J. Bradford DeLong: The Fed Should Buy Recession Insurance

If the United States falls into recession in the next year or two, the US Federal Reserve may have very little room to loosen policy, yet it is not taking any steps to cover that risk. Unless the Fed rectifies this soon, the US – and the world – may well face much bigger problems later, writes **J. Bradford DeLong**

Source: iStock

The odds of recession

The next global downturn may still be a little way off. The chances that the North Atlantic as a whole will be in recession a year from now have fallen to about one in four. German growth may well be positive this quarter, while China could rebound, too. And although US growth is definitely slowing – to 1% or so this quarter – this may yet turn out to be a blip.

Let's hope so. Because if the next downturn is looming, North Atlantic central banks do not have the policy room to fight it effectively. Should a recession arrive, the US Federal Reserve would ideally be able to cut interest rates by five percentage points, as is customary in such situations. But with short-term safe interest rates currently at 2.4%, it cannot. And with euro and yen interest rates still around zero, the European Central Bank and the Bank of Japan would be unable to help much, either.

Looking ahead, therefore, the big risk is not that inflation will start spiraling upward, with the Fed unable to raise interest rates fast enough to stabilize the economy. Rather, it is the downside risk that a year from now, the North Atlantic will be in recession, governments will not provide enough fiscal stimulus, and the Fed won't be able to reduce interest rates enough – leaving it nearly helpless to even try to stabilize the economy.

The Fed's options

The logical response to such an asymmetric risk is – or ought to be – to buy insurance to cover it. Worryingly, however, the Fed is not taking out any policy insurance at all against a possible recession, despite having at least three possible options from which to choose.

- For starters, the Fed could raise interest rates further now, creating more room for rate cuts if the US economy subsequently falls into recession. But Fed Chair Jerome Powell seems to have ruled out this option for the time being. In a recent interview, Powell said the Fed's policy rate "is in an appropriate place" in view of "muted" US inflation and increasing evidence that the global economy is slowing. "We're going to wait and see how those conditions evolve before we make any changes to our interest-rate policy," he said.
- Alternatively, the Fed could cut interest rates today to try to compensate for its inability to reduce rates enough in a future downturn. If growth then recovers and strengthens – as more likely than not it will – there is no harm done. US inflation expectations are well anchored, so the Fed could fully and cheaply offset looser monetary policy now with a tighter stance later. But if growth does not pick up, and the North Atlantic falls into recession, the Fed will have to cut interest rates frantically at the end of this year. And it will greatly regret that it did not get ahead of the curve by preemptively lowering rates today.
- The Fed's third option is to leave interest rates unchanged for now, but clearly and aggressively explain how it would fight a recession effectively, should one arrive over the course of the next year. In doing so, the Fed would need to be far more convincing than it was from 2010 onward, when the US economy was struggling to recover from the 2008 financial crisis. On that occasion, then-Fed Chair Ben Bernanke's monetary policy – and his pleas to Republican legislators and austerity hawks to put the national interest ahead of partisan point-scoring and support aggressive fiscal stimulus – were completely ineffective in generating growth above previous trend rates. As a result, the US recovery was anemic and unsatisfactory.

A more credible Fed plan to fight a possible recession in 2020, 2021, or thereafter might well boost business confidence and make the central bank's policies more effective. At the very least, it would reassure companies and investors who, fearing that US aggregate demand will be weak in 2020, might be starting to pull back. But this third option would require an aggressive intellectual and communications effort from the Fed, and there is currently no evidence of one.

If the US falls into recession over the next year or two, the Fed may have very little room to loosen policy. And yet it is not taking any steps to cover that risk. That is unwise. Unless the Fed buys some recession insurance soon, the US – and the world – may well face much bigger problems later.

