 3, no. 3 (Fall 2000): 32