A brief history of the Fed’s “mistakes”

After almost seven years with a zero interest-rate policy (ZIRP), the debate is heating up about the Fed’s next move. Whatever it does, some are bound to accuse it of having made a mistake: the mistake of having waited too long if inflation ever accelerates or if the markets become over-exuberant; or the mistake of having been too aggressive if it raises interest rates and the economy subsequently falls back into recession or the stockmarket crashes. The Fed is the perfect scapegoat. In this note, we will examine the Fed’s “monetary mistakes” over the past 80 years in an attempt to shed light on the present situation.

Monetary mistakes: the reality and the legend

When the Fed cut its policy rate to zero at the end of 2008, its decision was dictated by circumstances at that time (the beginning of the most severe recession in the post-war period). No Fed official had in mind that this policy would prevail until 2015, nor that it would be coupled with QE that would lead to a quadrupling of the Fed’s balance sheet. Above all, no-one had any idea at the time about how to exit such a policy.

A debate about the exit strategy did not really take place until 2011, and even today the Fed is shilly-shallying. The FOMC seems committed to raising rates in 2015, at earliest in June and at the latest in December. But some commentators have sounded alerts about the risk of acting…or not acting. To shed light on this subject, we will examine a number of episodes considered to be “monetary mistakes”, when the Fed did either too much or too little, too soon or too late, by surprising the market or being too predictable. On each occasion, it was said that the Fed should have acted differently. Let’s examine these “mistakes”.

1937: too soon

The accusation – The Fed began tightening monetary policy before the recovery was complete, causing a double dip.

- Economic environment – The long-awaited exit from the 1929 crisis began in 1933 and gathered pace at the end of 1936. Activity was booming; real GDP increased at an annual pace of more than 10% between 1934 and 1936. However, there was still much unused capacity; the unemployment rate stood at 14.3% in 1937, compared with less than 4% before the Great Depression (it peaked at 25% in 1934). Ignoring the slack, the Fed reacted as soon as the first signs of inflationary pressures appeared by raising the level of required bank reserves. Activity began to slow in spring 1937 and a recession ensued. One year later, industrial production had plunged by almost a third and the unemployment rate had leapt to 19%.
The Fed’s responsibility – With hindsight, the argument that the Fed triggered a fall back into recession does not hold up. Its tightening measures were modest: short-term interest rates were raised by no more than 0.50%. At the same time, fiscal policy was tightened sharply to restore a balanced budget, representing a restraint of 3 points of GDP. The double dip in 1937 had a fiscal cause, not a monetary one.

What this implies today – The differences are greater than the similarities. The Great Recession of 2008-2009, however severe, was a much less violent economic shock than the Great Depression of 1929-1932. There is no risk today of a fiscal tightening within a visible timeframe.

1965: too late
The accusation – The Fed failed to foresee nascent inflationary pressures. The tightening came too late and was the distant cause of the stagflation of the 1970s.

Economic environment – The Fed tightened its policy slightly at the end of 1965, which seems consistent with a drop in unemployment and an acceleration in inflation towards 2% after years of ultra-low levels. This was a sort of macroeconomic golden age: strong growth, low unemployment and contained inflation.

The Fed’s responsibility – A debate divided economists and central bankers at the time about the equilibrium unemployment rate (the level below which inflation accelerates). Confident in the effectiveness of Keynesian stabilisation policies (the inflation-unemployment trade-off), many thought that 4% or even 3% was within reach. Experience has shown that the equilibrium rate is somewhere between 5% and 6%. An excessively low unemployment target results in the adoption of an excessively accommodative monetary policy, which is not tightened sufficiently when inflation picks up. Over time, this laid the foundations for an upward spiral in inflation expectations after the surge in oil prices from 1973 onwards. Between 1952 and 1968, the inflation rate averaged 1.6% annually, and the unemployment rate was also very low at 4.8%. It is understandable that the Fed sought to preserve this ideal mix. Unfortunately, by wishing to give the same importance to supporting activity as to inflation stability, the Fed only managed to produce inflation and unemployment in the 1970s.

What this implies today – The present situation has a few similarities with that in 1965: inflation is weak and unemployment is close to its full-employment level. Note that the reference to 1965 has appeared several times in speeches by John Williams, president of the San Francisco Fed and Janet Yellen’s former chief economist. The difference today is that the Fed has an explicit inflation target (2%) and is not prepared to tolerate a significant deviation from it in the future.

1979: too brutal
The accusation – Paul Volcker, the Fed’s new chairman, shattered the economy (three years of recession) with an ultra-restrictive policy. But 20 years of prosperity followed.

Economic environment – In contrast to today, the economy was in stagflation, with high unemployment and inflation levels.

The Fed’s responsibility – The monetary debate is similar to that today, revolving around the use of quantitative tools and the Fed’s credibility. Paul Volcker ditched the pseudo inflation/unemployment trade-off and choose to dampen inflation expectations, even at the cost of triggering a recession (there were two: at the start of 1980 and then from mid-1981 to the end of 1982). The Fed’s interest rates peaked at 20% in 1980/81. This policy was only eased in July 1982, when inflation had fallen from over 14% to 6%. The Fed had established its credibility for the next three decades.

