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The Fed is not ready for the next recession

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By David Beckworth

An increasing number of observers believe that the United State is inching closer to a recession. They see the stock market rout, plummeting oil prices, and falling inflation expectations as an ominous sign for the economy. Some also worry that the Fed's raising of interest rates in December may have gotten ahead of the recovery. They fear this tightening of monetary policy could intensify these other dire developments and be the tipping point that pushes the economy into recession.

The Fed Has a Problem

Whether or not a recession actually occurs, one thing is certain. The Fed in its current form is not well equipped to handle another downturn. The Fed's inability over the past seven years to create a strong recovery from the last recession speaks to this weakness. The Fed tried everything from pushing interest rates to zero percent to buying up trillions of dollars of government bonds and yet it was still not able to generate the spending needed to get the economy back to full health.

Some blame this failure on the Fed running out of ammunition. But this cannot be the reason since the Fed could have cut interest rates further, as demonstrated by central banks in Europe and Japan that now have negative interest rates, and it could have bought more bonds.

The real reason for this failure is the Fed's firm commitment to low inflation. Like a governor placed on a truck's engine to control its speed, a commitment to low inflation helps prevent the economy from growing too fast. Normally, this is a good thing. But sometimes it can backfire. A truck driver may need to temporarily go faster to make up for lost time after being stuck in traffic. Similarly, an economy may need to temporarily speed up to get back to its full potential after a recession. Neither can happen with a rigid adherence to the speed limit.

This is why no matter what the Fed tried there never was going to be a sharp recovery from the 2007-2009 recession. All the Fed's tools—the setting of short-term interests, the buying and selling of government bonds, and the management of expectations—were handcuffed by its strict devotion to low inflation. They would never be allowed to generate the spending growth required to put the economy completely back to work. My own estimates show that in order for the Fed to have fully restored spending would have required inflation temporarily hitting between 3% and 4%. The Fed, however, has kept inflation between 1% and 2% since the end of the crisis.

This devotion to low inflation at all costs is a consequence of the Fed being an inflation-targeting central bank. The Fed officially became one in 2012 when it adopted an inflation target of two percent, but many studies show that it implicitly began targeting low inflation in the early 1990s. Over time the Fed's commitment to low inflation has become what the body politic expects from the central bank. Anything else is now simply intolerable.

This intolerance is why the Fed is not prepared for another recession. It has put itself into an inflation-targeting straightjacket that simply does not allow for the flexibility needed to keep spending stable.

Imagine, for example, that China devalues its currency 10% or more, as some expect. Given the sharp fall in stock markets and oil prices that occurred last August when China devalued only 2%, a drop of this magnitude would most likely be disastrous for financial markets and economic activity across the globe. For the U.S. economy, that could mean rising unemployment and a return to deflation. The Fed could respond with negative interest rates and additional purchases of government bonds, but could only do so up to the point they generated low inflation. That does not give the Fed much power.

How to Fix the Fed's Problem

So what can be done? One solution is for the Fed to abandon inflation targeting altogether and instead aim to stabilize total dollar spending in the U.S. economy. This approach would give the Fed freedom to vigorously respond to recessions without worrying about short-run movements in inflation. It would, however, still anchor inflation over the long run. It is exactly the fix the Fed needs.

Here is how it would work. The Fed would pick a target growth rate for total dollar spending and commit to keeping it on a steady growth path. That means the Fed would not only aim to keep current demand growth stable, but it would also make up for past misses of its target.

This approach is illustrated in the top panel of Figure 1. It displays the actual path of total dollar spending, as measured by nominal GDP (NGDP), as well as its 1984-2007 trend. If the Fed had adopted this historic trend as its target growth path then it would have had to make up for the 2008-2009 shortfall by temporarily growing NGDP faster than normal. Figure 1 shows three different paths total dollar spending could have taken back up to the trend. Each of them has total dollar spending temporarily growing faster than the trend growth rate of 5.2% in order to make up for the past miss of 2008-2009.

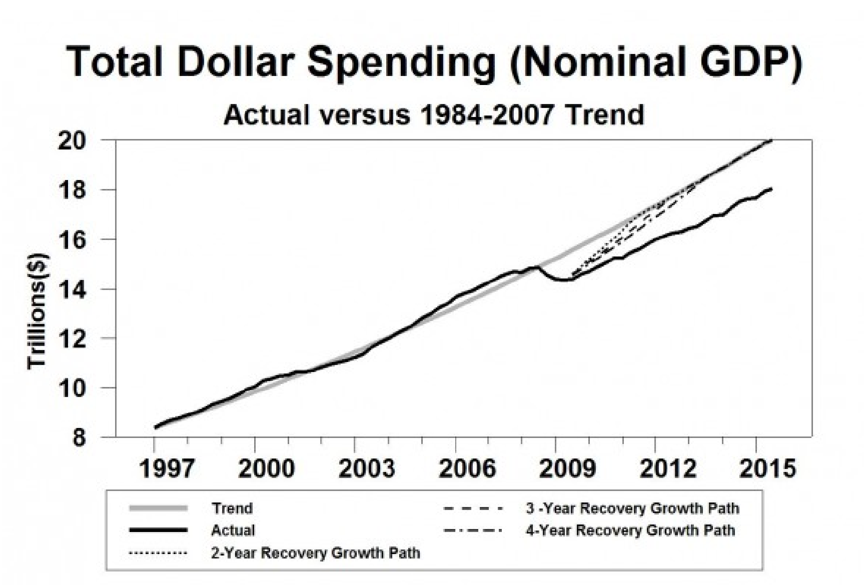
These periods of faster-than-normal NGDP growth would result in inflation temporarily rising above 2%. The second panel of Figure 1 shows the estimated inflation rates under the three different catch-up paths. In all cases, the departure of inflation from 2% is temporary and settles down once expenditures have returned to the targeted growth path. This is the equivalent of the trucker being able to temporarily speed up after being stuck in traffic in order to make up for lost time.

