

## CHAPTER 10

# Good and Bad Monetary Economics, and Why Investors Need to Know the Difference\*

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*There cannot be intrinsically a more insignificant thing, in the economy of society, than money; except in the character of a contrivance for sparing time and labour. It is a machine for doing and commodiously, what would be done without it: and like many other kinds of machinery, it only exerts a distinct and independent influence of its own when it gets out of order.*

—John Stuart Mill<sup>1</sup>

### **GOOD NEWS IS BAD NEWS?**

There are times when it appears that the market has economics backward. An example is the recent phenomenon of 100-point-plus daily drops in the Dow Jones Industrial Average that are reported to be due to higher-than-expected job growth or lower-than-expected unemployment. While a day's stock market movement has many causes, traders routinely say that good news on the job front is what is motivating them to sell. Yet over the long run, job growth, economic growth, and the stock market all proceed in the same direction. From 1981 to 1996, the U.S. unemployment rate fell from higher than 11 percent to lower than 5 percent; millions of new jobs were created, growth in real gross domestic product was robust, and

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the cumulative real total return on stocks was a remarkable 431 percent. It appears that strength in the job market is bad for stocks in the short run and good for stocks in the long run. How is this possible?

It is possible because the short-term and long-term consequences of an economic event are often very different, even opposite. This fact is not widely appreciated, even though it is a cornerstone of sound economic analysis. What traders say they see happening in the short run is, roughly speaking, the following chain of events: (1) the Federal Reserve, believing that a strong jobs report is a portent of future inflation, imposes a tighter monetary policy; (2) the tightening causes interest rates to rise and bond prices to fall; and (3) higher interest rates mean lower corporate earnings and a higher discount rate for calculating the present value of stocks, so the stock market falls. But the long-run consequences of strong jobs reports are likely to be a rising, not falling, stock market. This result cannot be predicted without the analytical tools of monetary economics, which distinguish carefully between short- and long-run effects. Here are some reasons:

- While newly hired workers cost their companies money, they are also expected to produce revenues greater than their costs. (Otherwise, they would not have been hired.)
- Newly hired workers will receive income they were not previously getting, creating wealth and leading to additional consumer spending.
- There is no information in the jobs report suggesting that the Fed should raise interest rates to combat inflation. If wages went up because workers became more productive, the payroll increase is not inflationary.
- A Fed tightening would not necessarily raise long-term interest rates. If it is effective in controlling inflation, it would be expected to lower the long-term bond yield.
- A Fed tightening would not necessarily lower corporate earnings. Again, it depends on the differential effect of lowered inflation on corporate revenues, expenses, and the discount rate for calculating present value.

(Note that inflation is a persistent increase in the general level of prices. A one-time increase in the general price level does not constitute the type of inflation being discussed here.)

In other words, many people form their interpretations of economic events on a flawed reading of the principles of monetary economics. Based on such a misreading, they could make flawed portfolio decisions. The objectives of this chapter are (1) to identify common flaws in the understanding of monetary economics; (2) to discuss how this misreading came to be as widespread as it is; (3) to provide what many economists believe is the correct framework for interpreting economic data.

## **MYTHS ABOUT MONEY, INFLATION, AND THE ECONOMY**

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Among many common misinterpretations of monetary economics are the following:

Myth No. 1

Easy monetary policy lowers interest rates; tight monetary policy raises interest rates.

Myth No. 2

Easy monetary policy leads to economic expansion; tight monetary policy slows economic growth.

Myth No. 3

Rapid economic growth increases inflation; slow economic growth decreases inflation.

These beliefs have led many investors to fear that rapid growth of the U.S. economy is bad for bondholders. Yet these beliefs and the policies they lead to are based on faulty economic reasoning and have been proved wrong time and again.

For brevity, and with tongue only slightly in cheek, let us refer to these misunderstandings of monetary economics as bad and to monetary economics properly understood as good. Some readers will recall that Henry Hazlitt used the same words in 1946.<sup>2</sup>

## **WHY BAD MONETARY ECONOMICS THRIVES IN THE POPULAR IMAGINATION**

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There are three chief reasons why bad monetary economics has staying power. First, traders and, to some extent, portfolio managers focus on the short term by necessity. For the sake of illustration, let's assume an easing by the Federal Reserve. Traders and portfolio managers see the initial impact of the Fed action. They see the Fed buying short-term Treasury securities and the resulting fall in the interest rate on those securities. What they do not realize (or care about) is that the Fed's action has put into motion a process that later on will result in higher interest rates across the yield curve (that is, on both short- and long-term securities). When interest rates eventually rise because of increased inflation, the action that put the process in motion and initially lowered interest rates will be long forgotten.

