“Get ready for here I come”

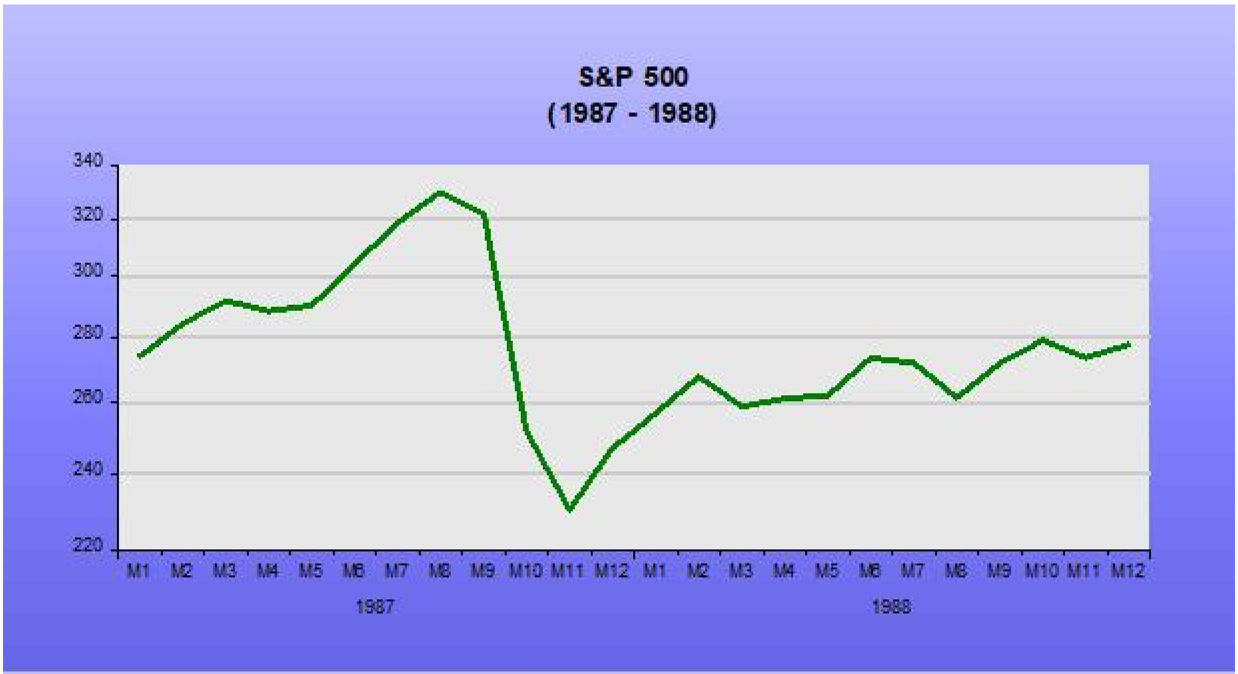
(Temptations)

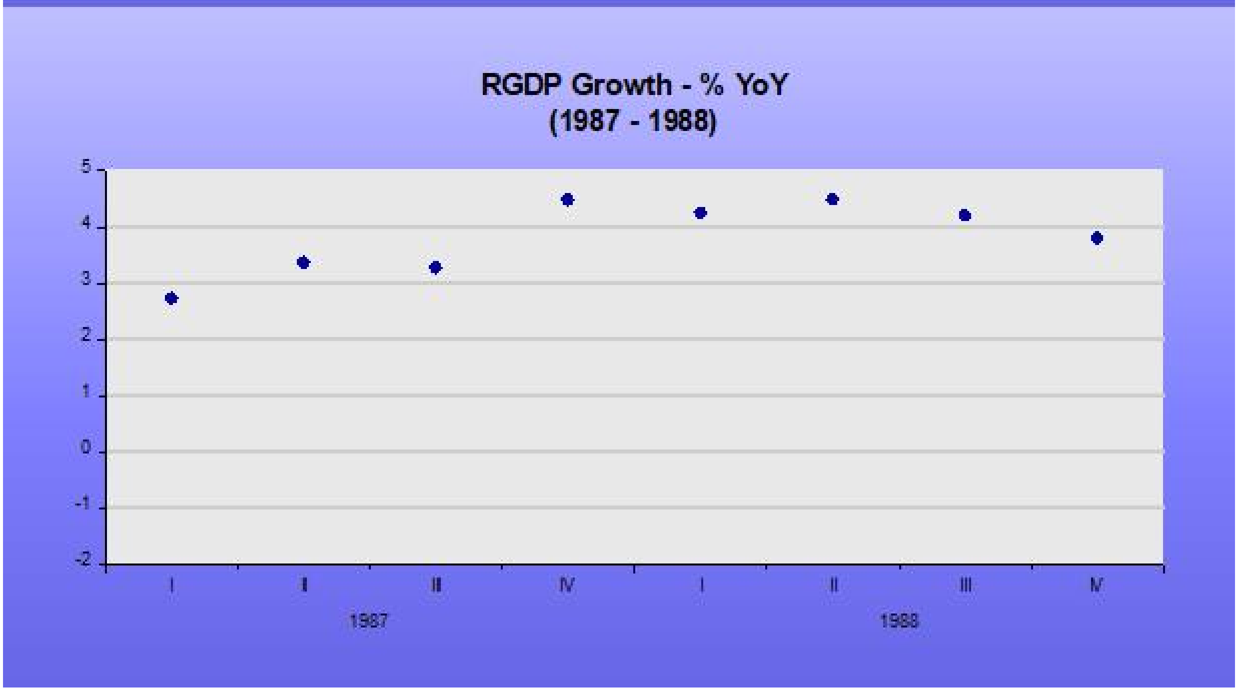
In the discussion, “Is the world ready for the next downturn”? Thomas Mayer, former Deutsch Bank Chief-Economist, points out:

