

Monetary Policy Informed by Fear!

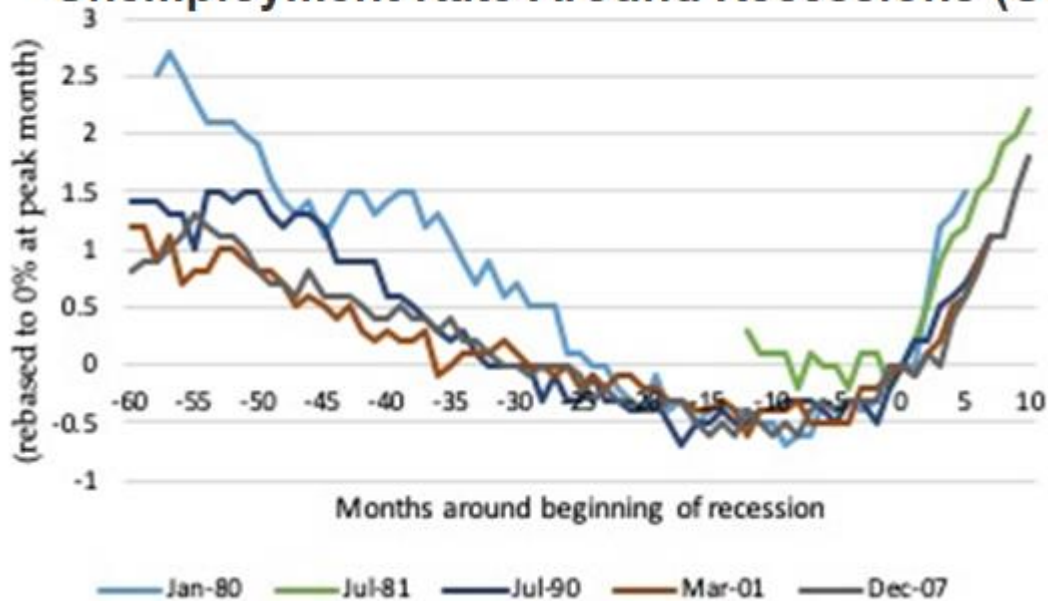
Antonio Fatas writes "[This time might not be different](#)":

The US does not seem to be able to sustain a low unemployment rate. Once we reach "full employment" (or even before), unemployment bounces back as we hit a turning point. I have written about this pattern in [my previous post](#):

All cycles display a V-shape evolution for unemployment. Unemployment reaches its lowest point around 12 months before the recession and, in most cases, unemployment is already increasing in the months preceding the recession. What is interesting is the absence of a single episode of stable low unemployment (or full employment). **It seems as if reaching a low level of unemployment always leads to dynamics that soon generate a recession.**

And shows this chart.

Unemployment Rate Around Recessions (US)



The pattern of US unemployment recessions suggests that low levels of unemployment are a strong predictor of sudden increases in unemployment, associated to crises. **We do not observe in the data any sustained periods of low unemployment.** But why is low unemployment unsustainable? What leads to a recession?

The academic literature tends to emphasize two set of variables: those associated to macroeconomic imbalances (such as inflation) and those associated to financial imbalances...

This result suggests that **recessions follow periods of low unemployment because imbalances are built during those years.** What is interesting is that the evidence shows that this is always the case, that the US economy has never managed to sustain a low rate of unemployment without generating the imbalances that lead to a recession. **If history is an indicator of future crisis, and given the current low level of unemployment, a recession is likely to be around the corner.**

The “imbalance”

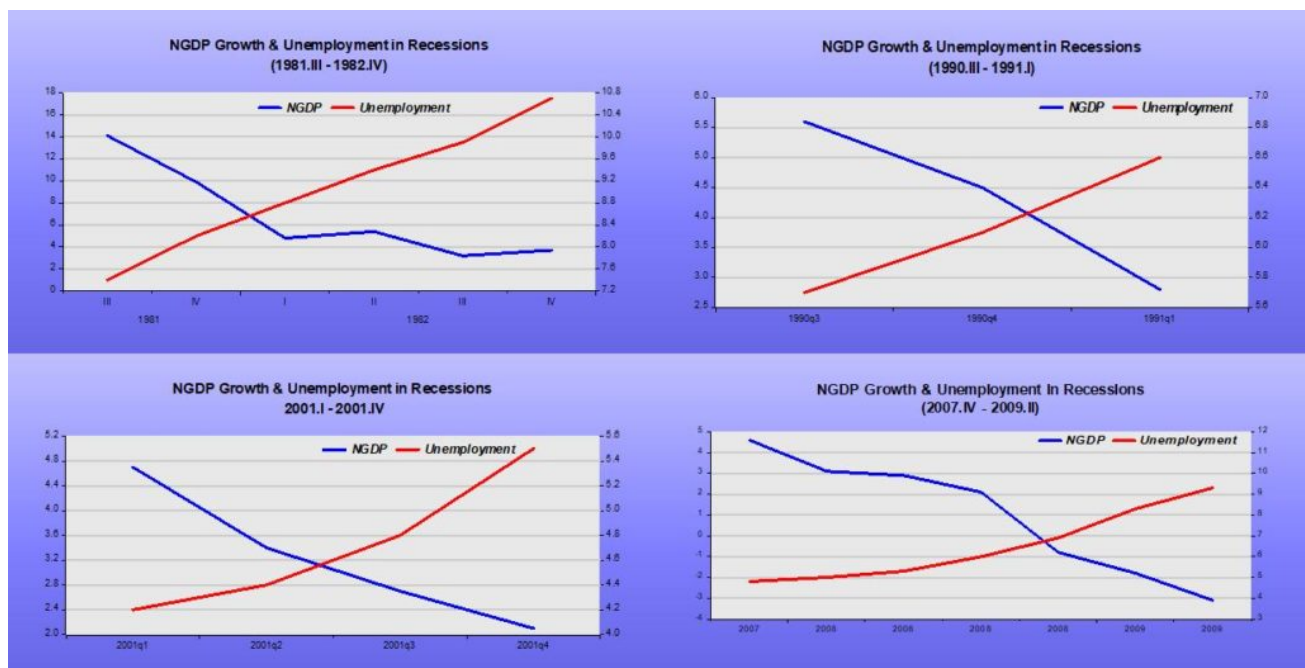
that gives rise to an increase in unemployment is the monetary “imbalance”.

When unemployment reaches a “low” level, the fear of inflation takes hold of US

monetary policy makers, so they tighten monetary policy (allow NGDP growth to

fall). Unemployment rises and economic activity drops.

The charts show the “X” pattern, which depicts unemployment rising from “low” levels with NGDP growth falling short of trend.



What would happen if they kept NGDP growth on a stable level path? Unemployment would likely remain low and stable, so you would witness a **sustained period of low unemployment!**

NGDP Growth & Unemployment in Expansion (2014.II - 2019.I)

