The Federal Reserve and Recessions:

A Discussion

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Introduction

The boom and bust cycle is as natural and intrinsic to capitalism as the cycle of life, death, and regeneration is to nature. Just as a plant or animal ages to the point where it is no longer useful and dies to provide nutrients for other life, capitalism regenerates through the death of old industries and ideas in a recession so that more productive methods can gain access to those resources and once again drive economic growth.

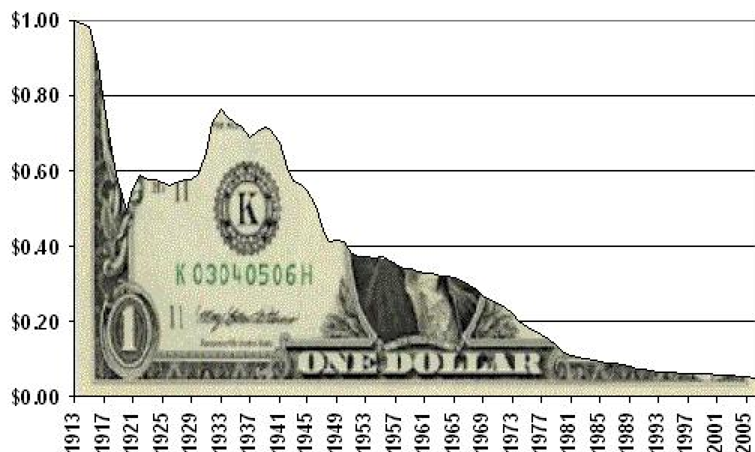
This week, we will be discussing the role of the Federal Reserve in our economy. Specifically, we will be addressing the question of whether the Fed can prevent recessions in the United States. This is a debate as old as the Fed itself, and is very closely related to the question of the proper role of the Fed as an institution. Naturally, there are two sides on the issue, perhaps better described as two extremes on the continuum and several individual positions along the way from one extreme to the other. So, let us broadly explore the two extreme positions regarding the Fed's theoretical and observed ability to prevent recessions. We will survey the course between these two views, provide rationale for the relevant points, and then move on to building a case for a hybrid position. As always, the framing question is given in the appendix.

The Fed Cannot Prevent Recessions

Probably the most extreme position on this issue is the view that the Fed cannot avoid, or even help to alleviate recessions, and it cannot contribute meaningfully to America's economic wellbeing. This is the view that the Fed, as a market distortion, only gets in the way of the free market and thus can only do economic harm. Many in the so-called "Austrian" school of economics, as well as a few political leaders (Congressman Ron Paul is probably the most vocal), hold this view. The premise is that the populace will be better-off if true market deregulation (opponents might use the word anarchy) is allowed to rule supreme. This view is often associated with support for a gold standard (or some sort of genuine link to real assets).

If real economic well-being comes from genuine innovation and natural resources, and the Fed provides neither, then it can only adjust the nominal currency values associated with these real assets in the short term. This only serves to obscure what is truly happening on a macroeconomic scale. Worse, the Fed issues currency that has no material value apart from the "value declaration" by the issuing institution. Naturally, this currency devalues in real terms over time, as seigniorage is the easiest short-term means of addressing a host of fiscal challenges.

This position would argue that the boom and bust cycle of the economy is a natural feature of any market, intrinsic to capitalism itself. It has its roots in human nature, and that nature cannot be changed by some interest rate determination or open market operation from some ivory tower. The Fed should not intervene in a recession, but should allow the economy to work its way out naturally. Further, if the Fed attempts to intervene in a recession, it lays the seed of inflation and devaluation which will only exacerbate future booms, exacerbating future busts, and so on. The Fed should keep its hands off, as it cannot address the matter in a manner beneficial to genuine, long-term growth. It has certainly not been completely successful in avoiding recessions, and has only done long-term



damage to the economy and the currency in attempting to remedy recessions that have come along. One obvious difficulty with this view is the fact that lower interest rates are genuinely stimulative, and the Fed does have substantial power over interest rates. But it is a fair point that this excess liquidity created in a recession likely combines with the eventual increase in "money velocity" to produce inflation and a follow-up boom and bust.