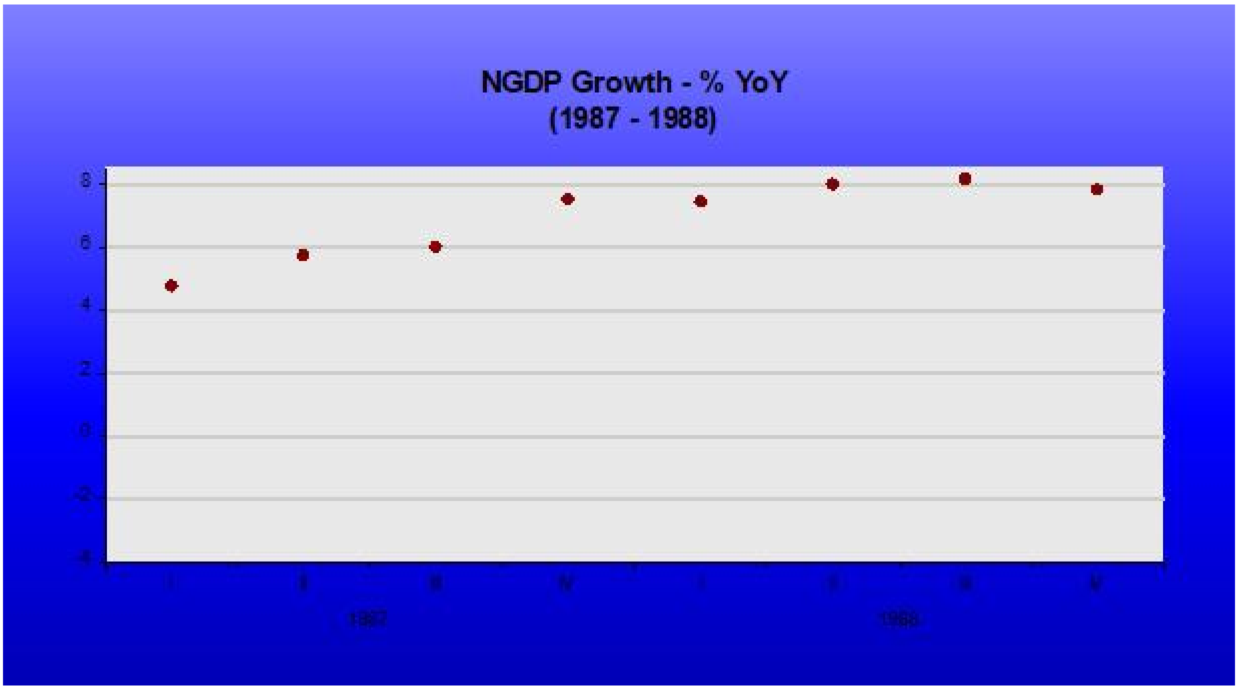
> As long as Keynesian economics is the shared mental model of most economists and almost all central bankers and politicians, **we proceed from one financial crisis to another**.
>
> The list is already fairly long: **the stock market crash** of 1987, **the savings and loan crisis** of the early 1990s, the **bond market crash** of 1994, the **emerging market crisis** of 1998, **the dot.com crash** of 2000–2003, and the **financial crisis** of 2007–2008.
>
> The list will only end when economists and policymakers realize the flaws of Keynesian economics.

Instead of looking for flaws in alternative “schools of thought”, I believe it´s more relevant to evaluate the behavior of the Federal Reserve during of those specific “financial crises”. In particular, I look at the real effect of the crisis (what happened to real GDP growth) and then, on the behavior of the Fed in the conduct of monetary policy (gauged by its ‘control’ of aggregate nominal spending (NGDP) growth).

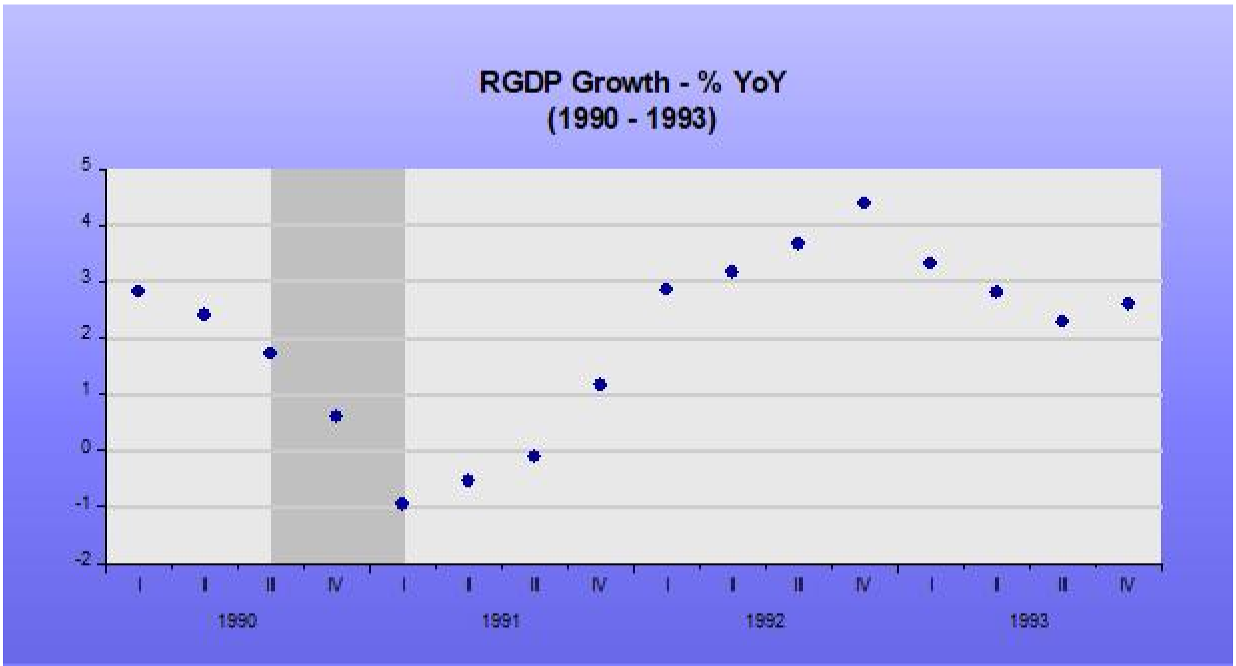
The 1987 stock market crash was a historical record, with the S&P 500 dropping 22% in a single day! The charts show that there were no real effects. Likely because nominal spending growth remained stable.

