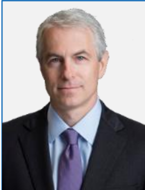
A Close VIEW

Only Hawks Go to Central Bank Heaven

JUNE 28, 2022



Authored by Steven Friedman
Senior Macro Economist

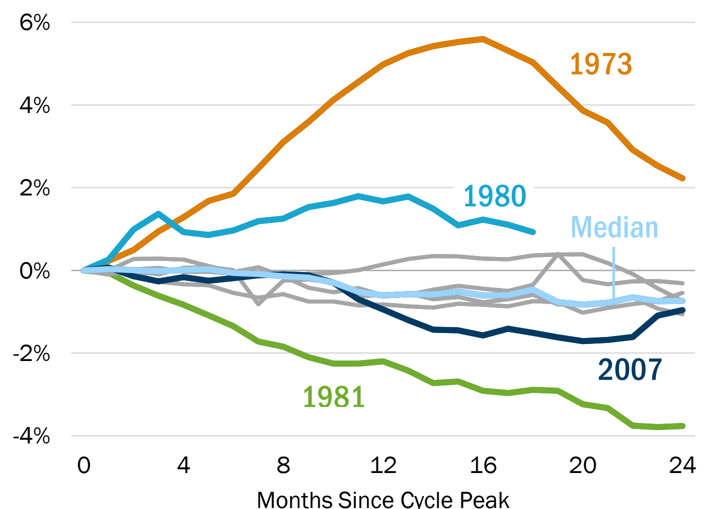
Many investors expect the next contraction to be brief and shallow, followed by a robust recovery, because they assume the Fed will quickly pivot to lower rates, aggressive use of forward guidance and quantitative easing. But if the recession occurs with inflation still high, the Fed won't be able to use these tools to the full extent. As a result, the downturn may be brief, but the recovery will likely be sluggish.

A common refrain among investors these days is that a recession looks all but inevitable in the U.S., but it is likely to be brief and shallow. After all, there are few imbalances in the economy. For example, neither residential housing investment nor business capital expenditures are particularly high relative to GDP. In addition, after a period of ultra-low interest rates and elevated refinancing activity, the ability of households and businesses to service their debts remains very strong in the aggregate. Such data suggest a high degree of resilience that should help households and businesses weather the next downturn.

This lack of economic imbalances makes a deep, 2008-style contraction highly unlikely, but those with expectations for a brief contraction and robust recovery are likely to be disappointed, in my view. Such expectations seem to assume the Federal Reserve will quickly pivot to very accommodative monetary policy, as it did in recent downturns, with the policy rate falling to close to zero, a return to quantitative easing and active use of forward guidance. But the odds of this are slim, for the simple reason that when the next recession begins, inflation is likely to still be high. As a result, the Fed will have less flexibility to respond aggressively to weaker growth and a rising unemployment rate.[1]

Inflation tends to be sticky. Historically, it has seldom declined sharply after recessions began. As Figure 1 shows, during eight recessions and recoveries between 1960 and 2009, the median outcome saw inflation decline by just 75 basis points after two years. Inflation fell sharply in only two instances: after the Great Recession of 2007-2009 and after the 1981 contraction, when the Paul Volcker-led Federal Reserve maintained a very restrictive policy stance throughout the recession and subsequent recovery. At the other extreme, the Arthur Burns-led Federal Reserve switched its focus to supporting growth during the 1973-1975 recession, and after two years, inflation was actually higher than it was when the recession began.

FIGURE 1: CHANGE IN CORE PCE INFLATION DURING RECESSIONS AND SUBSEQUENT RECOVERIES, 1960 - 2009



Source: Bureau of Economic Analysis, MacKay Shields.

1. In addition, as balance sheet run-off is highly unlikely to be completed before the next recession, there may be less appetite on the FOMC to fully redeploy another round of quantitative easing.

Figure 2 illustrates the very different policy responses to recessions and high inflation of the Burns- and Volcker-led Federal Reserve, as these outcomes have implications for the centrsal bank's likely course of action in the next recession. Under Burns, even as inflation began to rise above four percent in late 1973, the policy rate was kept above the rate of inflation only during the first half of the recession. Not surprisingly given this accommodative policy stance, core inflation continued to rise throughout the recession, and eventually stabilized mid-decade at a very high level, above six percent, before rising further during the second oil shock.

