

AT LAST - RECOGNITION AT THE FED

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On many previous occasions we have lamented the fact that economics and investment textbooks pay little attention to the balance sheet and its influence on the economy as a whole. You may recall that the main reason for our call on the recent recession came from paying attention to the Federal Reserve's Flow of Funds Schedule. It clearly indicated the degree of leverage being used in the economy. It more than doubled in the 2000s and obviously could not be sustained much longer, and it wasn't. The private sector is deleveraging, but the public sector is taking up the slack, at least for now. There will be a limit as to how much they can borrow, but it's still well into the future.

The good news is that at last those whose opinions count in such matters have taken notice. Please note the following quote from Don Kohn, vice chairman of the Federal Reserve Board of Governors:

"It is fair to say, however, that the core macroeconomic modeling framework used at the Federal Reserve and other central banks around the world has included, at best, only a limited role for the balance sheets of households and firms, credit provision, and financial intermediation. The features suggested by the literature on the role of credit in the transmission of policy have not yet become prominent ingredients in models used at central banks or in much academic research."

One needs to recognize the problem before it can be addressed. It looks like recognition is at hand. Let's get it into the macroeconomic model.