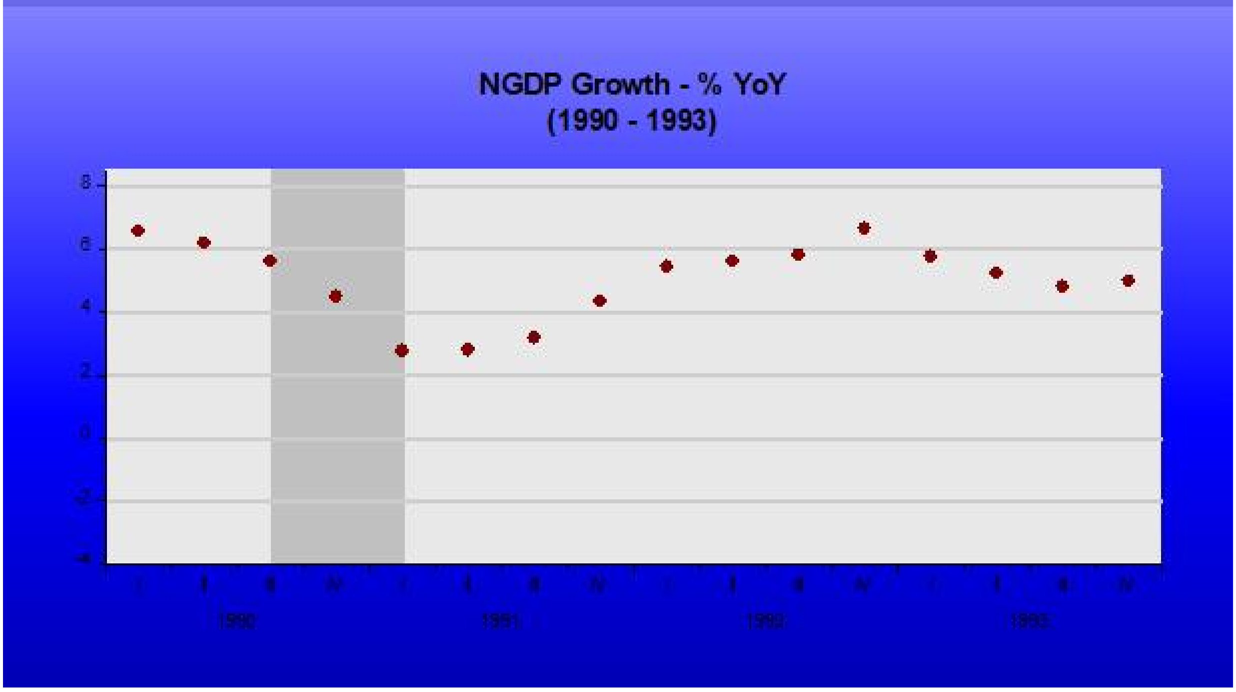

S&P 500
(1987 - 1988)
340
320
300
280
260
240
220
M1 M2 M3 M4 M5 M6 M7 M8 M9 M10 M11 M12 M1 M2 M3 M4 M5 M6 M7 M8 M9 M10 M11 M12
1987
1988


RGDP Growth - % YoY
(1987 - 1988)
5
4
3
2
1
0
-1
-2
I II III IV I II III IV
1987
1988



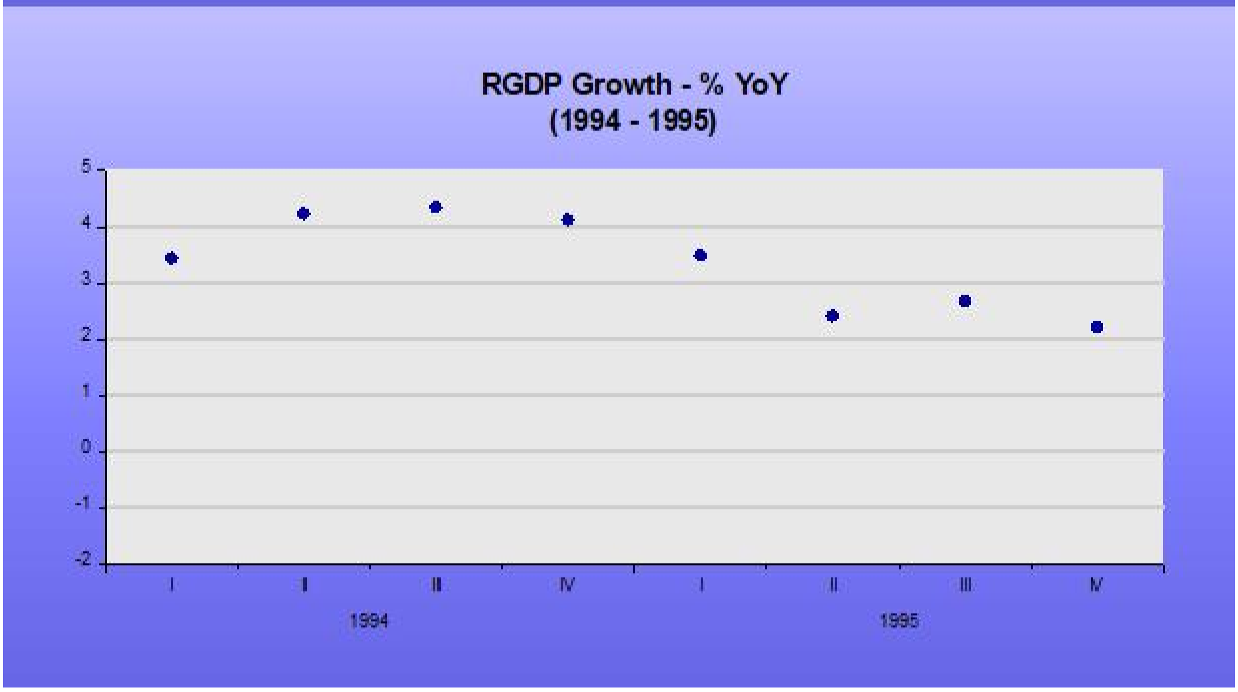
The S&L crisis of the early 1990s had real effects, with a recession being called. The Fed erred in letting nominal spending growth falter significantly.