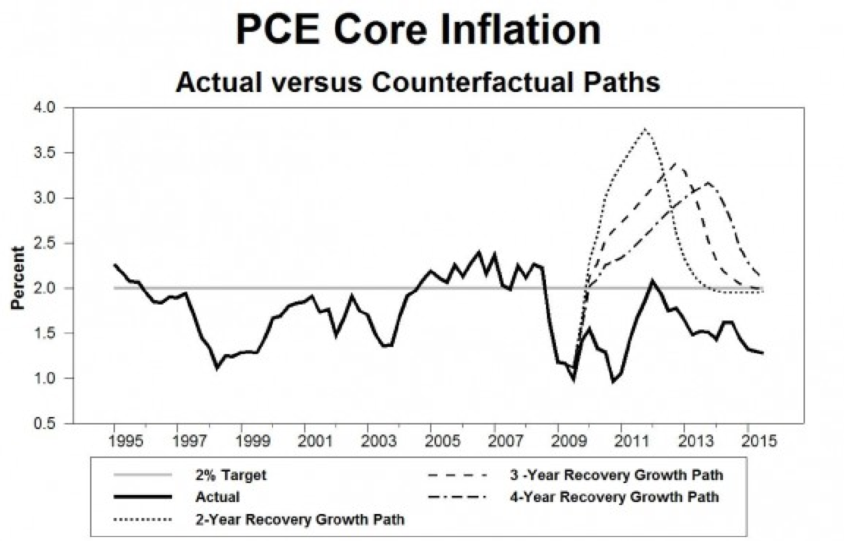
In the case of an economic boom, say a housing bubble, where spending grew faster than 5.2%, the opposite would happen. The Fed would slow down total expenditure growth until spending returned to the trend line.

One attractive feature of this approach, is that it would create expectations of stable spending that would become self-fulfilling. That is, households and firms would have less incentive to rapidly spend or hoard money in the first place if they believed the Fed would always correct for past misses in spending. This would help minimize boom-bust cycles.

Though no country has explicitly adopted a target growth path for NGDP, Australia and Israel did something very similar during the 2008-2009 period. They kept total expenditures on a stable growth path. Though this temporarily resulted in higher inflation for them, their economies were relatively unscathed by the Great Recession of 2007-2009. The United States and the Eurozone, on the other hand, failed to stabilize spending and suffered severe recessions. But hey, at least they got record-low inflation.

Figure 1:





How to Make the Fix Credible

As noted above, a NGDP growth path target should create its own self-fulling expectations of stable demand growth. One way to reinforce this tendency and insure against central bank incompetence is to have the U.S. Treasury Department provide an automatic backstop for the spending target. This would make the system foolproof.

The way it would work is that once a year the Treasury Department would check to see if the Fed was keeping total dollar spending on target. If it fell below target, the Treasury Department would automatically deposit bonds at the Fed and send the new money created by those deposits directly to households. It would continue to do so until spending got back up to its targeted growth path.

If total dollar spending were above target, the Treasury Department would again deposit bonds at the Fed. But this time the Fed would be required sell the bonds to the public, which would take money out of circulation. The Treasury Department and the Fed would continue doing this until spending fell back down to its targeted growth path.

The Treasury backstop would further reinforce the public's expectation that the NGDP target would be hit at all times. With this expectation, however, the Treasury Department would rarely if ever need to provide an actual backstop. The target, in other words, would become a self-fulling outcome where the public did the actual heavy lifting by adjusting their spending patterns.

The Treasury backstop would also provide a strong incentive for the Fed to do its job well. The public humiliation of having someone else doing their job would make Fed officials work very hard to stabilize spending the first place. This would reinforce the credibility of the target.

Saying Goodbye to the Business Cycle

A total dollar spending target would solve the Fed's current inability to adequately respond to recessions. It would also go a long ways in preventing them from ever happening in the first place since the boom-bust cycle in total dollar spending would largely disappear. This has implications that both conservatives and liberals can appreciate.

For conservatives there would be far less need for discretionary fiscal policy to respond to the business cycle. That would mean less growth of government debt. It would also mean that monetary and fiscal policy would be become far more predictable and rule-like.

For liberals there would be far less human suffering since large cyclical swings in unemployment would disappear. It would also mean more stable wage growth since a total dollar spending target would, in effect, also be stabilizing the growth of total dollar income.

Over the past seven years these desirable outcomes have been missing and speak to the urgent need for the Fed to adopt a new monetary regime like a NGDP growth path target. Until this happens, the Fed will continue to have a recession problem. And with a potential recession looming, this problem may become very real very soon. It is time to fix the Fed.

David Beckworth is a former US Treasury economist, visiting scholar at the Mercatus Center, and an associate professor of economics at Western Kentucky University.

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