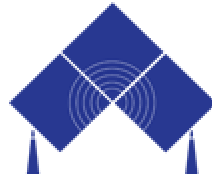

Did the Feds Mess Up the 2008 Recession?

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That was the question on the minds of several economists at a panel discussion held at the Cato Institute recently.

Daniel L. Thornton, former vice president and economic adviser for the Federal Reserve Bank of St. Louis, felt that the Fed was too slow to react and they were overly obsessed with interest rates, "The Fed was out of touch with reality [because] the [interest] rate was already there and they were debating it." As the Fed "expanded the monetary base…we started making a lot of loans." As a result of making loans, Thornton pointed out that "excess reserves of banking systems grew tremendously [by] about $350 billion." Yet the Fed continued to debate interest rates and "didn't consider all their options" because the Fed had "a lot of fright going on" during the recession.

In early 2009, Thornton claimed he went to a friend of his, who had contacts at the Fed, and tried to emphasize that "the economy was already stabilizing." Yet, the Fed continued to panic and continued their interest rate policies, also known as quantitative easing, by economists.

Scott Sumner, the Ralph G. Hawtrey Chair of Monetary Policy at the Mercatus Center at George Mason University, noted, "Something is wrong" when the Fed could not adequately predict an economic downturn. He said, "[It was] very rational for the Fed to have a bleak outlook on the economy" when stocks crashed in 2008 and to react the way it did. However, he was quick to point out that many could not have predicted the economic recovery because "[the] recovery happened quicker than expected." (Outside the Beltway, many are still waiting for that quick recovery.)

There is evidence on either side of the effectiveness of quantitative easing, Sumner said, but the issue is that current monetary policy focuses on interest rates and "the net effect on interest rates is not that clear." He continued, "If you're doing QE, something is wrong in monetary policy in a regime sense." In a 2008 recession environment, Sumner added, "QE makes things better than not doing QE" because "without the interest on reserves, it would have been more effective."

However, he found that "there's a lot of evidence that it worked in terms of the macro economy [i.e. the U.S. economy]." Sumner said that if the Fed unwound quantitative easing [i.e. reversed their monetary policy], that would have been "a wiser move for the Fed" in 2009 to continue the

economic recovery. Yet, the heralded U.S. economic recovery was not a strong one by any standard, Sumner noted. “We had the weakest recovery in U.S. history over any extended period,” he said, “an extraordinary period of low GDP growth; that obviously doesn’t look good if you’re trying to sell QE.” Even though “we’ve done better” with QE compared to the Eurozone, it was because the Eurozone had not implemented QE policies as early as the U.S.

Why didn’t the Fed unwind their monetary policy? They were concerned about creating market instability, but Sumner pointed out how Japan did so and their economy did not become more unstable.