What Should the Fed Do?

Joseph E. Gagnon and Michael Mussa discuss the latest steps by the Federal Reserve to help the economy—and what tools might be used if things get worse.

Edited transcript, recorded August 11, 2011. © Peterson Institute for International Economics.

Steve Weisman: With financial markets around the world questioning the recovery in the United States, what bullets do the Treasury and the Fed have to address the downturn?

This is Steve Weisman at the Peterson Institute for International Economics with Joseph Gagnon and Michael Mussa, senior fellows at the institute. Can the Federal Reserve, in particular, do anything more than its recent announcement of holding interest rates down until the year after next? Joseph Gagnon, first, you have proposed that the Fed could do more. Tell us what you think the Fed should do.

Joseph Gagnon: Let me just start by saying that I made that proposal the day before they [the Fed] met this week. They actually announced something that I thought was surprising, which was a conditional commitment to keep rates near zero for two more years, about twenty four months, which is something they had strongly resisted before. It is a different weapon in their arsenal, which in theory should work and maybe is partly responsible for the declines in long-term interest rates and the rise of the stock market since then. It's hard to be sure.

I do worry as to whether the markets will understand their statement, because it could be misinterpreted as being a very gloomy statement. In other words, it could be interpreted as meaning that the economy will be doing very poorly over the next two years and the Fed will have to keep rates near zero. I fear that many people do take that interpretation.

Steve Weisman: That's sort of a Catch-22. If they don't do anything, the markets will be upset. If they do do something, then it really sounds bad.

Joseph Gagnon: That's the problem. I think what the Fed needs to do is get ahead of this and communicate to the market that what they really mean. What I believe they really mean is that even if the economy picks up as they expect -- and they have marked down their forecast for the current year, but I doubt they're going to mark down their forecast for next year and the year after very much...

Steve Weisman: Have they marked it down for the second half of 2011?

Joseph Gagnon: We don't know yet, because they only release the forecast four times a year and they didn't release it this week. They didn't release a revised forecast this week. But when they do, I think they will – the words they issued implied that they were marking down the near term outlook this year.

Steve Weisman: Right.

Joseph Gagnon: But I suspect they won't mark down the longer term next year and the year after very much, if at all.

Steve Weisman: What was their forecast for growth next year?

Joseph Gagnon: They haven't forecasted anything. They give a range, but it's roughly three and a half to four over the next two years going out. I think what they mean to say is that even if the economy does that well, or as well as they project in those out-years, they won't feel a need to raise rates.

And they're trying to communicate that to the market, which says that it's not that it's a gloomy outlook, but the level of unemployment is so high, the output gap from potential is so deep, that they believe that even rapid growth for two, three years is not going to wake up inflation.

Steve Weisman: Before I come back to you and ask what your latest thinking on quantitative easing is, let me turn to you, Mike, and ask whether you also found the statement by the Fed of holding interest rates was productive?

Michael Mussa: I thought not. The fact that they got three dissents out of voting members of the FOMC [Federal Open Market Committee] suggested the serious concerns about that. The market initially sold off and then rebounded.

My view is that you don't make a statement like that without in effect nailing yourself in, to some degree. It's not an absolute commitment. But you're saying, contrary to what you might have believed earlier, unless things really turn out to show considerable strengthening of the economy, we're going to keep interest rates very low for at least another two years. If it doesn't mean that, it doesn't mean anything.

Steve Weisman: The market first went down, then it went up, then it went down. Today it went up again. We can certainly say the markets seem a little confused.

Michael Mussa: Obviously many other things are pushing the market around. The key worry has been the developments in Europe. And then in a market like this, where people are very nervous, there's a lot of short covering and other things, which just drives prices up and down for reasons that are not related to any fundamentals.

I would say it sold off on the Fed announcement, that it rebounded about to where it was, and then probably got pushed higher by the internal market dynamics. The market reaction I would read at this stage as essentially neutral to the Fed policy announcement – I mean, the announcement and the dissents.

So my only judgment is that there's a reasonable chance that the Fed would want to keep interest rates low for an extended period, even without the announcement. If the economy does turn out to be weak, that would certainly have been my expectation beforehand.