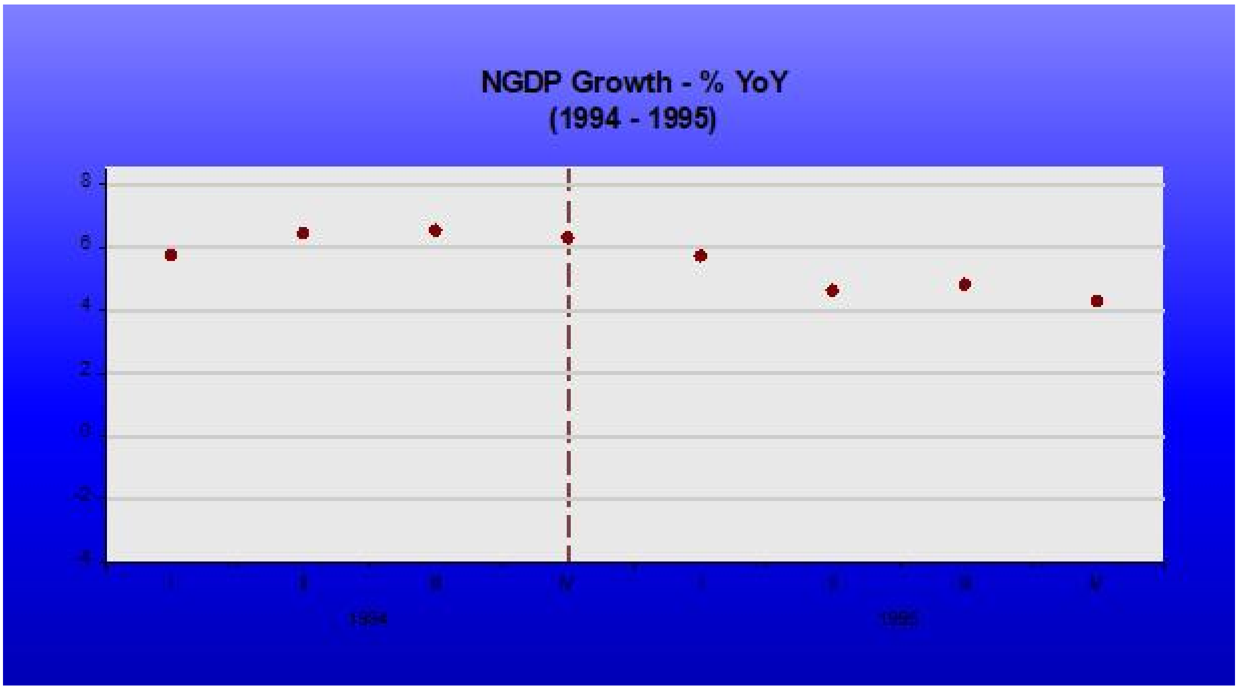




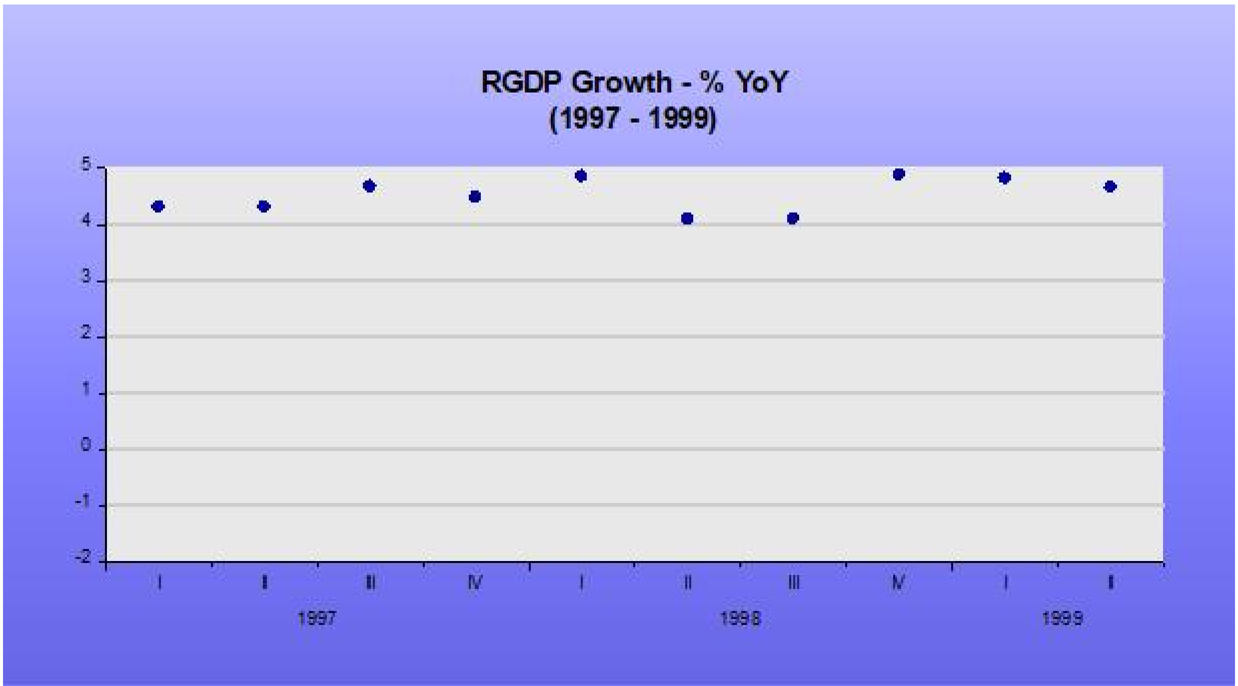
During the bond market crash of 1994, when the long-term yield shot up in a short period, the stock market stayed put. Real growth moved down slightly, mostly because nominal spending growth came down a little.

