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What the Fed Can Do in the Next Recession

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The U.S. economy has been growing, jobs are being created, and the hope is that this continues. We are in the seventh year of recovery since the Financial Crisis of 2008, and many experts think that a recession is likely in the next few years. With the federal funds rate near zero, if a slowdown were to happen sooner, the Federal Open Market Committee ("the Fed") will not be able to boost the economy by lowering rates back to zero. Although that logic is correct, unfortunately, some policymakers are using this line of reasoning to justify the Fed raising rates sooner and at a quicker rate.

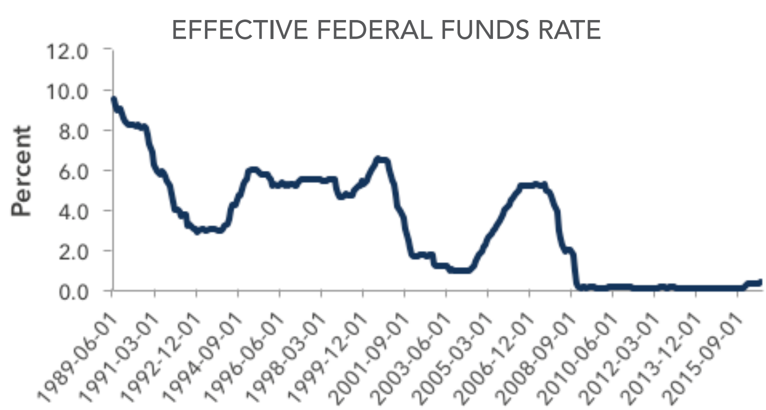
What those advocating raising rates don't realize, is that doing so too soon or too quickly can send the economy into a recession much faster and still not give the Fed much room to lower rates. However, lowering rates and quantitative easing, tools the Fed used in to fight the Great Recession, are not the only arrows in its quiver. In this article, I will briefly discuss some of the policy options, namely negative interest rates, targeting longer term rates, and helicopter money that the Fed could use to spur economic activity if a recession were to strike in this low rate environment.

Negative Interest Rates

The federal funds rate target range today is between 0.25-0.5 percent. If there were a recession tomorrow, reducing the federal funds rate to zero will clearly not be as effective as it was in 2008. To put things in historical perspective, the Fed cut the short term rate by 6.8, 5.5 and 5.1 percentage points in the 1990-91, 2001, and 2008 recession respectively.

It is this past percentage point decrease that is causing some experts to demand that the Fed hike rates quickly. With the federal funds rate near zero, one option the Fed has to stimulate the economy through the interest rate channel is to implement negative interest rates. That means banks are charged a fee on reserves above a threshold that they hold at the central bank instead of receiving interest on it. The logic is that in order to avoid the fee, banks will shift to other short and long term instruments, which will drive down their yields. Basically, by putting downward pressure on interest rates most relevant to borrowing and spending decisions, negative rates, in theory, work through the same channels as standard monetary policy.

Negative interest rates have been in the news because central banks in Europe and Japan have adopted this policy. The jury is still out on whether this tool has been effective considering that European economic growth is still anemic. The Fed would also have some serious legal hurdles and opposition from major banking institutions, because negative rates hurt bank profits. Until we get some very convincing data regarding its effectiveness over the next year or so, the chance of negative rates being used in the U.S. are quite low for the time being.



Source: Federal Reserve Bank of St. Louis

Targeting Long-Term Rates

The Fed usually spurs economic activity by influencing short term rates, but it also has the ability to target longer term rates even when short term rates are close to zero or slightly negative. Rate targeting works as follows: let's assume that the two-year Treasury rate was at 3 percent and The Fed says that it intends to hold the two-year rate at less than 1.5 percent, and is ready to buy any Treasury security maturing at two years. Since bond prices are inversely related to yield, the Fed would be acquiring those securities at a premium to the market price. The only way this strategy will be effective is if the market thinks that the Fed will be credible and will not abandon this policy sooner if, for example, they see inflationary pressures (bond yields rise in response to higher inflation). If the market does not trust the Fed, then all investors will sell their two year Treasuries to the Fed, which could then end up owning almost all eligible securities (inflate their balance sheet) without having much control over the direction of interest rates. On the contrary, if the market sees the Fed as credible, then the prices of eligible securities might move immediately to the stated level and the Fed might achieve its objective of lowering longer term rates without having to buy all the eligible securities. Lower yield on longer term securities allows firms to borrow cheaply to invest in their businesses and stimulate the economy.

Last week, the Bank of Japan ("BOJ") met to assess the current state of their monetary policy. Many economists thought that BOJ would discuss abandoning their easy money policy. BOJ, instead, went a step further and targeted the ten-year yield at 0 percent. To make sure that the market understands that the BOJ will honor its commitment, BOJ stated that it will tolerate inflation above its 2 percent target, essentially telling the market that it will honor its commitment even if there are inflationary pressures.

Targeting longer term interest rates could be a useful tool if a recession came tomorrow. Assuming that the market sees the Fed as credible, the Fed could reduce longer term rates without having to expand its balance sheet significantly. This, in my opinion, will be one of the top choices and will have more support from the masses than implementing negative rates.

Helicopter Money

Given that the scope for rate cuts is limited right now, the Fed can choose to adopt policies that target interest rates such as setting negative rates or targeting longer term rates. The benefits of low rates might erode and some unwanted costs may arise such as price inflation in other asset classes that may not have taken place had interest rates been higher. The price inflation in other asset classes happens when investors sell their bond holdings to the Fed and must now use the cash received in other investments to generate a return. However, as long as people can hold paper currency, another alternative exists: "helicopter money."

Helicopter money is a concept where the Treasury basically writes checks that can be used for any purpose such as a direct handout to its citizens or infrastructure projects. The way this happens is that the Treasury issues new bonds, but those bonds are bought by the Fed rather than financial institutions or other investors. The Fed creates new money and uses that to buy the bonds. The money that the treasury gets is used for the desired purposes. Now, one may ask how is this different from the Treasury issuing bonds and letting financial institutions or other investors buy them? The answer is that they are similar except that the Fed will require a lower interest payment compared to other bond buyers. If the bonds are issued at 1.5%, the Fed may only require that the Treasury pay 0.5% interest while it remits the rest back to the Treasury as a result, making the debt burden on this issuance slightly less than it would have been otherwise had outside investors been the primary buyers of these bonds.

Helicopter money can have a positive influence the economy in several ways:

1. Job creation if the money is spent on infrastructure projects.
2. Increase in household income if the money is given to its citizens which will lead to increased spending.
3. The increase in expected inflation as a result of the higher money supply. If rates stay low, then higher inflation reduces the real (nominal – inflation) cost of borrowing which can incentivize companies to make capital investments and spend more on their businesses.

Despite its theoretical appeal, I don't see this being the first option for the debt worried congress, but definitely one if the economy goes into a recession and seems like it will perform below potential for a long time. I'm sure if helicopter money was instituted, we would hear calls on how the U.S. will turn into Zimbabwe, where inflation is close to 50 percent per month. If you hear that, my advice would be to ignore those fake alarm bells.

Conclusion

As one can see, the Fed has other weapons in its arsenal that it can employ if it sees economic conditions worsen; even if lowering interest rates does not provide firepower it did in the past. The U.S. economy is growing between 2-3 percent annually, which by historical standards is low, but much better than economies of some other developed countries. One hopes that we don't have to talk about these alternative methods for a few years, but we also need to understand that there is a limit to what monetary policy can achieve on its own, and it is imperative for the fiscal authorities to wake up and do their part.

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