Opinion

Does the Fed Need Room to Cut?

BY JOHN A. WEINBERG

The U.S. economy has been growing steadily since the end of the Great Recession, and during most of that period, the target rate set by the Federal Open Market Committee (FOMC) remained exceptionally low. It has only been in the past few years that the FOMC has gradually raised the target rate to its current range of 2.25 to 2.5 percent, which is still low by historical standards.

Some have criticized those increases, arguing that despite the unemployment rate falling to unusually low levels, signs of incipient inflation are hard to find. Why risk potentially dampening the recovery in the face of a nonexistent threat, they have asked.

Recently, however, a different argument has been made by some other critics of FOMC policy actions. The target rate is too low, they claim. But not for the reason you might initially expect — namely, that they *do* see inflation on the horizon and believe the FOMC should act more aggressively than it has. Rather, they say the FOMC effectively needs to put more ammunition into its toolkit than it currently has to fight the next recession.

The argument goes something like this. When the economy has contracted in the past, the target rate has been substantially higher than it currently stands. As a result, the FOMC had room to cut to help foster a recovery. Writing in the *Wall Street Journal*, Harvard economist Martin Feldstein noted that the United States has experienced 11 recessions since 1945. With the exception of the Great Recession, most of those have been short and shallow. The reason, according to Feldstein? "[B]ecause the Federal Reserve historically has responded to downturns by sharply reducing the fed-funds rate."

Feldstein is correct that the Fed has in the past cut the target rate substantially during recessions. For instance, in response to the slowdown of the early 2000s, the Fed cut the target rate from 6.5 percent in December 2000 to 1.75 percent by December 2001. The magnitude of this reduction, about 5 percentage points, is roughly on par with the Fed's response to previous post-World War II recessions. Such historical comparisons suggest that the Fed is at risk of not being able to cut enough should a recession occur in coming years.

But in the standard models used for assessing interest rate policy, it is the level of the real rate that matters, not the change in the rate per se. With inflation expectations anchored around 2 percent and an effective zero lower bound for the nominal rate, the lowest you can bring down the real rate to is about -2 percent — no matter how high the nominal rate is when the Fed begins to cut.

It's not plain that increasing the nominal rate would be meaningful in the way that Feldstein and others have suggested, because it's not plain that a real rate of -2 percent wouldn't bolster the macroeconomy in the case of a typical downturn. Furthermore, it's true that rates are low by historical standards for an economy that has been expanding for nearly a decade. But relatively low rates are consistent with relatively modest growth, and annual real economic growth has been about 2 percent since the end of the Great Recession, roughly 1 percentage point lower than the rest of the post-World War II period. In a lower growth environment, it seems reasonable to believe that the Fed would not have to lower rates as sharply as it has in the past to achieve a real rate that would help bring the economy out of recession.

In addition, research done by my Richmond Fed colleague Christian Matthes, in conjunction with Regis Barnichon of the San Francisco Fed, tells me that we should not underestimate the costs of raising the target rate. Their research suggests that contractionary monetary policy shocks raise unemployment more strongly than expansionary monetary policy shocks lower it. That means, if anything, the cost of pushing rates in an expansion a little higher than would otherwise be expected could be greater than any benefit of being able to take rates down a little bit more in a recession.

One objection proponents of the "room to cut" argument might raise is that the rate increases they advocate would not be shocks, what Matthes and Barnichon discuss, at least not in the way that term is generally used. That is, those increases would be following an expected path. But raising rates higher than you otherwise would based on current economic conditions and the near-term outlook in order to create room to cut could act as a shock.

All that said, we never really know with high precision what the "correct" target rate is for any given set of economic conditions, and small differences in rates appear to make relatively little difference most of the time. Also, the efficacy of monetary policy is strongly affected by whether it instills confidence. So it's possible that if the public believes that having room to cut will be important in a future downturn, there might be some benefit to a slightly higher rate in the present at relatively little cost. But I suspect that any such benefit wouldn't be significant. And, importantly, the types of increases that current room-to-cut advocates favor are far from small and could bring with them considerable costs. **EF**

John A. Weinberg is a policy advisor at the Federal Reserve Bank of Richmond.