Central Bankers Beware

By Bernard Connolly

AI's effects are unpredictable.

Is it really different this time? Is incoming Fed Chair Kevin Warsh preparing to repeat the mistake that Alan Greenspan made in the second half of the 1990s, one that allowed something very favorable—the information technology revolution—to produce a succession of bubbles that have threatened financial, social, and political stability in the Western World? Or does the widespread fear that artificial intelligence will wipe out swathes of service sector jobs and upend comfortable middle-class lifestyles sharply differentiate the economics of the present investment boom from those of the late 1990s?

The Iran war reminds us that everything—and particularly financial markets—can change very quickly. But whatever lessons we may or may not have learned from events at the beginning of the millennium about the pros and cons of military interventionism, economists and policymakers seem reluctant to learn from the unravelling of the dot.com boom at around the same time. Warsh has echoed Greenspan's late-1990s comments about new technology and productivity growth. He claims that AI-related productivity improvements will so reduce inflation that interest rates can be significantly lower than otherwise. Both sets of comments radically misunderstand the importance of time and of sequencing.

Capitalism is above all else about the relationship not between classes, as Marxists pretend, but between the present and the future. For the proper functioning of a capitalist society—long may we preserve one—there needs to be a positive relationship between two links between the present and the future: the anticipated rate of return on investment and the *ex ante* real rate of interest. In a Crusoe economy, if the solitary islander discovers an attractive

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investment opportunity—making a ladder, for instance—then even if nothing changes his rate of time preference (even if he does not, for instance, become privy to greater worry about uncertain outcomes), he will reduce his consumption or curtail other investment activities in order to provide the resources (principally labor time) needed to implement the new project. Investment and saving—abstinence from consumption—will always be in balance. And, *ex ante* at least, when the new investment has been completed, additional resources are available and investment needs are reduced, so that consumption can increase by more than the initial abstinence and postponed investment projects can be resumed. In a decentralized monetary economy, however, in which both unemployment and overheating are possibilities, when attractive new investment opportunities appear there has to be some mechanism to induce saving (abstinence from consumption) and/or a postponement of previously existing investment projects. In short, the *ex ante* real rate of interest must rise.

Former Fed Chair Ben Bernanke was particularly culpable, after the fact, in not recognizing that necessity. He claimed that monetary policy is too blunt an instrument for avoiding inappropriate booms, since it would deter the investment required to seize new technological opportunities. But monetary policy, operating through increased interest rates, is exactly what is needed to postpone lower-return projects (including consumption) in order to provide the resources for the higher-return projects. The market value of firms with "new" tech projects should rise, but that of other firms should fall. (As an aside, but an important one, in an economy facing a world interest rate not entirely determined by domestic developments, the need to postpone "old" projects is reduced by importing resources from abroad—an increased current account deficit and bigger capital inflows; whether that consideration is trumped by pressing geostrategic concerns is a question to which space does not permit an answer here).

If monetary policy does not tighten, there will be violently destabilizing swings in the balance of supply and demand, first as demand increases when supply has not yet increased, then as demand falls (as the new investment projects are completed) and supply has by now increased.

It is easy to recognize exactly such a pattern in the late 1990s and the beginning of the 2000s, as Greenspan kept on refusing to raise rates soon enough and far enough. The point of inflection came in the summer of 2000, when it was as if company leaders had all got out of bed one morning and realized with a shudder that the demand to take up all the additional supply they were creating was not going to be there: it had already happened. Say's Law does not operate in a monetary economy. Instead, there was what I christened at the time a Super-Say's Law effect, in which the prospect of future supply created more than corresponding present demand, followed by a Super-Say's Law-in-reverse effect, in which demand fell just as supply eventually increased. The subsequent efforts of the Fed to prevent recession and deflation, via sub-normal interest rates and large-scale asset purchases, created bubbles in asset prices (notably home prices) and credit that came close to destroying the economies of the West in the financial crisis of 2007–2009 and continue today, threatening not only financial stability but also social and political stability via the enrichment of elites while "normal" people struggle.