This article was originally published by [Project Syndicate on 15 March 2019]

Author

Alissa Lefebre
Economist
alissa.lefebre@ing.com

Deepali Bhargava
Regional Head of Research, Asia-Pacific
Deepali.Bhargava@ing.com

Ruben Dewitte
Economist
+32495364780
ruben.dewitte@ing.com

Kinga Havasi
Economic research trainee
kinga.havasi@ing.com

Marten van Garderen
Consumer Economist, Netherlands
marten.van.garderen@ing.com

David Havrlant
Chief Economist, Czech Republic
420 770 321 486
david.havrlant@ing.com

Sander Burgers
Senior Economist, Dutch Housing
sander.burgers@ing.com

Lynn Song
Chief Economist, Greater China
lynn.song@asia.ing.com

Michiel Tukker
Senior European Rates Strategist
michiel.tukker@ing.com

Michal Rubaszek
Senior Economist, Poland
michal.rubaszek@ing.pl

This is a test author

Stefan Posea

Economist, Romania
tiberiu-stefan.posea@ing.com

Marine Leleux
Sector Strategist, Financials
marine.leleux2@ing.com

Jesse Norcross
Senior Sector Strategist, Real Estate
jesse.norcross@ing.com

Teise Stellema
Research Assistant, Energy Transition
teise.stellema@ing.com

Diederik Stadig
Sector Economist, TMT & Healthcare
diederik.stadig@ing.com

Diogo Gouveia
Sector Economist
diogo.duarte.vieira.de.gouveia@ing.com

Marine Leleux
Sector Strategist, Financials
marine.leleux2@ing.com

Ewa Manthey
Commodities Strategist
ewa.manthey@ing.com

ING Analysts

James Wilson
EM Sovereign Strategist
James.wilson@ing.com

Sophie Smith
Digital Editor
sophie.smith@ing.com

Frantisek Taborsky
EMEA FX & FI Strategist
frantisek.taborsky@ing.com

Adam Antoniak
Senior Economist, Poland

adam.antoniak@ing.pl

Min Joo Kang
Senior Economist, South Korea and Japan
min.joo.kang@asia.ing.com

Coco Zhang
ESG Research
coco.zhang@ing.com

Jan Frederik Slijkerman
Senior Sector Strategist, TMT
jan.frederik.slijkerman@ing.com

Katinka Jongkind
Senior Economist, Services and Leisure
Katinka.Jongkind@ing.com

Marina Le Blanc
Sector Strategist, Financials
Marina.Le.Blanc@ing.com

Samuel Abettan
Junior Economist
samuel.abettan@ing.com

Franziska Biehl
Senior Economist, Germany
Franziska.Marie.Biehl@ing.de

Rebecca Byrne
Senior Editor and Supervisory Analyst
rebecca.byrne@ing.com

Mirjam Bani
Sector Economist, Commercial Real Estate & Public Sector (Netherlands)
mirjam.bani@ing.com

Timothy Rahill
Credit Strategist
timothy.rahill@ing.com

Leszek Kasek
Senior Economist, Poland
leszek.kasek@ing.pl

Oleksiy Soroka, CFA
Senior High Yield Credit Strategist

oleksiy.soroka@ing.com

Antoine Bouvet
Head of European Rates Strategy
antoine.bouvet@ing.com

Jeroen van den Broek
Global Head of Sector Research
jeroen.van.den.broek@ing.com

Edse Dantuma
Senior Sector Economist, Industry and Healthcare
edse.dantuma@ing.com

Francesco Pesole
FX Strategist
francesco.pesole@ing.com

Rico Luman
Senior Sector Economist, Transport and Logistics
Rico.Luman@ing.com

Jurjen Witteveen
Sector Economist
jurjen.witteveen@ing.com

Dmitry Dolgin
Chief Economist, CIS
dmitry.dolgin@ing.de

Nicholas Mapa
Senior Economist, Philippines
nicholas.antonio.mapa@asia.ing.com

Egor Fedorov
Senior Credit Analyst
egor.fedorov@ing.com

Sebastian Franke
Consumer Economist
sebastian.franke@ing.de

Gerben Hieminga
Senior Sector Economist, Energy
gerben.hieminga@ing.com

Nadège Tillier
Head of Corporates Sector Strategy

nadege.tillier@ing.com

Charlotte de Montpellier
Senior Economist, France and Switzerland
charlotte.de.montpellier@ing.com