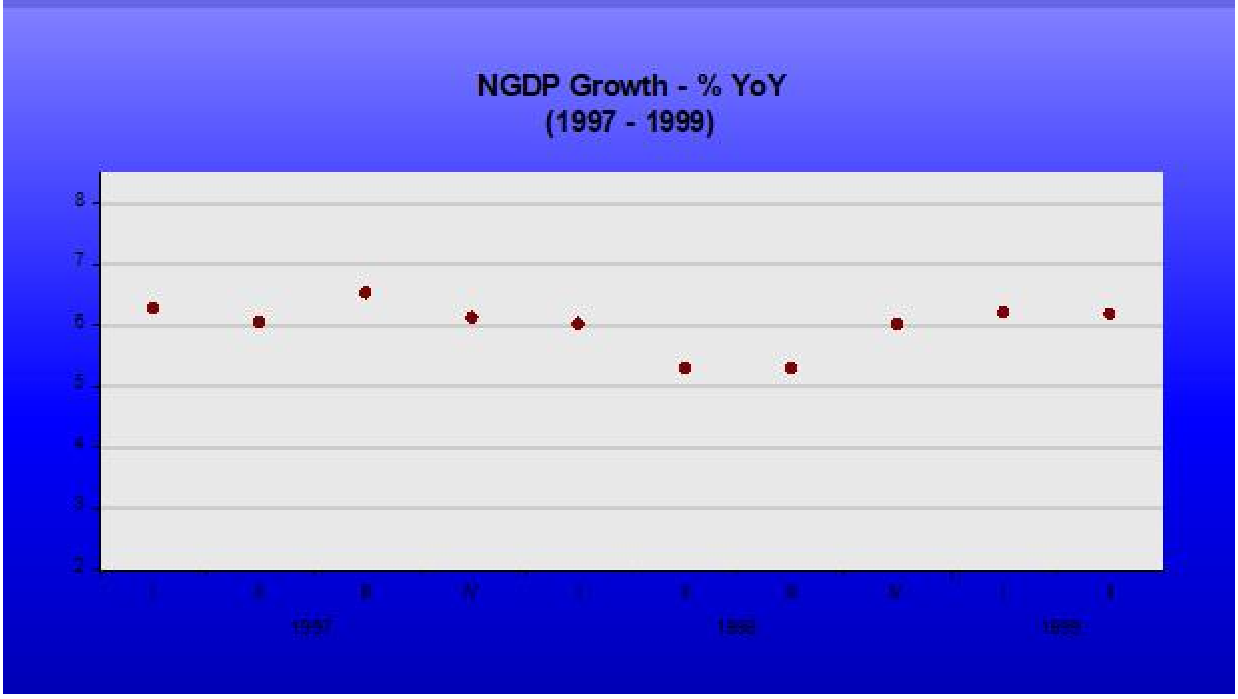

10-yr Yield & S&P 500
10-yr TB
S&P 500
8.0
7.6
7.2
6.8
6.4
6.0
5.6
640
600
560
520
480
440
M1 M2 M3 M4 M5 M6 M7 M8 M9 M10 M11 M12 M1 M2 M3 M4 M5 M6 M7 M8 M9 M10 M11 M12
1994
1995

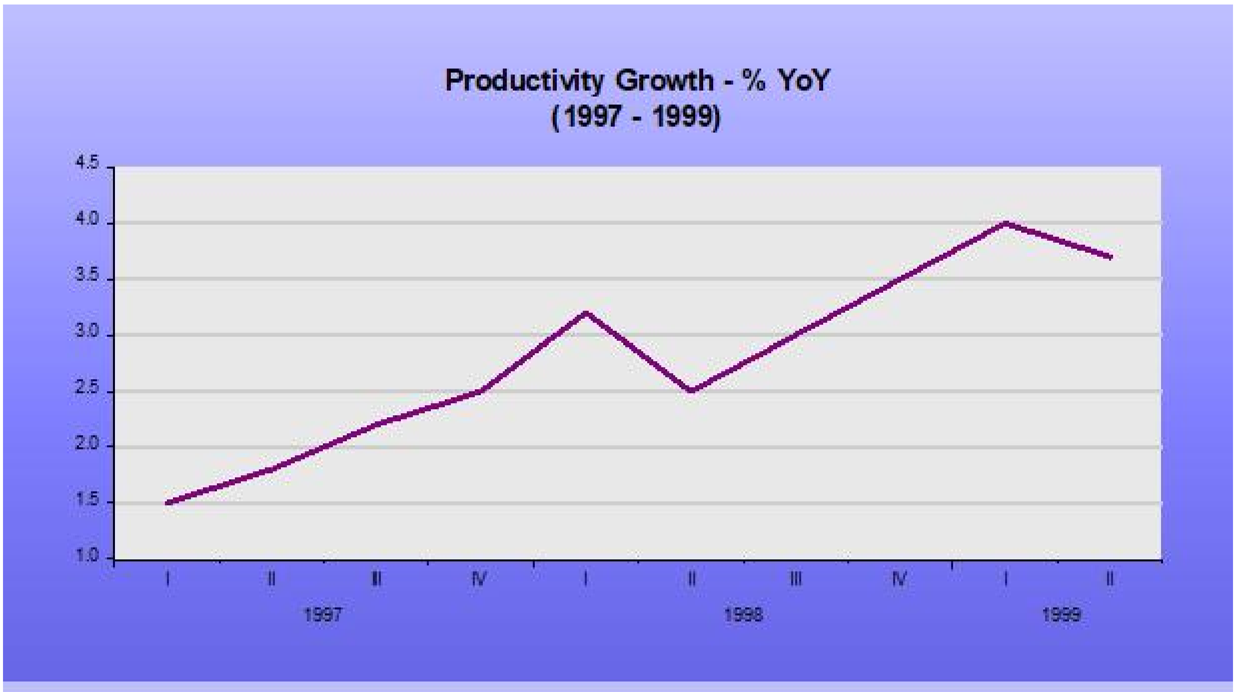

RGDP Growth - % YoY
(1994 - 1995)
5
4
3
2
1
0
-1
-2
I II III IV I II III IV
1994
1995

