Timothy Taylor Says Fed Will Resort to QE Early in Next Recession—But Will That Work?

Global interest rates are still near historical lows; indeed 10-year German bunds pay 0.49% interest, and 10-year Japanese government bonds pay 0.12%. The US pays more, a 10-year Treasury offers 3.10% or so.

Timothy Taylor of the excellent **Conversable Economist** pointed out recently that the US Federal Reserve will likely face the zero bound early in the next recession, and will have to resort to QE. Depending on when the next recession is, the Fed may be back to the capital markets buying bonds before it has sold much of its existing $4.0 trillion stockpile of bonds and mortgage-backed securities, largely acquired in the Great Recession-2008 Version.

Indeed, a global glut of capital and secular stagnation may make historically low inflation and interest rates the new norm posits **The Brookings Institution**. In short, the Fed will likely be out of conventional ammo in the first inning of a recession.

But Does QE Work?

“QE is controversial, the theory is muddy and the empirical evidence is open to interpretation, in part because there is little data to work with,” says Stephen D. Williamson, former St. Louis Fed scholar.

Certainly, it seems like QE should work, but the Bank of Japan has purchased back 45% of Japan’s gigantic pile of JGBs—a pile that is equal to 225% of Japan GDP—and the nation is still at 1% inflation and slow growth. As always in macroeconomics, the topic is made muddy by extenuating circumstances, such as Japan’s aging and shrinking population, though that has been offset by rising female labor participation rates. So we have headlines like this: **“Bank of Japan’s balance sheet now larger than country’s economy”.** Even if one posits QE works, one might ponder if such large-scale QE as seen in Japan would be tolerated in the US.

There are confounding issues in the case of QE in the US, such as the Fed’s mysterious decision to pay interest on excess reserves. Also, Mercatus scholar David Beckworth argues the Fed made clear QE was not permanent, and so markets expected no permanent increase in

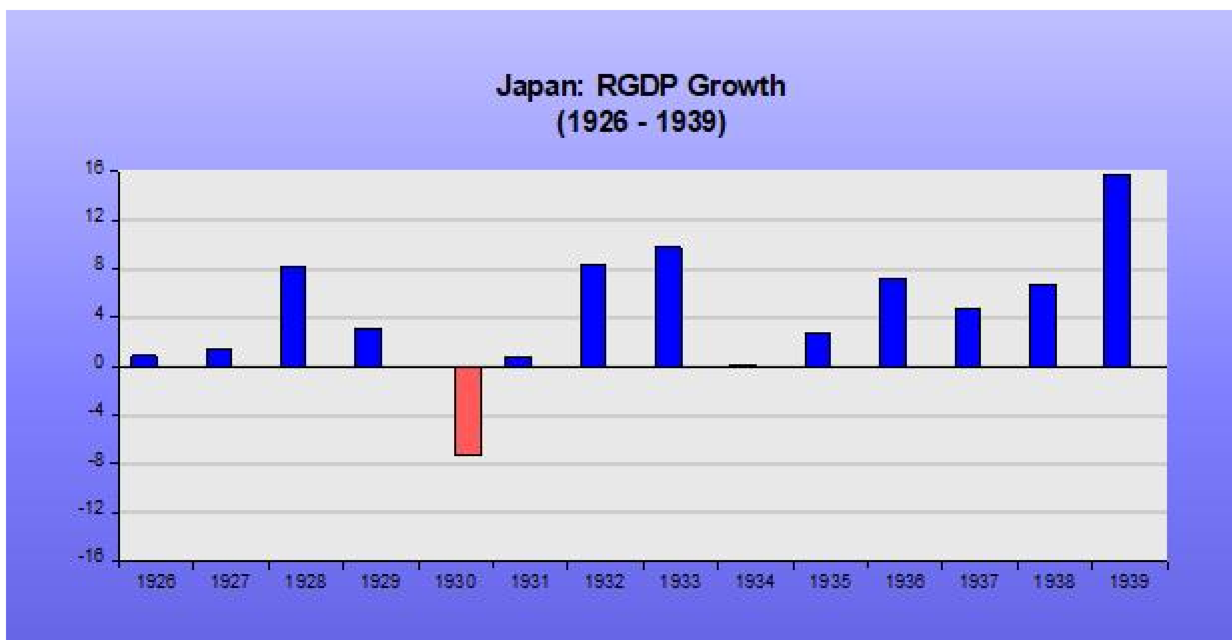
the monetary base, thus limiting QE effectiveness.

Money-Financed Fiscal Programs

There seems to be a consensus among macroeconomists that money-financed fiscal programs (MFFP), aka helicopter drops, would be effective, but at the risk of inflation, and especially so if political office holders came to embrace "free money."

Below is a chart of Japan's Real GDP Growth 1926-1939.

Japan was then, as now, an exporting nation, and found global markets dead after 1929. Japan was the only developed nation to sidestep the Great Depression, as it turned to money-financed fiscal programs, under Finance Minister Takashi Korekiyo. (Unfortunately, MFFP were used in a military build-up, that is to say wasted from a classic, macroeconomic viewpoint).



The Japan Great Depression record is remarkable, and doubly so as it is almost unknown in the West. One may wonder why. Former Fed chief Ben Bernanke, in a speech delivered in Japan in 2003 endorsed MFFP.

Perhaps Western governments would abuse MFFP, the usual critique.

Then, others might regard the Great Recession of 2008, and the subsequent 10 years of sluggish growth, as abusive as well.