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Five Macroeconomic Myths

By Edward C. Prescott

THE SKY IS NOT FALLING. No need to panic and start playing around with all sorts of policy responses. Despite the impression created by some economic pundits, the U.S. economy is not a delicate little machine that needs to be fine-tuned with exact precision by benevolent policymakers to keep from breaking down. Rather, it is large and complex, with millions of people making billions of decisions every day to improve their lives, the lives of their families and the health of their businesses.

On the one hand, it's difficult to screw up all these well-intentioned people by crafting bad policy, but, on the other hand, it is of course entirely possible to do so. And once things are broken, they are much harder to fix. For example, all those doomsayers predicting a recession will get their wish if taxes are suddenly raised, new productivity-strangling regulations are enacted, the U.S. turns against free trade, or some combination thereof. Otherwise, we should expect 3% real growth, based on 2% increases in productivity and 1% population growth. This economy is fundamentally sound.

So we have to be careful that we don't believe everything we read in the papers. Things are never as bad as the last data that was released, nor are they as good. Likewise, policy should not be revised at every turn, nor rules changed by political whim. Meaning, we should be careful about accepting conventional wisdom as, well, being wise. One of the great disciplines of economics is that it challenges us to question status quo thinking. So let's take a look at five pillars of contemporary conventional wisdom that have current standing, and see how well they hold up.

Myth No. 1: Monetary policy causes booms and busts. Greg Mankiw, former chairman of the Council of Economic Advisers, wrote the following in a 2002 paper: "No aspect of U.S. policy in the 1990s is more widely hailed as a success than monetary policy. Fed Chairman Alan Greenspan is often viewed as a miracle worker." Or, as Mr. Mankiw later asks, was Mr. Greenspan just lucky?

One of the mysteries of the 1990s is how to explain the economic boom when the increase in capital investments — as measured by the national accounts — grew at a subdued pace. The numbers simply don't add up. However, it turns out that something special happened in the 1990s, and it wasn't monetary policy. In a recent paper, Minneapolis Fed senior economist Ellen McGrattan and I show that intangible capital investment — including R&D, developing new markets, building new business organizations and clientele — was above normal by 4% of GDP in the late 1990s.

This difference is key to understanding growth rates in the 1990s: Output, correctly measured, increased 8% relative to trend between 1991 and 1999, which is much bigger than the U.S. national accounts number of 4%. Associated with this boom in unmeasured investment is the huge amount of unmeasured savings that showed up in the wealth statistics as capital gains. This was the people's boom, the risk-takers' boom. We should hang gold medals around these entrepreneurs' necks. So indeed, it does seem that Mr. Greenspan was lucky in that a boom happened under his watch; but we can at least say that he did a pretty good job of keeping inflation in check. Here's hoping for the same performance from our current chairman.

What about busts? Let's begin with the assumption that tight monetary policy caused the recession of 1978-1982. This myth is so firmly entrenched that I could have called this downturn the "Volcker recession" and readers would have understood my reference. To accept the myth, you have to accept a consistent relationship between monetary policy and economic activity — and as we've just seen, this relationship is simply not evident in the data.

Between 1975 and 1980, the inflation-corrected federal funds rate was low; at the same time, output trended upward until late 1978. So far, things look somewhat promising for the mythmakers. But looking closer at the data we see that output began its downward trend in late 1979 while monetary policy was still easy through most of 1980. Also, output continued its decline through 1982, when it began to climb at a time when monetary policy remained tight.

These facts do not square with conventional wisdom. Our obsession with monetary policy in the conduct of the real economy is misplaced.

One caveat: I am not saying that there are no real costs to inflation — there certainly are. And if we get too much inflation we can exact high costs on an economy (witness Argentina as an example). However, I am talking here of the vast majority of industrialized countries who live in a low-inflation regime and who are in no danger of slipping into hyperinflation. It is simply impossible to make a grave mistake when we're talking about movements of 25 basis points.