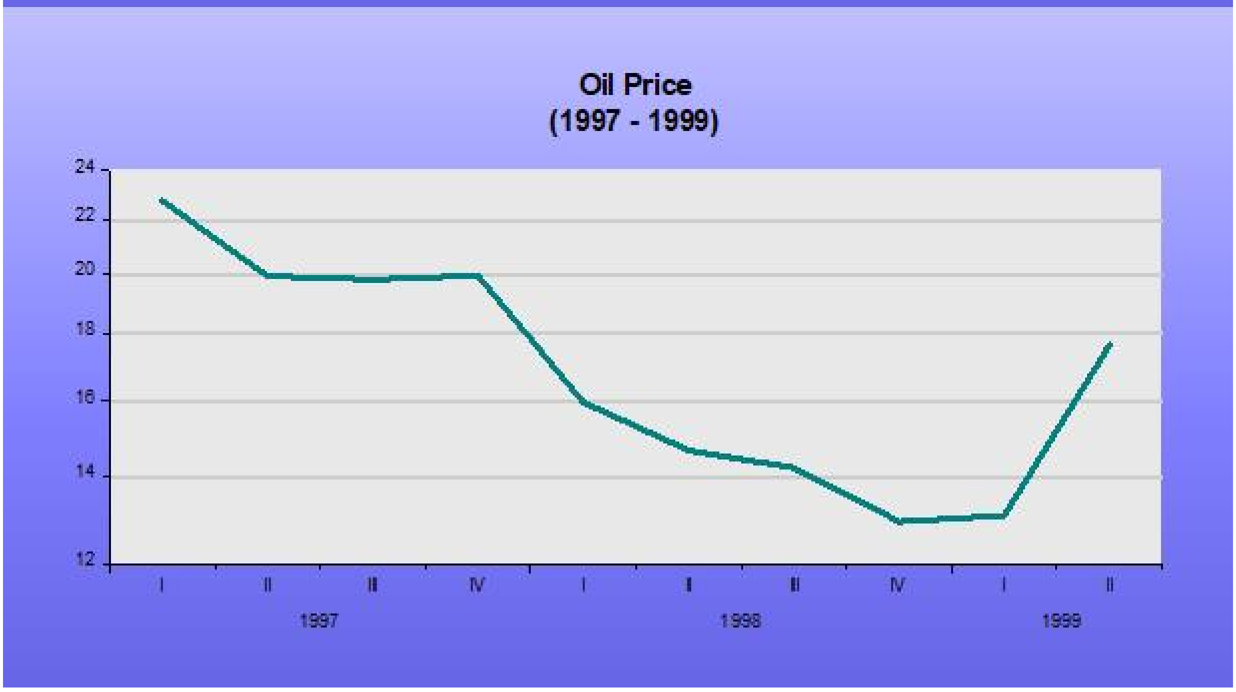


During the emerging markets crisis (Asia/Russia), real growth remained strong. This largely reflected a combination of two positive supply shocks. The rise in productivity growth and the big drop in oil prices. Nominal spending growth remained well behaved.


RGDP Growth - % YoY
(1997 - 1999)
5
4
3
2
1
0
-1
-2
I
II
III
IV
I
II
III
IV
I
II
1997
1998
1999

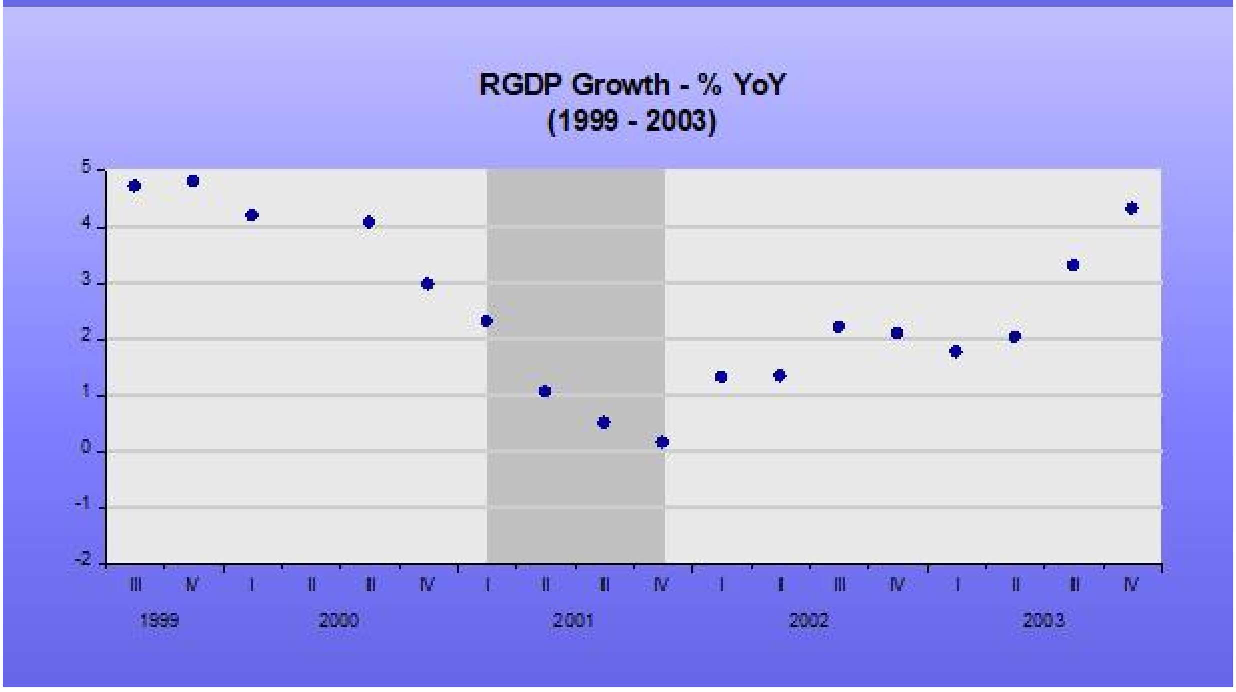

NGDP Growth - % YoY
(1997 - 1999)
8
7
6
5
4
3
2





The dotcom crash had a major effect on the NASDAQ, but there were significant spillovers into the S&P 500, which fell by about 45% over a period of 24 months. There was a noticeable real effect, with the economy entering a recession in 2001. Note that the Fed tightened monetary policy, with nominal spending growth falling significantly below trend.