The Fed Can Prevent Recessions

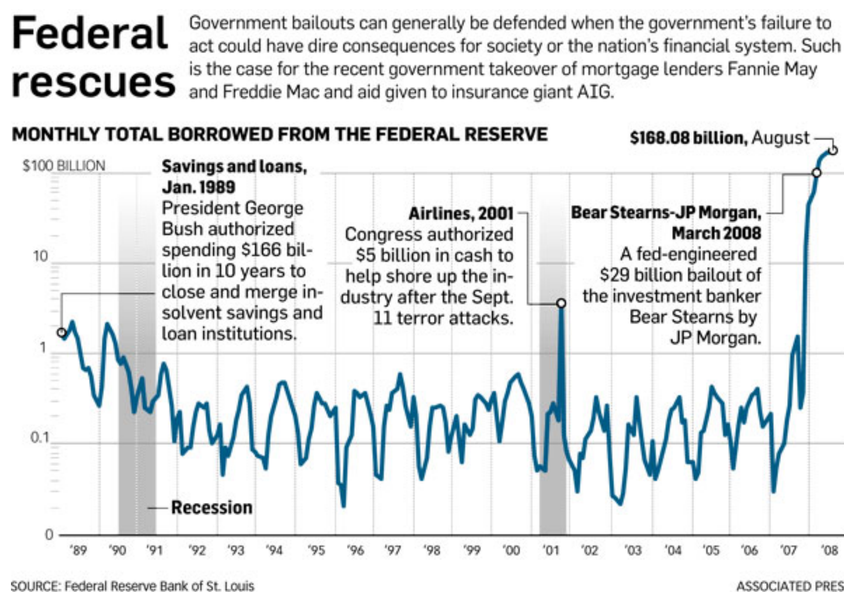
At the other end of the spectrum is the view that the Fed can prevent recessions, or at least substantially alleviate a recession in progress. It must be conceded that the Fed has not been, and likely cannot be 100% successful in avoiding all recessions. This view is closely related to the view that the Fed has a rightful place in American public policy – the view that, while imperfect, the Fed has done much more good than harm in helping the economy to prosper over the last century.

No serious-minded supporter of this view would challenge the fact that paper money has lost, and will continue to lose purchasing power. Rather, they would shift the discussion to a more fundamental question. What is the purpose of paper money - to be an absolutely stable store of value, or to be an economic tool of exchange that promotes the welfare of the American people? Clearly, the two are not the same.

Consider, for a moment, a world in which the total money supply is fixed not by policy-makers, by a gold standard. New "money" is discovered at a ferocious pace at first, until finding gold becomes harder and harder. Then the money supply grows by random intervals at random times, completely uncontrolled by any policy-making body. In a gold-standard world, central bankers do not cease to exist; they are in the mines trying to find new money. The nations with the largest gold reserves become the wealthiest in real terms – the world's "issuers of real currency." Moreover, because the gold supply cannot continue to grow at the same pace as the

population or the real economy, perpetual deflation ensures a worldwide depression relative to the thriving economy to which we are accustomed.

The Fed certainly has real influence in the economy, because economic agents treat currency as real money and the Fed controls the currency. The Fed is able to "throttle" the economy, attempting to smooth out bumps along the way through several policy tools, most significantly open market operations, setting reserve requirements, and serving as the "lender of last resort" in times of crisis. As the graphic below shows, the Fed has acted several times in recent history to ensure the soundness of the financial system. The Fed exercises a dominating influence over the market price of capital, or prevailing interest rates, and so has the power to make a host of business expansion projects profitable or unprofitable, based on the cost of capital.



