The Fed Taunts Hyman Minsky?

This week George Mason University icon Tyler Cowen interviewed Nobel Prize winner Paul Krugman, and the economic figure of Hyman Minsky came up.

Krugman pondered if there was a "Minsky financial cycle" in the near future—often dubbed "a Minsky moment"—referring to a scenario in which elevated asset prices suddenly decline, triggered by a sudden market reappraisal of prospects. To be sure, it can be argued asset values are high presently, especially in global institutional real estate, and especially in Asia. Also, the PE's on the US stock market are well above long-term averages.

Presently, the specter of higher interest rates and stalled economic growth is haunting global markets, resulting in some rather stiff selloffs. Emerging markets are worried capital will leave for risk-adjusted higher rates in the US and elsewhere. Most likely, the much-discussed international trade tensions are worrying, but not of a scale to be consequential. But trade-tangles are in the headlines. Krugman posits we may face a "smorgasbord" recession.

Yet, the Fed Has Sacralized the 2% Inflation Target

So, perhaps the Fed should stop its reverse QE program, and at least hold steady on rates, no?

The problem is the Fed regards its 2% inflation target as sacrosanct, commented Krugman. Why does even the "dove" Janet Yellen, former US Federal Reserve chair, genuflect to the 2% IT totem?

"My answer is that, for reasons that are less intellectual and more almost social, anyone who's been associated with central banking is *really* wedded to the 2 percent inflation target," explains Krugman.

Krugman and Cowen do not address the topic, but the Reserve Bank of Australia has had a 2% to 3% inflation band target since the early 1990s, and has tolerated stretches of 4% inflation—and has not had a recession since 1991.

An important observation is that 4% inflation to Australia did not lead to Zimbabwe or the Weimar Republic, nor did bringing inflation back down to the 2% to 3% range in Australia incur a recession.

The Australian approach seems rather sensible and effective, and rarely discussed in US macroeconomic circles.

Add on: Krugman also ponders a Fed without ammo in the next economic downturn. Interest rates will go to zero in a recession, maybe in the first inning. Of course, the Fed can go to QE, or perhaps finally the idea of money-financed fiscal programs will be broached. But in general, Krugman anticipates a flat-footed central bank and national government response to the next recession. And as for prophylactic measures, they are not even on the table.

IMF Warns of Hymie Too

The International Monetary Fund in its August External Sector Report also warned that US asset values are bloated, in large part due to foreign capital inflows resulting from current-account deficits. In brief, the US imports goods and pays for them by selling debt, property or other assets.

Speaking in institutionalese, the IMF said chronic US trade deficits "could constrain global growth and possibly result in sharp and disruptive currency and asset price adjustments."

The Fed Beckons Minsky

So we possibly have Hyman Minsky at the global economy threshold, and the Fed is beckoning him in, issuing taunts with each rate hike. Perhaps the global economy will only experience a correction in asset values and then a minor recession. World financial authorities insist banks are sturdier than in 2008.

Let's hope for the best.