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The Fed Has Plenty of Ammunition Left

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Highlights

- The Federal Reserve reduced its benchmark interest rate by 50 basis points to 1% today–its lowest level since June 2004.
- We are likely headed for the largest contraction in aggregate demand, and consumer spending in particular, since the early 1980s.
- If lower interest rates don't do the trick, the Fed still has plenty of other tools at its disposal.

The Federal Reserve reduced its benchmark interest rate by 50 basis points to 1% today–its lowest level since June 2004. The central bank also left the door open to further easing without firmly committing to any additional action. In its policy statement, the Fed said that actions taken thus far should support "a return to moderate economic growth" but that "downside risks to growth remain." The Fed also reiterated that it will act as needed to promote sustainable economic growth and price stability.

The return to a 1% federal funds rate has been a source of controversy amongst some market commentators who believe lowering the overnight rate to 1% in June 2003 and holding it there for a year is what got us into the current mess in the first place. At the same time, they argue that interest rate cuts are not an effective means of addressing what ails the US economy, believing it is less about liquidity and more about solvency. Advocates of this position also contend that the Fed should keep its powder dry or else risk running out of ammunition.

Flawed Arguments

But these arguments are flawed. While it is true that the Fed probably kept interest rates too low for too long, current conditions in the economy and financial markets are quite different from those which prevailed in the early part of this decade. In the aftermath of the bursting of the technology bubble in 2001, the risk of a broad based deflation was much smaller because household spending, and thus aggregate demand, remained positive throughout the economic downturn.

Today, by contrast, we are likely headed for the largest contraction in aggregate demand, and consumer spending in particular, since the early 1980s as households repay debt and replenish depleted savings. As Fed Chairman Ben Bernanke said in a November 2002 speech titled, "Deflation: Making Sure 'It' Doesn't Happen Here, "Preventing deflation is always preferable to attempting to eradicate it once has already taken hold." The Japanese experience is perhaps the most telling. The Bank of Japan's refusal to take decisive early action resulted in a lost decade between 1992 and 2002 in which the economy was in recession two-thirds of the time and deflation reigned. Therefore, it is critical that the Fed do everything in its power to prevent a deflation from occurring even if this means reducing interest rates to zero.

Those arguing that rate cuts are not an effective means of addressing what ails the US economy are missing the point. Separating the issues of liquidity and solvency is a fruitless exercise since a company with no access to liquidity will quickly become insolvent as it cannot fund normal business operations to generate profits. Although the Fed's credit facilities, including the Commercial Paper Funding Facility, have helped ease short-term funding pressures, the central bank is the only one lending out money for periods longer than overnight. Thus, the recent improvement in three-month LIBOR is more of a mirage than a reality. The Fed is hoping that if it pushes the fed funds rate low enough, it will encourage ordinary commercial banks to get back in the business of lending to consumers, businesses as well as other banks.

Plenty of Ammunition Left

And if lower interest rates don't do the trick, the Fed still has plenty of other tools at its disposal. During his 2002 speech on deflation, Bernanke stated that if the Fed were to eventually reach the zero-bound on interest rates it may choose to pursue a quantitative easing as a means of getting cheap money to where it is most needed. Under such a strategy, the central bank purchases long-dated Treasuries or perhaps even agency mortgages to bring down market interest rates. While such

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- We are forecasting a peak to trough decline in real GDP of 2.5%, making this the most severe recession since 1981.
- While financial markets have already discounted a US recession, its depth and duration remain uncertain. Volatility is likely to remain high until there is greater clarity.

extreme measures sound far fetched, they do have precedents in the late 1940s when the Fed capped interest rates on government debt.

Where will the money come from to pay for all this? For starters, the Fed's decision to begin paying interest on reserves has effectively set a floor on the federal funds rate and thereby eliminated constraints on the central bank's balance sheet. Previously, the Fed needed to sterilize the money it was pumping into the financial system through its credit facilities with offsetting sales of US Treasuries to keep its balance sheet from growing. Otherwise the money supply would expand and the federal funds rate would fall. As a result of sterilization, the Fed's balance sheet was essentially unchanged at $900 billion between January and September of this year. Since then, however, the Fed's balance sheet doubled in the span of one month to $1.8 trillion. With the sterilization constraint removed, the Fed will look to further expand its balance sheet to provide liquidity.

The US Recession Is Well Underway

The rapid policy response in the US suggests the risk of a Japan-style decade of stagnation is small. Nevertheless, indicators of employment, income, sales and output suggest the US economy probably slipped into a recession during the first quarter of 2008. Since World War II, the average peak to trough decline in real gross domestic product during a recession has been on the order of 1.9%. The last two recessions in 1990 and 2001 were much milder with declines of 1.3% and 0.2%, respectively. This time around, we are forecasting a peak to trough decline in real GDP of 2.5%, making this the most severe recession since 1981. The contraction in output will likely be accompanied by a rise in the unemployment rate to 7.9% from the current level of 6.1% and the cyclical low of 4.4% reached in March 2007.

While financial markets have already discounted a US recession, its depth and duration remain uncertain. Volatility is likely to remain high until there is greater clarity. The extraordinary measures adopted so far will take time to work, but the amount of liquidity flooding the system should help to thaw the credit freeze. Thus, for investors who have a long enough time horizon and a strong stomach, the current market environment may present an opportunity.

2008-2009 Recession Forecast Compared to Prior Recessions