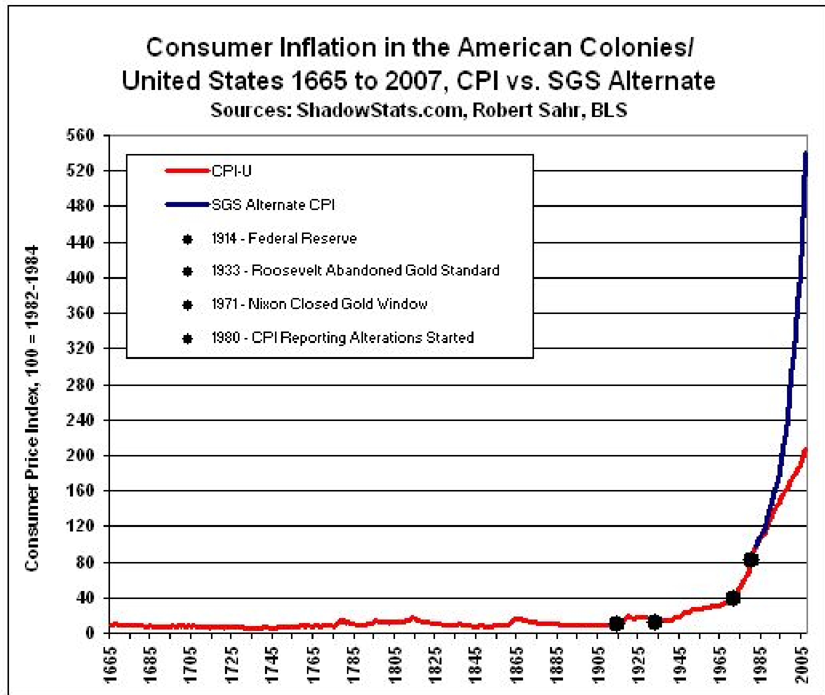
Certainly, nobody has 100% perfect foresight. However, the Fed has expanded credit availability during recessions and contracted the money supply during booms, has adjusted reserve requirements in line with economic conditions, and has provided capital to sound firms in times of crisis. In doing so, the Fed has succeeded in partially "leveling out" the normal economic cycle. It is true that this has come at the cost of devaluing the currency over time and contributing to future booms, but the money is for the people and not the reverse. A healthy economy better serves a nation than a currency too strong for economic development.

This position would hold that the Fed is able to dampen and alleviate recessions, even if recessions cannot be eliminated altogether. The Fed can do much good for the population by working to smooth out the normal ebbs and flows of any economy, by eliminating bank runs and major financial panics, and ensuring that the financial system of the nation remains functional. Fiat money or no fiat money, the faith of the people in any fractional reserve system is paramount for efficient operation. The Fed has done an admirable job over the years managing a currency that has both earned the respect of the world and has encouraged economic growth.

A Hybrid Position

As is often the case in a public policy debate, the author believes that there is some element of truth in both sides here. It is true that the Fed has managed open market operations in such a way that it has made capital more available in recessionary times and less available when inflation was a danger. The Fed has not been successful in completely eliminating recessions, nor can it be, because this would require predicting the future.

The Federal Reserve has a "dual mandate" of price stability and full employment, and yet these goals are often in mutual conflict. A "loose money" policy beneficial to national employment and GDP figures is usually harmful to price stability, and a "tight money" policy aimed



at maintaining price stability is not conducive to the economic expansion needed for full

employment. Nonetheless, the Fed seeks to achieve these goals primarily through open market operations, reserve requirements, and loans to member banks based on trailing economic indicators, which exhibit a fair amount of lag. Given the challenges in such an operation, this author believes that the Fed has done fairly well in a very difficult task.

It is true that the Fed has devalued the American currency (as the foregoing graphic shows), contributed toward economic bubbles that inevitably lead to busts, and created a very convenient means for the US government to rack up enormous outstanding debts. This is the price paid for the elimination of the devastating financial panics of the nineteenth century and an unprecedented standard of living for the median citizen of any nation.

Conclusion

In this paper, we have looked at the extreme positions on the question of the Fed's ability to avoid recessions, on the way to looking at a hybrid position that better reflects the complex reality of our experience. It is fair critique that this hybrid position has much more in common with a "pro-Fed" stance than an "anti-Fed" stance. As we mentioned previously, the position that the Fed can do nothing to help alleviate or avoid recessions, and even that it should not interfere in any substantial economic manner, is very much not a mainstream view.

It is the author's view that the Federal Reserve has been a very positive influence for virtually all Americans, regardless of class or economic status. While some have benefitted more than others, the Fed has largely helped us out of economic downturns and been a large reason for the success that virtually all Americans enjoy today. If any financial professional were able to forecast economic conditions with 100% certainty, they would not be working for the Fed – they would be running a hedge fund. However, the author believes that the Fed has done a reasonably good job with the tools it has been given to partially avoid and alleviate recessions.

Appendix: Framing Question

Can the Fed prevent U.S. recessions?

Yes. The Fed has the power to reduce market interest rates and can therefore encourage more borrowing and spending. In this way, it stimulates the economy.

No. When the economy is weak, individuals and firms are unwilling to borrow regardless of the interest rate. Thus, the borrowing (by those who are qualified) and spending will not be influenced by the Fed's action. The Fed should not intervene, but should let the economy work itself out of a recession.

What is your opinion on this issue?

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