A second reason for the persistent belief in bad economics is the fallacy of *post hoc ergo propter hoc* ("because event A is followed by event B, A caused

B”). Monetary policy has frequently been conducted, in the United States and abroad, in a manner that is highly correlated with real economic activity. This makes growth seem to cause inflation when in fact there is no natural relation. In a recession, the Fed eases because such an action may be effective in stimulating a sluggish economy. Certainly, easing is much desired by the voters and by businesses. A year or two later, during the expansion (and we will never know whether the expansion would have occurred without the easing), the increase in the money supply is reflected in accelerating inflation. It only appears that the expansion has caused the inflation; actually, it was the long-forgotten Fed easing that caused it. The downward phase of the business cycle creates the same illusion in reverse: Out of concern about inflation, the Fed tightens and both growth and inflation slow. But again, the slower growth did not damp the inflation. The Fed tightening did.

Most of the real economic growth in the United States in the 20th century, of course, took place under conditions of little or no inflation, or of deflation. The roaring 1920s had an annual inflation rate of negative 0.4 percent (excluding 1929, which didn't roar). From 1952 to 1965, a period during which the economy once again boomed, inflation proceeded at the docile annual rate of 1.3 percent. More recently, observers have been amazed at the low inflation rate (relative to this generation's experience) in the booming economy of the 1990s. They should not be amazed; that is the way it usually happens. The inflationary booms that punctuated the generally depressing period from the late 1960s to the early 1980s were aberrations, not the rule.

The third reason that traders and portfolio managers may have absorbed bad monetary economics is that they learned it in school. The model often presented in undergraduate macroeconomics courses assumes the economy is in a depression and there can be no inflation. Among the exercises carried out with this model is tracing the effect of monetary policy on interest rates and the level of economic activity. This forms the policy analysis part of the course. Then refinements are introduced to make each component of the model conform better with economic reality, in which (for example) the economy is not in a depression and there can be inflation. However, the policy implications of the refined model are typically not traced out, even when they overturn the conclusions of the primitive model.

### **GOOD ECONOMICS VERSUS BAD ECONOMICS IN GENERAL**

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The faulty analysis of monetary relationships is a symptom of a deeper misunderstanding that might be called bad economics in general. This consists

of confusing short-run with long-run outcomes, intended with actual effects of a policy, and nominal with real quantities.

*The short run versus the long run.* Bad economics looks only at the short-run consequences of an action and assumes that these consequences are the end of the process. Good economics sees the short-run effects as the beginning of a process and tries to predict what will happen at the end of the process.

*Intended effects versus actual effects.* Bad economics assumes that the intended effects of a policy will be realized. Good economics incorporates the law of unintended consequences as a guiding principle. It ignores the intended or advertised goals of a policy and uses economic analysis to predict and discern the actual effects.

*Nominal versus real quantities.* Bad economics fails to distinguish nominal from real quantities; good economics highlights the distinction. What is worse, bad economics says that you can control real quantities by manipulating nominal variables. Good economics recognizes that, in the long run, nominal variables control only nominal quantities.

## **GOOD AND BAD MONETARY ECONOMICS**

Bad monetary economics is the application of bad economics to the analysis of the money supply, inflation, and interest rates, and the effect of these variables on the real economy. Consider the Fed trying to lower interest rates by easing monetary policy. To implement this policy, the Fed buys short-term Treasury securities on the open market, increasing the quantity of reserves available to banks. In turn, this increases the amount of bank credit and the money supply. The increase in the demand for Treasuries pushes their prices up and interest rates down. Hence, one is tempted to reach the conclusion that easy monetary policy lowers interest rates.

Another way to reach the same false conclusion is by looking at the money supply and money demand curves that are taught in undergraduate courses in macroeconomics. When plotted against interest rates, the money demand curve is downward sloping. A shift to the right in the money supply curve causes the point of intersection between the supply and demand curves to move so that it occurs at a lower interest rate. What makes this analysis bad economics? First, it looks only at the initial impact. We see interest rates fall when the Fed buys the Treasuries and conclude that interest rates have fallen. However, the initial fall in interest rates is only the first in a sequence

of events that will result in interest rates rising. We will follow this sequence of events through to its proper conclusion in a moment. Second, it assumes that because the Fed intends or wants to lower interest rates, it will succeed in doing so. There is no reason to expect this. Third, it fails to distinguish between real and nominal interest rates.