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Is this a disaster that thinking such as Warsh's now threatens to repeat and amplify? That risk is real. But there are important differences between the AI revolution and the internet revolution of the 1990s. Importantly, at the height of the internet boom in 1999 and into 2000, consumer confidence was sky-high. The new technologies seemed to promise untold consumer benefits while displacing only few employees—some postal workers perhaps, but not, in popular imagination, many other jobs (this was before Amazon became the giant it subsequently grew into, for instance). Consumption, instead of being held back to provide resources for new projects, rose moderately strongly. In present circumstances, however, the very widespread fear, justified or not, that AI will destroy people's jobs without creating new employment quickly enough has depressed consumer confidence and has been having, it seems, at last some restraining effect on consumption—the consumption of "normal" people at least, even as continuing asset price and credit booms sustained, pre-Iran, the consumption of elites. So is there a mechanism—not the Crusoe mechanism but a potentially sinister mechanism (and a prolonged Iran would be another)—that could neutralize destabilizing swings in the supply/demand balance even without significant increases in real interest rates?

Continued on page 61

Continued from page 27

No one can—or should—predict with any confidence exactly how the impact of AI will play out. All that is clear is that advances in AI are taking place at an astonishing rate.

Their labor-saving (or labor-destroying, according to taste) impact will in the future free more labor resources for the construction of tangible capital—more hospitals, for example.

But their recent impact has been to create enormous calls on resources to build data centers and the like. All else being equal, that calls for higher real interest rates. But while the impact on the economy as a whole is likely to be highly favorable, that may mean little in the calculations of many individuals. In the game of snakes and ladders which is, predominantly and undoubtedly for the better but to some extent for the worse, the capitalist economy, the ladders for the few will truly reach to the sky, but many, many people will perceive only snakes menacing their jobs and their lifestyles.

In the spring of 2025, when tariff fears initially crashed stock markets, the right course for the Fed briefly seemed clear: however regrettable it might have been in the context of the past quarter-century of maintaining bubbles, it was going to have to cut rates hard to support the economy if the depression of asset prices was maintained for long.

But once markets recovered, the picture became very fuzzy indeed—and has been made even fuzzier by the Iran war. That war, too, if it continues, poses the policy question of whether "it's different this time." The policy response certainly needs to be. What turned the oil shocks of the 1970s from a one-off shock to the overall price level into a prolonged period of horrendous inflation was a set of policies in the West that attempted to shield populations from the real-income-reducing impact of higher oil prices. Such policies—including subsidies, regulation, acceptance or even promotion of union power, prices and income policies, and indexation mechanisms—directly involved or led to highly inflationary fiscal and monetary policies. Now, "the West" is divided along multiple axes. One is that the United States as a nation is, thanks to its domestic production of oil, much less adversely affected by high oil prices than is the rest of, say, the G7—although the country's socio-political problem of a K-shaped economy will be aggravated by those high prices. To repeat, no one can sensibly predict the balance, either now or in the future, between saving and investment in response to the conflicting consequences of AI. And no one knows how long-lasting the consequences of the Iran war may be. Given that, the Fed will unavoidably have to be data-dependent. At present, inflation in the United States remains above target and productivity advances have not yet permeated the economy, while previously incipient labor market weakness seems to have been contained. In the circumstances, the caution of the pre-Warsh Fed about cutting rates seems, for now, to have been amply justified.

True, the conjuncture could turn on a sixpence, as in 2000–2001 or 2007–2008, if we see booms in asset prices or credit collapse (it is useful to recall that in the late spring of 2008 the Fed was contemplating a tightening of policy in response to a surge in oil and commodity prices; by the end of that year it had reduced policy rates to zero). And the worries of "normal" people about jobs displacement might weigh on current consumption sufficiently to allow AI investment to continue without causing initial overheating (and a widened trade deficit) and subsequent recession. These, including persistent oil shocks translated into ongoing inflation by misguided "cushioning" policies, are contingencies, not confidently predictable outcomes. With macroeconomic uncertainty so pronounced, the Fed will need a laser focus on data and must be prepared to move rapidly and forcefully, in either direction, should contingency look increasingly likely to become reality. The Powell-led Federal Open Market Committee appears to have accepted at least the first element of this prescription, which might seem anodyne enough. But the worry is that a less dubitative, indeed a one-sided, view based on a faulty *a priori* analysis of how a capitalist economy ought to work might be a consequence of Warsh's apparent thinking. ◆

The AI *vs.* Digital Revolution

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