Where the Fed Will Be When the Next Downturn Comes

The easy-money policy may bump inflation over 3% in the next few years, setting up interest-rate increases.

By Martin Feldstein
July 5, 2016 7:18 p.m. ET

Testifying before the Senate on June 21, Federal Reserve Chair Janet Yellen said the chances of the U.S. economy sliding into recession this year are "quite low." I agree. But the Fed still faces the difficult problem of what to do when the next downturn occurs if interest rates are still extremely low.

The Fed's traditional response to an economic slump is to cut rates sharply in order to stimulate interest-sensitive spending. When the U.S. economy headed into recession at the end of 2007, the Fed cut the short-term federal-funds rate by three percentage points within 12 months. But it can't do that anytime soon with short rates at less than 1%. And raising the federal-funds rate now to 3% or more would push the economy into recession.

Yet, whether by accident or intent, Fed policy is headed down a path that could eventually solve this problem. The Fed's plan to continue a very easy monetary policy over the next few years is likely to drive the inflation rate to more than 3%. The Fed could then raise the federal-funds rate rapidly, reaching at least a 3% nominal rate, while still keeping a low or negative real fed-funds rate. This would put the Fed in a position to cut rates sharply when a new downturn occurred.

Based on the Fed's own numbers, the real federal-funds rate will still be negative at the end of 2017. All of this is aimed at driving down the unemployment rate to only 4.6% in 2018, the median of the Federal Open Market Committee's projections. Since that rate is less than the 4.8% rate Fed policy makers judge to be the long-term sustainable rate, their projections of unemployment imply that inflation will continue to rise beyond the Fed's stated 2% target.

If the Fed succeeds in achieving this—raising the inflation rate above 3% and then raising the fed-funds rate close to that level without pushing the economy into recession—it will have solved the problem of having a high-enough fed-funds rate to deal with a traditional economic downturn.

Financial markets may of course get nervous if the Fed continues to have a very low interest rate even after it has achieved its dual goals of low unemployment and a 2% inflation rate. But the Fed could then argue that the 2% inflation rate was never intended as a ceiling but as an average rate to be achieved over time. Since annual inflation has been below 2% for more than three years, it would arguably be consistent with the Fed's goal to have inflation temporarily above 2%.

Of course, this path of future inflation and interest rates may not be what the Fed has in mind. But it does look consistent with the Fed's current actions and its projected plans for interest rates over the next two years. It would be a clever policy but it would also be a policy of high-risk fine-tuning.

It's risky because the financial markets may not be convinced that the Fed will act to reverse an inflation rate that has drifted above 3% and continues to rise. That could cause long-term interest rates to rise sharply, leading to declines in the prices of equities and of commercial real estate. The resulting higher mortgage rates would depress house prices and housing demand. The higher long-term interest rates would also inflict large losses on bondholders who had bought long-term bonds with very low coupons. These financial losses could precipitate an economic downturn. Fed actions to cut its newly increased fed-funds rate might not be enough to reverse that downturn.

What is the alternative? It's not helpful now to say that the Fed should have started to normalize short-term rates back in 2014. But there is no reason for the Fed to continue to aim for a negative real fed-funds rate through 2017 in an economy that is already essentially at full employment and experiencing a rising rate of inflation. The Fed could now accelerate the planned increase in short rates, limiting the rise in inflation. The higher real interest rates would also reduce the incentive for investors and lenders to reach for yield in ways that create risks of financial instability.

When the U.S. economy does experience the next economic downturn, economic recovery need not depend on monetary policy alone. The appropriate response would add a short-term fiscal stimulus combined with longer-term reductions in spending that would prevent a net increase in the out-year deficits. Once the coming election is behind us, it would be good for the next president and the Congress to design such a fiscal package so that legislative action could happen promptly when it is needed.

Mr. Feldstein, chairman of the Council of Economic Advisers under President Ronald Reagan, is a professor at Harvard and a member of the Journal's board of contributors.