M&B News Update

September 7, 2012 Bernanke Justifies Fed Action

At the September meeting of the Federal Open Market Committee (FOMC), the policymakers will again discuss potential actions to stimulate the economy further. Based on Fed Chairman Bernanke's speech at the annual Jackson Hole conference at the end of August, the Fed seems poised to act. With a weak employment report today (September 7), the data support the Fed doing something to stimulate the economy; but will Fed action have much impact?

In his speech at Jackson Hole, Chairman Bernanke went through the history of the Fed's extraordinary actions in response to the financial crisis of 2008, including its use of quantitative easing, operation twist, and forward guidance. With interest rates near zero, the Fed engaged in quantitative easing by using newly created money to buy government bonds. When the Fed buys long-term government bonds, long-term interest rates decline, perhaps stimulating spending or perhaps leading to higher stock prices (and thus increasing wealth and hence spending). The Fed also engaged in operation twist, selling short-term bonds and buying long-term bonds for the same purpose. The use of forward guidance occurs when the Fed says, as it did on several occasions in the past year, that it expects short-term interest rates to remain very low (near zero) until some date specified in the future (most recently, late 2014). The idea is that if people expect short-term interest rates to remain low for a long time, then long-term interest rates will also be low.

The Fed has used these tools for a number of years now and the economy is still weak. Some economists interpret that fact to mean that monetary policy is not effective. Monetary policy might be ineffective because interest rates are very low and thus lowering them further is irrelevant. That is the case if we are in a liquidity trap, so that any money the Fed creates is held at banks, which don't increase their lending as a result. In that case, you might think the Fed should not bother using its tools, which have the potential to create problems in the future as the economy recovers, such as high inflation (if the Fed doesn't tighten policy fast enough) or high interest rates (if the Fed has to tighten quickly to prevent inflation from rising).

But, an alternative point of view, which may carry the day on the FOMC, is that expansionary policy is now less effective, so the Fed needs to do more of it! In other words, if it takes a $500 billion purchase of bonds by the Fed today to accomplish what a $100 billion open-market purchase would have done four years ago, then scale up policy by a factor of five. As policy becomes less effective, the thinking goes, the Fed needs to do even more, not less.

The effectiveness of monetary policy may hinge on the question of whether the damage done to the economy by the financial crisis has created structural problems or not. Think back to the 1970s. In that era, the U.S. economy was hit by a series of oil-price shocks that damaged the structure of the economy. The dramatic change in the price of energy made many production processes in the steel and auto industries obsolete and millions of workers in those industries became unemployed. The Fed tried to stimulate the economy by increasing the money supply and reducing interest rates, but it failed because inflation rose and the economy stagnated. The reason is that the damage done by a high price of energy created structural damage, shrinking the steel and auto industries dramatically. It was not easy for unemployed steel and auto workers to find jobs in other industries. The process of labor adjustment took many years, so the Fed's stimulative policy did nothing but cause an increase in the inflation rate.

Did the financial crisis in 2008 lead to similar structural damage to the economy? It seems clear that the housing construction industry was crushed by the crisis, thanks to foolish sup-prime lending and the overbuilding of homes that the government encouraged earlier in the decade. With housing starts falling by 75%, many construction workers and those in related support industries lost their jobs. Many of those jobs will never come back, so there is clearly much structural unemployment.

Chairman Bernanke spent much of his Jackson Hole speech arguing that although some of the damage to the economy was structural, most of it was cyclical. The key damage to the economy was done by the fall in the value of people's homes, the decline in their wealth, and the realization that they had taken on too much debt. So, since 2008, many households have reduced spending. The question is: can increased government spending or expansionary monetary policy stimulate the economy enough to offset the reduced consumer spending? Or should we live with it, wait until households repair their balance sheets and gain enough wealth to increase spending? It seems likely that the FOMC at its meeting will decide not to wait but to try to stimulate spending by taking further actions to reduce long-term interest rates.