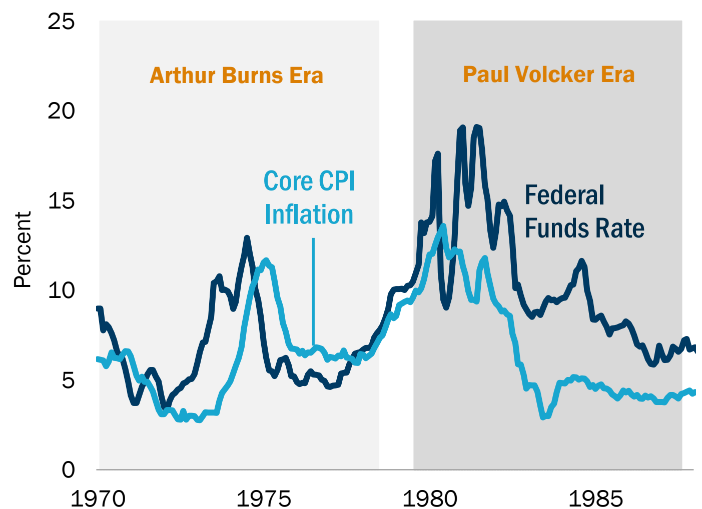
In the Volcker era, by contrast, the Fed cut the policy rate below the inflation rate during the 1980 recession but increased the policy rate sharply above the inflation rate once again when the economy showed signs of stabilizing, as the right side of Figure 2 shows. Focused on beating inflation, the Volcker-led Fed kept policy restrictive and induced a second recession in 1981. And policy remained tight, with the policy rate staying above the rate of core inflation throughout the subsequent recovery.

The economic outcomes of these two policy responses differed sharply, even apart from inflation. Figure 3 shows that the unemployment rate remained above its estimated natural level for the majority of Volcker's term as Federal Reserve Chairman. While Volcker's war on inflation inflicted pain on many households through a persistently weak labor market, it is widely credited with laying the groundwork for the Great Moderation, the 20-year period of low inflation and decreased economic volatility that started in the mid-1980s.

What can we expect from the Powell-led Fed, when the next recession occurs? If the recession begins early next year, with core PCE inflation still above 4% [2], I think Powell is much more likely to maintain a "Volcker-esque" focus on bringing down inflation than, like Burns, to switch his focus to supporting the economy and labor market. A key lesson that today's policymakers take from the Great Inflation is that delaying action to bring inflation down to a more tolerable level leads to worse economic outcomes down the road; price stability is necessary to keep the economy close to maximum employment over the long term. As the saying goes, only hawks go to central bank heaven.[3] And judging by his own comments, Powell wants to join Volcker there.[4]

The fundamental difference between the current environment and the early 1980s is that, with inflation lower, long-term inflation expectations remain well-anchored. This suggests that, despite its forecasting errors and slow response to inflation pressures, and criticism from pundits to the contrary, the Fed's inflation-fighting credibility remains intact. This should give the Powell Fed *some* flexibility to respond to weaker growth, even with high inflation, but not the full flexibility to cut rates close to zero and maintain an easy policy stance for long. Significantly shifting its focus from inflation-fighting to restoring growth would risk a mid-1970s outcome, with rising inflation expectations and inflation remaining high. If Powell has fully absorbed the lessons of the Great Inflation, limited monetary policy support is likely in the next recession, and thus the recovery is much more likely to be sluggish than robust.

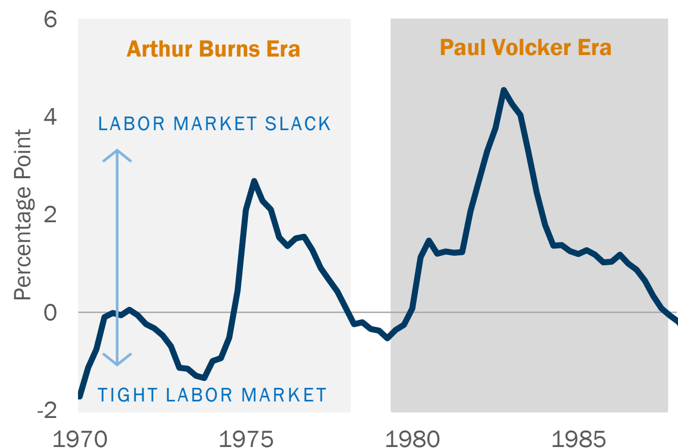
FIGURE 2: INFLATION AND THE POLICY RATE UNDER BURNS AND VOLCKER



Source: Bureau of Labor Statistics, Bloomberg. G. William Miller served briefly as Federal Reserve Chairman between Burns and Volcker.

FIGURE 3: LABOR MARKET CONDITIONS UNDER BURNS AND VOLCKER

UNEMPLOYMENT RATE LESS NATURAL RATE OF UNEMPLOYMENT



Source: Bureau of Labor Statistics, Congressional Budget Office. G. William Miller served briefly as Federal Reserve Chairman between Burns and Volcker.

2. The FOMC's June economic projections indicate that the 18 Committee participants expect core PCE inflation to end 2022 anywhere from 4.1 to 5.0 percent.
3. This saying paraphrases Bob McTeer, who used variations of it in many speeches during his tenure as President of the Federal Reserve Bank of Dallas from 1981 to 1991.
4. See, for example, Powell's discussion in his post-meeting press briefing on May 4 of Volcker's legacy and lessons for policy today.

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