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Opinion **On Wall Street**

Why offbeat policies could spearhead future recession battles

The US Federal Reserve may fight downturns in radical new ways

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In each of the past three downturns, the Fed reduced the policy rate by at least five percentage points © Bloomberg

4 HOURS AGO Matthew C. Klein

It's not difficult to imagine the US economy tipping into recession by the early 2020s, if not before. Monetary tightening has already squashed the difference between short-term and long-term interest rates to its narrowest level since the start of the financial crisis. Federal Reserve officials forecast slower growth and higher joblessness over the next few years from further interest rate increases. The danger is that the tools used to fight the last downturn may be insufficient next time around. Investors should prepare for some radical innovations.

The textbook central bank response to a recession is to lower short-term interest rates. In each of the past three downturns, the Fed reduced the policy rate by at least five percentage points. Even if that option were available in the next recession — and it probably won't be — short-term interest rates don't directly affect the things people care about. Big business investment decisions are mostly determined by their share prices and their forecasts for consumer demand. Small businesses are constrained by bank lending terms. Households care about access to mortgage credit, vehicle financing and student loans.

An important new paper from Mike Konczal and JW Mason, of the left-leaning Roosevelt Institute, argues it's therefore time to "abandon the idea that macroeconomic management can be carried out by setting one interest rate or any other single, economy-wide variable". Instead, they believe central banks should target financial conditions across the economy through specific lending programmes and asset purchases, a feature of the Fed's response after the financial crisis.

Such an approach means the Fed controls the entire level and slope of the yield curve, instead of only focusing on the front end. The Fed capped long-term interest rates from 1942 through 1951, and the idea was recently brought back into vogue by the Bank of Japan. The approach has two advantages: first, longer-term Treasury yields are more closely connected to the mortgage rates and stock prices that affect actual economic decisions. Second, explicit yield targets obviate the need to spend trillions of dollars on bond buying. The Fed only held about 10 per cent of the total supply of US government debt in the 1940s and 1950s.

The next steps would be expanding the range of entities eligible to borrow from the central bank and expanding the range of assets eligible to be purchased. In the crisis, the Fed created special lending facilities for issuers of commercial paper, auto loans, and credit card debt. The Fed bought about $1.8tn in mortgage bonds between 2009 and 2014 — about a fifth of the total supply. The US government already guarantees or owns about $1tn in student loans. The European Central Bank and the Bank of Japan have been buying risky assets including corporate bonds, securitised small business loans, stocks and real estate investment trusts. The ECB and Bank of England have also offered long-term loans to banks on concessional terms in exchange for lending to households and businesses.

Konczal and Mason want to make these normal activities of the central bank, rather than “unconventional” policies to be used only in extreme circumstances. But perhaps their most intriguing proposal is to have the Fed announce it will make emergency loans to distressed states and localities. These are the units of government responsible for most of America’s infrastructure spending and the provision of essential services. They also borrow in a fragmented bond market that often forces them to cut spending during recessions to offset shrinking tax revenue. Giving them a backstop from the central bank should stabilise the economy by making it easier for these governments to sustain investment during downturns.

Traditionalists who find all this unappealing — Konczal and Mason say they want the Fed to “embrace its role” as “a central planner, shaping both the character and the level of economic activity” — should consider the alternative. Marvin Goodfriend, an experienced central banker and Donald Trump’s latest nominee for the Federal Reserve Board, dislikes “balance sheet policy” because he thinks it is “distortionary credit allocation . . . taking risks on behalf of taxpayers”.

His preferred approach, however, is even more radical. Goodfriend wants to “unencumber interest rate policy” from the zero bound and have the Fed fight recessions by sending interest rates far below zero. The central bank would enforce the policy by letting the “exchange rate” between paper money and bank deposits “float”.

Whoever gets their way, investors should be ready for significant changes in American central banking.

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