S&P 500
(1999 - 2003)
1,600
1,500
1,400
1,300
1,200
1,100
1,000
900
800
III
IV
I
II
III
IV
I
II
III
IV
I
II
III
IV
I
II
III
IV
1999
2000
2001
2002
2003


RGDP Growth - % YoY
(1999 - 2003)
5
4
3
2
1
0
-1
-2
III
IV
I
II
III
IV
I
II
III
IV
I
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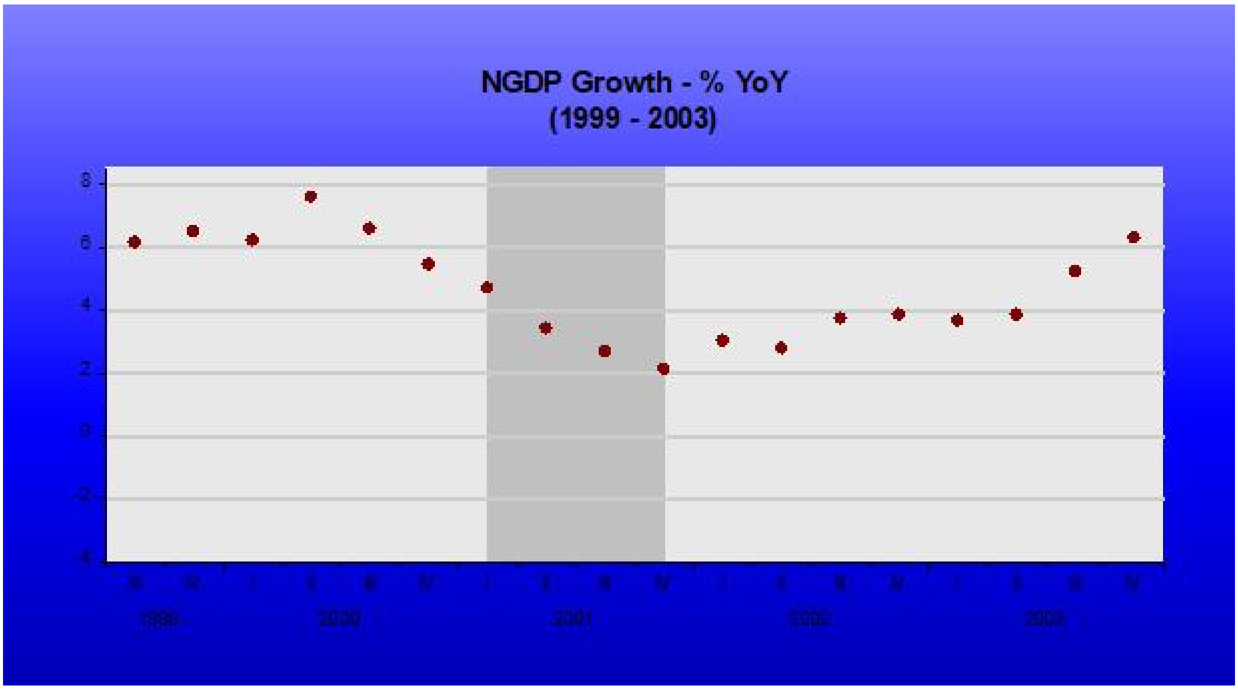
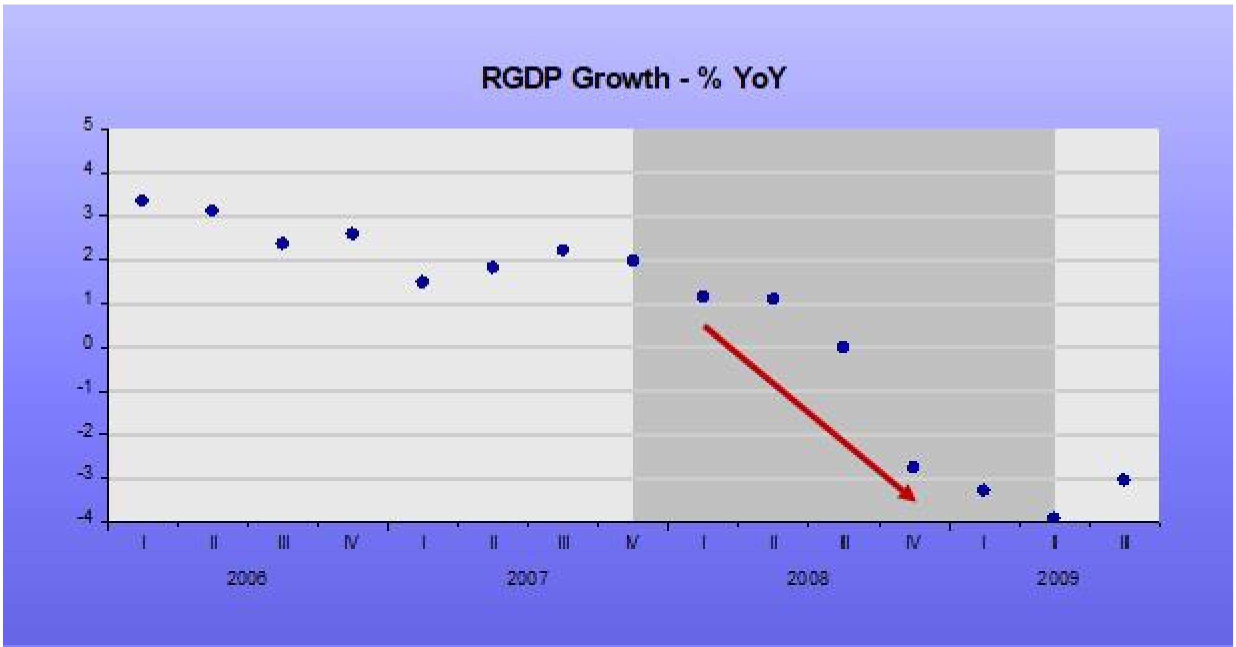
III
IV
I
II
III
IV
1999
2000
2001
2002
2003