Myth No. 2: GDP growth was extraordinary in the 1990s. Even though I referred to the expansion of the '90s as a boom, inasmuch as it was a period of above-trend growth, and I noted the strong gains due to unmeasured investment, we have to put things into historical context. So let's return to the data. GDP growth relative to trend in the early 1960s was 12%, and in the famous 1980s boom (from the end of 1982 to mid-1989) it was a very impressive 9.7%.

And how about the boom from the previous decade? From 1996 to 1999, GDP grew 3.8%, about in line with the 3.9% growth of the early 1970s and less than the 5.5% growth of the mid-1970s expansion. Even when we account for unmeasured investment and add four percentage points, the 1990s growth spurt — fueled by rapid growth in tech industries — still falls short of the 1980s boom and does not approach the 1960s, both of which were fueled by tax cuts.

So we have to be careful about mythologizing the 1990s and drawing misguided policy lessons; yes, it was a boom, and it was better than we think, but let's keep that boom in perspective.

Myth No. 3: Americans don't save. This is a persistent misconception owing to a misunderstanding of what it means to save. To get a complete picture of savings we need to investigate economic wealth relative to income. Our traditional measures of savings and investment, the national accounts, do not include savings associated with tangible investments made by businesses and funded by retained earning, government investments (like roads and schools) and business intangible investments.

If we want to know how much people are saving, we need to look at how much wealth they have. People invest themselves in many and varied ways beyond their traditional savings accounts. Viewing the full picture — economic wealth — Americans save as much as they always have; otherwise, their wealth relative to income would fall. We're saving the right amount.

Myth No. 4: The U.S. government debt is big. The key measure here is privately held interest-bearing federal government debt, which includes debt held by foreign central banks, and does not include debt held by the Fed or government debt held by the government. So let's turn to the historical data once again.

Privately held interest-bearing debt relative to income peaked during World War II, fell through the early 1970s, rose again through the early 1990s, and then fell again until 2003. Even though that number has been rising in recent years (except for the most recent one), it is still at levels similar to the early 1960s, and lower than levels in most of the 1980s and 1990s. This debt level was not alarming then, and it is not alarming now. From a historical perspective, the current U.S. government debt is not large.

Myth No. 5: Government debt is a burden on our grandchildren. There's no better way to get people worked up about something than to call on their sympathies for their beloved grandkids. The last thing that I want to do is to burden my own grandchildren with the sins of profligacy. But we should stop feeling guilty — at least about government debt — because we are in better shape than conventional wisdom suggests.

Theory and practice tell us that the optimal amount of public debt that maximizes the welfare of new generations of entrants into the workforce is two times gross national income, or GDP. This assumes 1% population growth, 2% productivity growth, 4% real after-tax return on investments, and that people work to age 63 and live to age 85. Currently, privately held public debt is about 0.3 times GDP, and if we include our Social Security obligations, it is 1.6 times GDP. In either case, we could argue that we have too little debt.

What's going on here? There are not enough productive assets — tangible and intangible assets alike — to meet the investment needs of our forthcoming retirees. The problem is that the rate of return on investment — creating more productive assets — decreases as the stock of these assets increases. An excessive stock of these productive assets leads to inefficiencies.

Total savings by everyone is equal to the sum of productive assets and government debt, and if there is an imbalance in this equation it does not mean we have too little or too many productive assets. The fix comes from getting the proper amount of government debt. When people did not enjoy long retirements and population growth was rapid, the optimal amount of government debt was zero. However, the world has changed, and we in fact require some government debt if we care about our grandchildren and their grandchildren.

If we should worry about our grandchildren, we shouldn't about the amount of debt we are leaving them. We may even have to increase that debt a bit to ensure that we are adequately prepared for our own retirements.

There are at least three lessons here. First: Context matters. Take what you read in the paper with a many grains of historical salt. Second: Current data often provide poor guidance for effective policy making. To make forward-looking policies you have to understand the past. Finally: Establish good rules, change them infrequently and judiciously, and turn the people loose upon the economy. Booms will follow. ■

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(See related letter: *"Letters to the Editor: Beware Economic Stresses Just Over Horizon"* — *WSJ* Dec. 22, 2006)