However, I think locking yourself in that way -- to the extent they did -- is a mistake. We saw last year, when they started out on quantitative easing, they expressed considerable concern with the core inflation rate falling below one percent. "We're facing deflation," [they said].

It turned out that core inflation rate picked up quite considerably early this year, and we did not see the output gap move from a very large positive to a substantial negative, which their model basically requires in order to explain how it is that the inflation rate popped upward. So I think the model underlying the inflation forecast suffered very substantial damage in recent developments.

Steve Weisman: Joe, you very powerfully said in one of your recent postings that we are seeing a policy failure unlike anything since the Great Depression. What more should the Fed do?

Joseph Gagnon: Yes. I think we can't expect the Federal Reserve to prevent all fluctuations in the economy and to be able to get the inflation rate to be totally stable on any particular level. But what has happened is that the unemployment rate has been nearly twice what the Federal Reserve and many other observers believe is its equilibrium level, long-run level, and this has gone on for 28 consecutive months.

That is the longest since the Great Depression. We've had such a long period of incredible slacks. So it seems to me that we are so far from where the Fed would like the economy to be, where we'd all like the economy to be, that there is scope for greater action.

Steve Weisman: What would that action be?

Joseph Gagnon: To some extent what they did this week was an alternative to what I proposed, which had some benefit. I think the net effect is less than what I would have wanted, but it was an alternative approach to getting at some stimulus.

I would like to see the Fed and the administration work together to really help homeowners. There are a lot of homeowners. I recently read an estimate of as much as $5 trillion worth of mortgages that are guaranteed by the government already, by the housing agencies, that are now owned by the government.

And people who cannot refinance, in fact most of these people, are current in their payments. They're not defaulting. They have just seen the value of their house fall so low that their mortgage is more than 80 percent of the value, and they don't meet the standard criteria for refinancing.

This has happened on a scale that we have not seen before. What it's meant is that these people who in normal times would be able to refinance their house into a lower interest rate mortgage and save themselves a lot of money are not able to do that. If the government would make that possible…

Steve Weisman: And the Fed and the administration can do that?

Joseph Gagnon: The administration – we own Fannie and Freddie now. We've always owned Ginnie Mae. So we can direct them to make it easier. Streamline the process for people who are current in their payments to refinance. They put restrictions on them. They have to use the current service. I don't even know the details, but they put restrictions on them, such that people have not taken advantage of this. They need to relax those restrictions and send letters out to people and say, "Look. Did you know that you can refinance?"

Steve Weisman: But just to be clear on another quantitative easing -- QE3. You're in a wait-and-see posture?

Joseph Gagnon: I would add to that, that the Fed's role could be to help that process. Right? In other words, if there were a refinance boom, the Fed could step in and buy some of those mortgages to help keep the rates from…

Steve Weisman: I see. The equivalent of [quantitative easing]…

Joseph Gagnon: Yes. To help keep the rates from rising in this process. To help give it a little bit more certainty, those who want to refinance, to know that, yes, the Fed will keep rates low during the refinance process so that it will get a good low rate.

Steve Weisman: Mike, what do you think of this approach?

Michael Mussa: The Treasury announced a couple years ago that they were going to raise the limit up to 105 percent of the appraised value of properties. I think that for people that Joe described, I have no problem with going up to 110 or even 115 percent. I just don't think that many people want to walk away from their properties if they have income that enables them to pay their mortgage. So, allowing people to take advantage of the substantially lower mortgage interest rates that we have at present so that they can refinance their mortgages seems to be quite sensible if they are good candidates to actually pay those mortgages, which they are in many cases. Now, I think this has nothing to do with monetary policy.

Steve Weisman: Even if the Fed steps in to buy the mortgages?

Michael Mussa: Plausibly, it might. But mortgage rates are in fact very low, so we'll need to see the extent to which that action would be needed in that regard. The problem has been that the people in the category of having homes under water, mortgages under water, have found difficulty in refinancing at significantly lower interest rates. And so they've not been able to do what I did: call up my bank and say, "I want a lower rate. Refinance me."

Joseph Gagnon: Yes. If I could just say, I think the rates now are incredibly low and they're plenty low enough if you can get people into refinancing. I think the role for the Fed would be more to step in if there was a wave of refinancing, because this program was widely successful and it put a lot of upward pressure on rates. It would be nice for the Fed to say, "Well, look. In that case we will step in somewhat to prevent that."