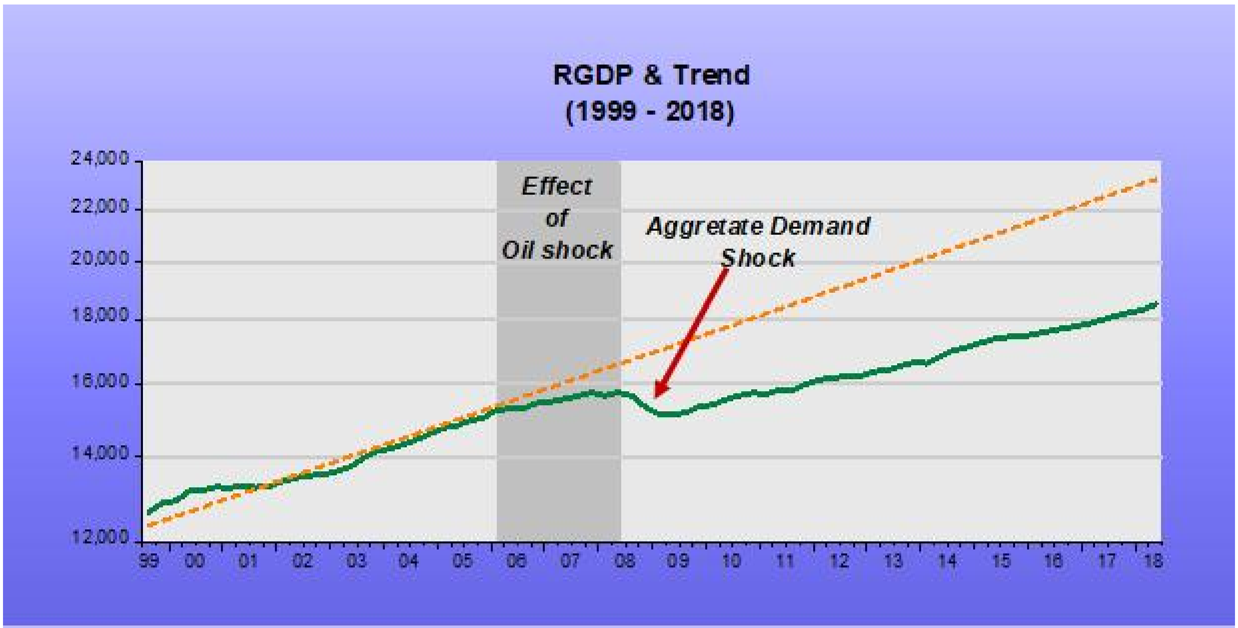


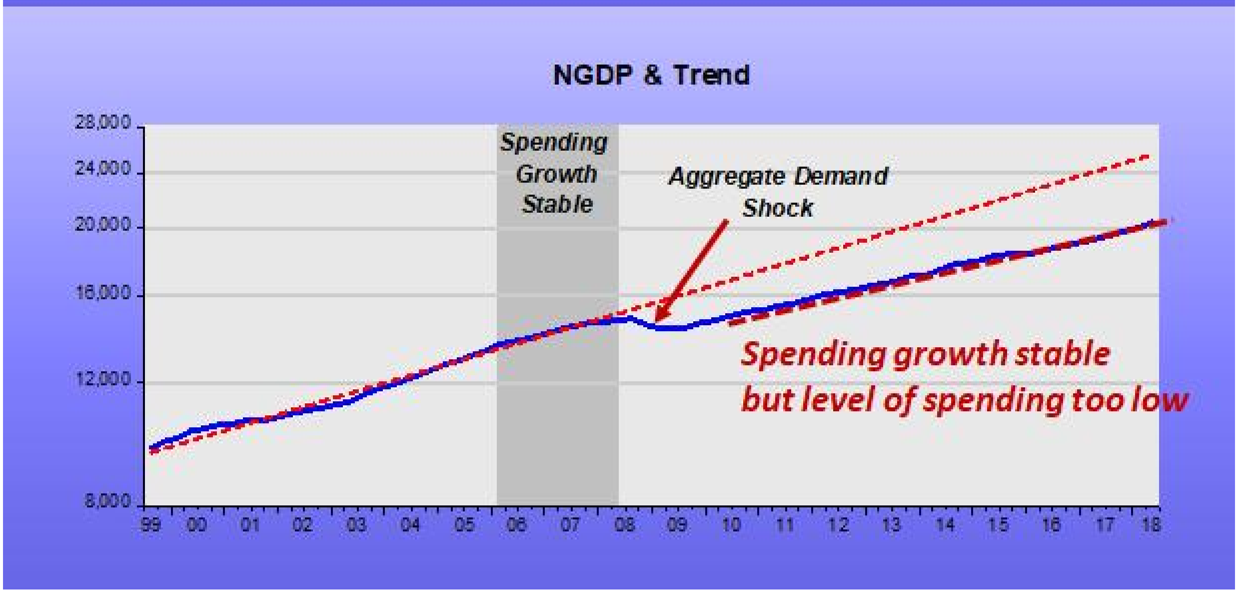
The previous crises were “rehearsals” to the “main event”, the crisis of 2008-09. The real effect was massive, but it only became so because monetary policy was not just tightened but squeezed, with nominal spending growth “falling off the wagon”.



So, “are we ready for the next downturn”? The question is tricky because if we are ready for a downturn, it will likely be “small”; at least it won´t be caused by a monetary policy error. In the previous crisis, we´ve seen that if monetary policy keeps spending growth on “an even keel”, the real effects of supply shocks are contained.

Although over the past eight years, the Fed has kept spending growth stable, the **level of spending is too low.** The charts illustrate.





For some time the Fed has emphasized the need to “normalize” monetary policy. The reference is to the level of the policy rate. The implication of our analysis is that to “normalize” policy means, first, to get aggregate nominal spending to a higher level and second, keep it growing at a stable rate at this new higher level. Once the Fed does that, it will be “ready for another downturn”!