Laura Straeter
Behavioural Scientist
+31(0)611172684
laura.Straeter@ing.com

Valentin Tataru
Chief Economist, Romania
valentin.tataru@ing.com

James Smith
Developed Markets Economist, UK
james.smith@ing.com

Suvi Platerink Kosonen
Senior Sector Strategist, Financials
suvi.platerink-kosonen@ing.com

Thijs Geijer
Senior Sector Economist, Food & Agri
thijs.geijer@ing.com

Maurice van Sante
Senior Economist Construction & Team Lead Sectors
maurice.van.sante@ing.com

Marcel Klok
Senior Economist, Netherlands
marcel.klok@ing.com

Piotr Poplawski
Senior Economist, Poland
piotr.poplawski@ing.pl

Paolo Pizzoli
Senior Economist, Italy, Greece
paolo.pizzoli@ing.com

Marieke Blom
Chief Economist and Global Head of Research
marieke.blom@ing.com

Raoul Leering

Senior Macro Economist
raoul.leering@ing.com

Maarten Leen
Head of Global IFRS9 ME Scenarios
maarten.leen@ing.com

Maureen Schuller
Head of Financials Sector Strategy
Maureen.Schuller@ing.com

Warren Patterson
Head of Commodities Strategy
Warren.Patterson@asia.ing.com

Rafal Benecki
Chief Economist, Poland
rafal.benecki@ing.pl

Philippe Ledent
Senior Economist, Belgium, Luxembourg
philippe.ledent@ing.com

Peter Virovacz
Senior Economist, Hungary
peter.virovacz@ing.com

Inga Fechner
Senior Economist, Germany, Global Trade
inga.fechner@ing.de

Dimitry Fleming
Senior Data Analyst, Netherlands
Dimitry.Fleming@ing.com

Ciprian Dascalu
Chief Economist, Romania
+40 31 406 8990
ciprian.dascalu@ing.com

Muhammet Mercan
Chief Economist, Turkey
muhammet.mercan@ingbank.com.tr

Iris Pang
Chief Economist, Greater China
iris.pang@asia.ing.com

Sophie Freeman
Writer, Group Research
+44 20 7767 6209
Sophie.Freeman@uk.ing.com

Padhraic Garvey, CFA
Regional Head of Research, Americas
padhraic.garvey@ing.com

James Knightley
Chief International Economist, US
james.knightley@ing.com

Tim Condon
Asia Chief Economist
+65 6232-6020

Martin van Vliet
Senior Interest Rate Strategist
+31 20 563 8801
martin.van.vliet@ing.com

Karol Pogorzelski
Senior Economist, Poland
Karol.Pogorzelski@ing.pl

Carsten Brzeski
Global Head of Macro
carsten.brzeski@ing.de

Viraj Patel
Foreign Exchange Strategist
+44 20 7767 6405
viraj.patel@ing.com

Owen Thomas
Global Head of Editorial Content
+44 (0) 207 767 5331
owen.thomas@ing.com

Bert Colijn
Chief Economist, Netherlands
bert.colijn@ing.com

Peter Vanden Houte
Chief Economist, Belgium, Luxembourg, Eurozone
peter.vandenhoute@ing.com

Benjamin Schroeder
Senior Rates Strategist
benjamin.schroder@ing.com

Chris Turner
Global Head of Markets and Regional Head of Research for UK & CEE
chris.turner@ing.com

Gustavo Rangel
Chief Economist, LATAM
+1 646 424 6464
gustavo.rangel@ing.com

Carlo Cocuzzo
Economist, Digital Finance
+44 20 7767 5306
carlo.cocuzzo@ing.com