Good monetary economics derives from the economic thinking that prevailed around the beginning of the 20th century. J. G. Knut Wicksell (1851 to 1926) postulated that there was a natural rate of interest that was determined by market forces, such as the supply of and demand for capital.<sup>3</sup> According to Wicksell's theory, monetary policy can only temporarily move the interest rate away from the natural rate; markets will always move it back toward the natural rate after an intervention. Some years later, Irving Fisher (1867 to 1947) drew the distinction between real and nominal interest rates.<sup>4</sup> He was the first economist to state clearly that the (nominal) interest rate on a bond is composed of two parts: the expected inflation rate over the life of the bond and a real interest rate representing the gain in purchasing power expected by the bondholder. The tendency of bonds to incorporate inflation expectations into their nominal yields is known as the Fisher effect.

Milton Friedman, who won the 1976 Nobel Prize in economics for his efforts, combined the insights of Wicksell and Fisher.<sup>5</sup> He postulated that there is a natural real rate of interest. According to Friedman's theory, which still stands as the best explanation of these phenomena, expansionary monetary policy temporarily reduces both real and nominal rates. However, the growth of the money supply stimulates spending, causing an increase in the demand for loans and in prices, returning the real interest rate back to the natural rate. And the increase in expected inflation will result in a higher nominal interest rate through the Fisher effect.

By following the process from the initial easing through to its conclusion, one can see that the Fed's policy had a result opposite of that which was intended, and also opposite of that which many of today's investors are banking on. Like an orbiting spaceship that has to apply the brakes so that it will fall to a lower orbit and increase its speed, the Federal Reserve has to raise—not lower—nominal interest rates in the short run in order to lower them in the long run.

### **HOW MONETARY ECONOMICS BECAME CONFUSED**

Bad monetary economics was common among academic economists from the end of World War II to the 1970s. The Great Depression of the 1930s shook much of generally accepted, neoclassical economic theory to its

foundations. The failure of neoclassical theory to predict or at least explain the Great Depression was the grounds for a revolution in the economics profession and the creation of a new economic paradigm.

In that new paradigm, the level of *animal spirits* among business executives is said to determine the state of the economy. (Animal spirits are what make Bill Gates continue to reinvest billions of dollars and prodigious amounts of personal energy in Microsoft, instead of cashing out and taking it easy.<sup>6</sup>) If there are not enough animal spirits, the theory proposes, the economy will fall into a depression. A depression is not necessarily self-correcting; without government intervention it could last indefinitely. Once government intervention restores the economy to full employment, the government must continue to intervene because there is no reliable source of animal spirits to keep the economy from falling into a depression again.

The government intervention that was prescribed in the Great Depression of the 1930s was aggressive fiscal policy supplemented by easy monetary policy. Aggressive fiscal policy would keep aggregate spending high so that a further economic contraction would be prevented. Easy monetary policy would keep interest rates low, encouraging capital expenditures and helping to move the economy closer to full employment.

These policies were not just an emergency measure to deal with the Depression. They reflected a whole new approach to public management of private economic activity and were continued after the Depression was over. Because the adoption of these policies by many non-communist countries coincided with the tremendous growth of world income in the 1950s and 1960s, policymakers and economists generally came to accept the new paradigm. In retrospect, it is not likely that the world economic boom of that period was due to expansionary macroeconomic policy. As the economist Allan Meltzer and others have noted, it was more likely the result of population growth and freer global trade in both goods and capital.<sup>7</sup>

In its original form, the new economic theory did not predict inflation. The inflation experienced during the economic expansion of the 1950s and 1960s—at a rate we would today consider very moderate—led to a modification of the theory. In its modified form, the benefit of government intervention (low unemployment) comes at the cost of inflation.<sup>8</sup> However, because inflation is a minor inconvenience when compared with the alternative of high unemployment, the government should pursue expansionary fiscal and monetary policies, but be careful not to overheat the economy and cause too much inflation.

