An Avoidable Recession

The 2007-2009 recession was a disaster.
Some lives were ruined while far more were disrupted. An entire generation
endured a half-decade of underemployment in the pathetic pseudo recovery that
followed. The Great Recession didn't have to happen, the Fed could have
followed the Greenspan playbook and "got out ahead of the markets" (even Trump **got it at the time**). The Fed could have done more than expected
and reshaped expectations. It could have done its job.

We can at least say that 2008 was a
relatively challenging period. The subprime housing crisis stressed an
over-optimized financial system. Strong growth in China drove oil prices to
alarming heights. The dollar was plunging, with the Euro around $1.50 in summer
2008. The Fed, staffed with academics who had spent a career studying the
1970s, was worried about inflation, and they had at least some justification.

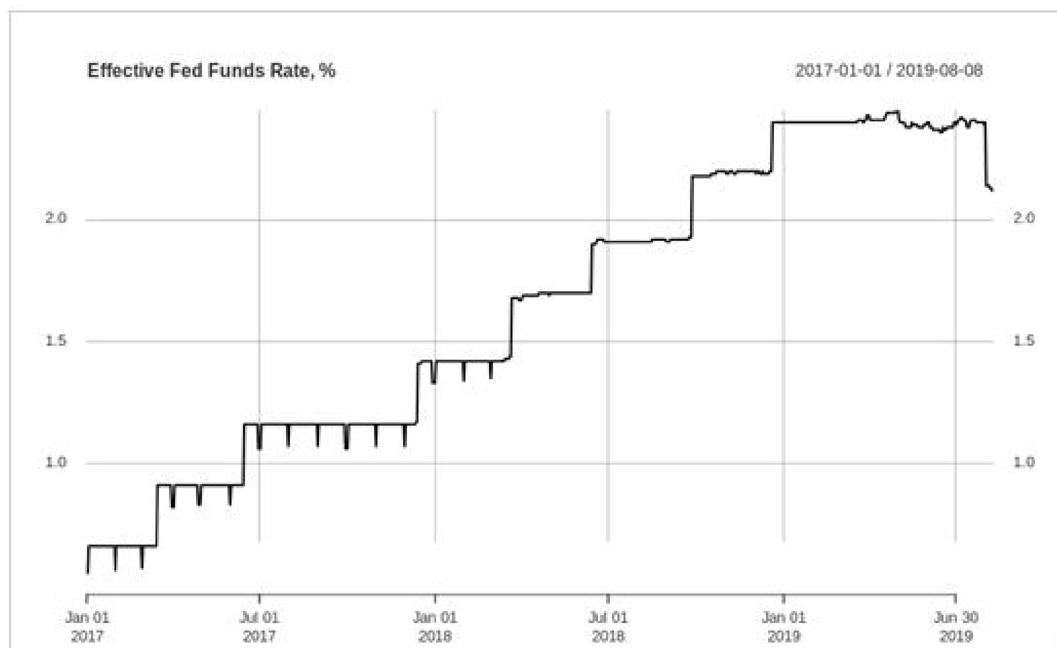
Things are different today. Oil is cheap,
measured inflation is low and has been low for a decade. Despite the trade war,
inflation expectations are firmly below the Fed's own target. The labor share
of GDP, a broad measure of the cost of labor, is near historic lows. We should
not be talking about recession, yet bizarrely, that seems the likely future for
the US economy.

A Recap

When Jerome Powell ascended the Federal Reserve throne in February 2018 things were looking up. It seemed the USA finally had what it needed: a Fed boss who wasn’t afraid to see a little prosperity. Someone who might allow inflation to hit 2.5% for a few years. Someone who, backed by an administration interested in easy money, could see the US economy hit its potential.

Our NGDP forecast rose from around 4% in
October 2017, to near 4.5% by early 2018. By September

2018, the forecast had soared to 5.2%, driven by buoyant signals from markets and strong nominal income growth. The situation quickly reversed, when in October 2018 the Fed raised rates and Powell began publicly citing the long-discredited Phillips-Curve model. This was a strange episode, and seems to have been an act of open defiance against Trump, who’d publicly questioned Powell’s previous rate increase in June. Another rate increase followed in December, causing a serious drop in equity prices and an associated plug in our NGDP forecast.



It was **obvious at the time**, at least to us at
NGDP Advisers, that the last two rate increases of 2018 were a terrible move.
These decisions killed the outlook and set the stage for recession in 2020. It
was also avoidable, it wasn't like 2008. Inflation was tame, inflation
expectations were in line with objectives, low even if one considers that the
Fed 'owes' the public for years of inflation shortfalls under Bernanke and
Yellen. The justifications give at the time, relying on unclarified concerns
about the unemployment rate falling "too low", were pure sophistry.

The Road Ahead

The Fed cut rates on August 1st, 2019. This long delayed cut was muted by a statement that the Fed was not intending to initiate a series of cuts, undermining the stimulative aspect of the cut itself. Markets plunged, the yield curve inverted further. If the Fed sought to cause a recession while going through the obvious monetary policy motions, they couldn't have done a better job. Our NGDP forecast stands at 1.7% after all this, the lowest level we've ever forecasted. If this is indeed how NGDP growth progresses over the next year, this will almost certainly result in a recession, that's now the baseline take: recession in 2020. We can't say how bad the recession will be, that depends entirely on the Fed's response in the coming months. Judging by the relatively high level of stock prices, the market seems to think the Fed will figure it out.

To avoid recession, the Fed needs to cut rates 50 basis points, at its next meeting. Moreover, it needs to make statements that amount to "We will get NGDP growth back over 4.5%, soon". The worst case is they continue to neuter rate cuts with tight-money language, getting rates down to 0% without stimulating the economy. This would set us back to the regime of quantitative easing, which the Fed has proven inept at deploying.