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Limits of Economic Knowledge

by Richard W. Rahn

WHY POLICYMAKERS MUST CONCENTRATE ON WHAT IS KNOWN

The good news is that the U.S. economy is now on track to grow more than 3 percent this year for the first time in 13 years. The bad news is that the economy would be growing even faster if it were not for policy mistakes.

Business people and investors hate uncertainty, and the more uncertainty, the less prone they are to invest, particularly in new things that have a greater risk. And it is precisely the willingness to invest in higher-risk investments that most often has the greatest payoff, both for the individual and the economy.

The Trump administration deserves credit for cutting back on needless, counterproductive and vague regulations that only served to increase uncertainty. It reduced tax rates for businesses and individuals, thus increasing incentives to work and invest. On the other side of the ledger, the administration has greatly increased uncertainty by arbitrarily increasing tariffs on a number of countries. Granted, this has led to perhaps some improvement in trade treaties — but the continued uncertainty of what the resolution with China will be is an economic drag. The administration has also increased uncertainty by failing to rein in federal spending.

Rocket scientists and space engineers are able to place the Mars Rover on a far-away planet with great precision, but economists cannot agree on how much growth is possible, let alone hit a target with some reasonable precision. During the Obama years, many economists who supported his policies were selling a line that we had reached a "new normal" where the economy could not grow more than two percent a year on a sustained basis. Other economists, including this writer, argued that such a limitation was pure bunk.

The president has been critical of the Fed for increasing interest rates — and most of the economic establishment has sided with the Fed against the president. (Real estate developers, for obvious reasons, normally favor low interest rates.) The president may have been wrong, but in fairness, the Fed has a dismal forecasting record and even former Chairman Alan Greenspan confessed in his book, "The Map and the Territory," to having made major policy mistakes.

What is the right rate of interest? How does one know that? Why is the government in the business of trying to set interest rates anyway? (The interest rate is the price of money — and most people have learned that disaster normally is the result of government bureaucrats attempting to set the price of almost anything.) Students were taught that the interest rate consisted of two components — the expected rate of inflation and the real rate of return to money. Real rates were normally considered to be in the 2 percent to 3 percent range — so if the expected inflation rate was 2 percent, the nominal rate of interest for the safest investments (like government bonds) would be 4 percent to 5 percent.

Sounds so simple. But year by year, we have less and less knowledge about the rate of inflation. Back when people spent most of their income on a largely standardized set of goods, it was relatively easy to measure the changes in the price level. A couple of hundred years ago, a family may have spent 70 percent of its income on food — flour, corn, rice, eggs, etc. Now the family spends a small fraction of that on largely "prepared" meals. How do you compare the real cost of an old landline with a smartphone — two different products?

Rather than a small yearly amount of inflation — given the change in what people now buy in goods and services and the benefits that they obtain, it can be argued we have actually had a massive amount of deflation — meaning a much larger increase in living standards than has been reported. Many rant about medical inflation, but new devices and drugs not only enhance our lives but keep us alive. Is that deflation or inflation?

Some economists, like the well-known Canadian economist Michael Walker, argue that, as the population ages, saving rates rise — and the increasing quantity of saving should cause the real rate of interest to fall. There is also evidence that it now may take less new capital investment (from saving) to obtain a given increase in output. Others argue the opposite.

The point is that there is much that economists do not know, but there are some things that good economists do know, and hence policymakers ought to concentrate on the knowns. For instance, we know that increasing government spending as a percentage of GDP beyond some point is a net drag on economic growth and employment — and that the United States is well beyond that point, as are most developed countries. Thus the administration and Congress should reduce spending as a percentage of GDP.

Economic growth, employment and real wages can continue to improve, if policymakers concentrate on removing the known barriers to growth, rather than trying to manipulate variables where they lack sufficient knowledge and/or control, or creating some new magical government spending scheme. The most successful countries tend to have smaller and simpler government sectors. The lessons should be clear.

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