What this implies today – The question of whether such high inflation in the 1970s was due to an overly accommodative monetary policy or to other factors (oil shock, Vietnam war, arrival of baby-boomers on the job market) has not been settled. The two series of causes are intertwined. Two lessons should be drawn from this episode. The first is that a central bank sometimes needs to prioritise the objectives of its mandate. The second is that monetary policy has a proven effect on nominal variables (expected inflation), but not on real variables. The Fed has adopted an ultra-stimulating policy in recent years to boost employment, but it still needs demonstrating that the steep drop in unemployment is the result of the ZIRP and QE. It could afford this exceptional policy all the more easily thanks to global deflationary pressures. The risk would be to forget that wages and prices can accelerate when the utilisation rate of production factors starts to increase.
1994: too unexpected

The accusation – The Fed tightened its monetary policy by surprise, catching the markets off guard and triggering a global bond crash.

- Economic environment – At the start of 1994, the market was convinced that the economy was still in convalescence after the recession of 1991 (unemployment rate of 6.5% and a stable inflation rate of between 2% and 2.5%). It did not anticipate any monetary policy shift.

- The Fed’s responsibility – Without any preparation, the Fed decided to exit its policy of zero (real) interest rates in place since mid-1992. In the space of one year, the Fed funds rate was raised from 3% to 6%. The bond market took fright and ten-year yields soared from 5.8% to 7.9% between January and September 1994. The central bank’s transparency (minutes, speeches and press conferences) was only embryonic at that time. Based on today’s criteria, the Fed committed a communication error. In February 1994, the FOMC expected to raise interest rates by around 150bp. It was the bond market’s over-reaction that, by sparking fears of an increase in inflation expectations, led the FOMC to raise interest rates by 300bp. While the timing does not seem to have been a mistake, better communication would have made for a softer landing possible. Despite the severity of the financial shock, the economy absorbed this monetary tightening without much difficulty. The following years were very prosperous, perhaps too much so, since they led to “irrational exuberance”.

- What this implies today – The Fed is clearly terrified of triggering an over-reaction by the bond markets. Its communication is totally different today from that in 1994, but the taper tantrum episode in summer 2013 demonstrated that the steering of expectations is not a high-precision tool.

2004: too gradual

The accusation – The Fed raised interest rates so slowly and so gradually that bond yields did not react (the bond market conundrum). This created overly loose financial conditions, leading to the subprime bubble and the financial crisis.

- Economic environment – In mid-2004, unemployment was falling, inflation was showing the first signs of strengthening and the FOMC kicked off its rate-tightening cycle. These rate increases were perfectly pre-announced to avoid any surprises. They occurred in 25bp increments per meeting over two years (from 1% to 5.25%). These automatically-controlled increases did not affect bond yields, which fuelled the housing credit bubble until its explosion in 2007.

- The Fed’s responsibility – The Fed’s passivity in the face of the subprime bubble is now widely derided and has cost Alan Greenspan his reputation. However, the FOMC’s archives show that the Fed was neither unaware of nor indifferent towards this phenomenon. The problem is that the Fed thought it lacked the tools to burst the bubble and that its role mainly consisted of minimising the effects on the real economy. It is also clear that it underestimated – like everyone else – the role played by financial innovations (securitisations), which, in the case of the subprime market, spread this risk just about everywhere rather than diminishing it.

- What this implies today – The lesson from this episode is the central bank’s attitude towards the risk of financial instability. It is possible to identify financial bubbles without it being easy to tackle them with conventional monetary tools, explaining the use of micro- and macro-prudential surveillance. Thanks to Jeremy Stein, then a member of its Board, the Fed has repeatedly underlined excessive risk-taking in some markets since 2013. At the same time, it has not dared to exit its zero interest-rate policy, which is the very source of the reach-for-yield phenomenon.

Today: too… [the future will tell]

The unemployment rate is close to the full employment zone (between 5% and 5.5%). Inflation is artificially depressed by the fall in the oil price, but it has a good chance of returning towards the Fed’s target in 2016. In short, the Fed has rarely been as close to meeting the targets of its dual mandate. While it has drawn the QE era to a close (not without a volatile market reaction during the summer of 2013), it is clearly hesitant to exit the ZIRP. The Fed seems to be wallowing in the comfort of inaction.

If the Fed had followed its own forward guidance in 2013, when it was based on critical unemployment and inflation thresholds, it would have begun to raise its policy rates in the middle of 2014, at the very moment when the economy was
accelerating strongly. For sure, no-one would have thought to criticise it for these first steps towards monetary normalisation. Unfortunately, it missed this opportunity. Normalisation, if launched, will therefore take place in a more difficult environment (GDP growth and job creations will probably slow, the dollar has already appreciated significantly and market valuations are more strained).

By seeking to avoid past “mistakes”, the Fed may have quite simply forgotten that the current environment is in many respects totally new and consequently calls for an unprecedented exit strategy. As the debate currently stands, it seems that the Fed is leaning towards a 2004-type strategy (gradually and largely pre-announced rate hikes) in the hope above all else that bond yields will react on the upside, but not too much so. Wishful thinking?
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