As we shall see, the inflation of the 1950s and 1960s was not caused by prosperity, nor was prosperity caused by inflation. Rather, inflation was the entirely predictable outcome of a monetary policy that tried, and predictably failed, to keep interest rates low.

## **THE RETURN OF SOUND MONETARY ECONOMICS AMONG ACADEMIC ECONOMISTS**

The Depression-born macroeconomic theory was widely, but not universally, held by academic economists through the 1950s and 1960s. However, there were notable exceptions, such as Friedrich Hayek<sup>9</sup> and Milton Friedman. In his presidential address to the American Economic Association in 1967,<sup>10</sup> Friedman showed that the Depression-era paradigm was bad economics. He noted that the theory focused exclusively on short-run effects and confused real and nominal quantities. Through the Fisher effect, he explained, expansionary monetary policy leads to higher rather than lower interest rates. There is no long-run trade-off between inflation and unemployment, as Friedman's contemporary, Edmund Phelps, had recently demonstrated. Expansionary monetary policy can lead to increasing inflation, even if unemployment is rising.<sup>11</sup>

The experience of the 1970s vindicated Friedman. (Friedman's presidential address is one of the few cases of an economist making a prediction that was correct, as opposed to rationalizing an event after the fact.) As inflation and unemployment rose together, the notion of a trade-off vanished. Interest rates rose rather than fell during a period of monetary expansion. The theory that was born in the Great Depression of the 1930s died in the Great Stagflation, or inflationary recession, of the 1970s. Bits and pieces of it may appear in newer theories, but the grand theoretical edifice is gone.

## **WHAT MONETARY ECONOMICS REALLY SAYS**

Now that we have seen what bad monetary economics is, how it came to be widely believed, and how it died out in academia, let's see what good economics says about interpreting data. Investors should pay attention to the following relationships between money, nominal interest rates, real interest rates, inflation, and real economic growth.

Growth does not cause inflation. Monetary expansion causes inflation. An economic report that suggests growth has been or will be higher than expected should be taken as good news for stocks.

Inflation does not cause growth. A nation cannot inflate its way out of a recession because ultimately real economic forces, not monetary forces, determine the level of real economic activity.

Monetary policy will neither slow nor accelerate the real economy much in the long run. There may be substantial effects in the short run, but these effects are more likely to be reversed than not.

Stockholders should do nothing in response to an unexpected monetary policy change, because in the long run, stocks are real assets and should not be sensitive to inflation. Bondholders should expect to benefit in the long run from an unexpected Fed tightening and to be hurt by an easing.

If inflation is accelerating, it is because of past Fed easings, not because of prosperity and growth. However, because inflation is one of the few things on which the Fed does have a long-term influence, a tightening will damp the threat of inflation—and will not, except in extreme circumstances, cause a recession.

If growth is sluggish or if we are in a recession, a Fed easing is not likely to pull us out of it. We can have higher inflation without economic growth, as happened in the 1970s.

As John Stuart Mill noted long ago, money “only exerts a distinct and independent influence of its own when it gets out of order.” When the monetary system is working, it is not the monetary authority that runs the real economy, but business executives, workers, shareholders, and consumers. Good corporate projects earn a 15 percent or 20 percent or 30 percent return on investment, and the decision to undertake them or reject them does not depend on whether the Federal funds rate is 6 percent or 6.5 percent (or 0.5 percent, as the Japanese are finding out to their dismay). The Fed does not allow economic growth to occur through easy money; nor does it prevent growth from occurring through tight money.

In the long run, the monetary authority has influence only on nominal variables, such as the rate of inflation and nominal interest rates. Long-run investors should be concerned about Fed actions only to the extent that nominal factors affect the real return on their investments and their standard of living. Beyond this, it is only in an extreme situation in which the whole monetary structure of the economy is threatened that investors should be concerned with the actions of the monetary authority.

## NOTES

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1. Mill (1929), p. 488.
2. Hazlitt (1946).
3. Wicksell (1898).
4. Fisher (1930).
5. Freidman (1968).
6. Keynes (1936) famously characterized business people as being driven by “animal spirits” rather than by a rational calculus as presumed by neoclassical economic theory.
7. Meltzer (1981).

8. The supposed trade-off between inflation and unemployment is known as the “Phillips Curve,” as it is based on the empirical findings of Phillips (1958).
9. See Hayek (1931) for his theory of the business cycle.
10. Friedman (1968) is a transcript of that address.
11. Phelps (1968).

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