Steve Weisman: Part of the analysis of the downturn is that the government is out of tools in its arsenal in the face of another potential slow down. Congress seems unlikely to approve any stimulus on the fiscal side. Mike, do you think it might to be wise to consider some fiscal short term stimulus, possibly as part of a long term package that Congress and the administration are going to try to prepare this fall?

Michael Mussa: I wouldn't rule it out entirely. But I would note when somebody suffers a serious injury, the doctors treat him. If it's an acute case, the period of recovery is often prolonged and there's very little beyond a certain point that the doctors can really do that's useful and cost effective.

I think that the damage that the US economy has suffered as a consequence of what preceded the recent recession and the recession itself was usefully confronted early on to prevent the catastrophic outcome.

But I think the additional amount that can done by seeking to apply further medication through monetary policy is really pretty limited, that we're just going to need to endure a fairly sluggish recovery that is going to extend over a considerable period.

The problems in the housing sector built up when we built up the housing price bubble. Part of the cure is that we're just going to have live through correcting the consequences of that over a period of time. Already a lot has been done to control the extreme downside, but some of it is just going to take time for these processes to work through.

And on fiscal policy, we used it moderately actively. We might do a little bit more, but I think at this stage naked fiscal stimulus -- that is to say fiscal stimulus that does not contain within the legislation the specific provisions to pay for it over the longer term -- should be out of consideration. We've got a very large deficit, and if we're going to provide additional temporary stimulus, we should be providing [a means] to pay for it over the next decade or so -- either by raising revenue or by cutting back other categories of spending.

Steve Weisman: Naked fiscal stimulus. Joe?

Joseph Gagnon: Maybe you wanted to hear more disagreement, but I'm actually fully in agreement with Mike on that point. I actually think that stimulus in the short term that is paid for explicitly in the long term is actually more powerful in my view than stimulus that isn't, because it engenders more confidence that it's not going to cause more problems down the road.

Steve Weisman: But at best it would only be accompanied by a commitment to pay for it in the long term – by definition it is not easy to bind a future Congress.

Joseph Gagnon: There are no absolute guarantees. But if you spell it out, and [there is] specificity on how you spell it out, then yes. It can work.

Michael Mussa: You have to vote for it. That is: either vote for the taxes or vote for the spending cuts that are going to finance it. So it's not just free, which is what we've done with our fiscal expansions so far.

Steve Weisman: What form would this modest stimulus take? Aid to the states? Extending the payroll tax cut at least partially?

Joseph Gagnon: I think extending or even enlarging the payroll tax cut would be my first go-to thing. I think I'd support most anything. I mean, people talk about certainly unemployment benefits extended somewhat. I think people talk about infrastructure programs. I think, although I would support that, in an intelligently designed way, it doesn't strike me as the best way to do macro stabilization, just because it's so hard to time just right.

Michael Mussa: I'd be cautious. I think, especially if you believe (which I do not) the latest revisions of the GDP figures, you'd have to say that the deal they cut last December to cut the payroll tax and extend unemployment benefits and the quantitative easing undertaken by the Fed have been a total flop in terms of stimulating the growth of the economy.

Now I think that that's too negative an overall assessment. Nevertheless, there's simply no credible basis for saying they were highly successful. So, more of it is not necessarily a good idea. A little bit more of it, I think, is maybe well worth trying. But the notion that this is a particularly powerful and useful tool is not really well confirmed by recent experience.

Steve Weisman: What's the latest range of your own estimate for growth next year for the United States?

Michael Mussa: I think that I was previously anticipating around three percent, fourth to fourth. I'd now cut that back to two and a half. It does depend in part on whether there's some…

Steve Weisman: You mean fourth to fourth 2012 to 2011?

Michael Mussa: From fourth quarter 2011 to fourth quarter 2012.

Steve Weisman: Right.

Michael Mussa: The second half of this year, I'm superbly confident is going to see an acceleration of measured GDP growth, because I think we mis-measured the first half.

Steve Weisman: Joe and Mike, thanks. I'm not looking for disagreement. I'm looking for illumination, and thank you both for providing it.