Grasping Reality with Both Hands

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Two Years Late and Many Dollars Short

I remember back two years ago, talking to a future subcabinet Obama official, asking what was the Plan B in case the Recovery Act that they could get through Congress turned out to be too small. He told me that there were lots of other things that could and would be done--the Treasury could leverage up its TARP money and use it to stimulate the economy, and Fannie Mae and Freddie Mac could restructure mortgage finance, and the Federal Reserve could act to raise inflation expectations and change asset supplies via quantitative easing.

Now David Leonhardt looks back on all the things the Fed has done--or, rather, not done--over the past two years:

> Fed's More Aggressive Move May Not Go Far Enough: For much of the last year, there were three basic camps on what the Federal Reserve should be doing. One focused on the risks of the Fed's taking more action to help the economy. This camp — known as the hawks, because of their vigilance against inflation — worried that the Fed could be sowing the seeds of future inflation and that any further action might cause global investors to panic. Another camp — the doves — argued instead that the Fed had not done enough: inflation remained near zero, and unemployment near a 30-year high. In the middle were Ben Bernanke and other top Fed officials, who struggled to make up their minds about who was correct. For months, they came down closer to the hawks and did little to help the economy. On Wednesday, they effectively acknowledged that they had made the wrong choice.
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> The risks of inaction have turned out to be the real problem.
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> The recovery has not been as strong as the Fed forecast.... Since May, the economy has lost 400,000 jobs.... What's striking about the last six months, however, is how much more accurate the doves' diagnosis of the economy has looked than the hawks'. Early this year, for example, Thomas Hoenig, president of the Kansas City Fed and probably the most prominent hawk, gave a speech in Washington warning about the risks of an overheated economy and inflation. Mr. Hoenig suggested that the kind of severe inflation that the United States experienced in the 1970s or even that Germany did in the 1920s was a real possibility. When he gave the speech, annual inflation was 2.7 percent. Today, it's 1.1 percent.
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> The doves, on the other hand, pointed out that recoveries from financial crises tended to be weak because consumers and businesses were slow to resume spending. Around the world over the last century, the typical crisis caused the jobless rate to rise for almost five years....
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> [G]lobal investors have continued to show no signs of panicking. If anything, as the economy weakened over the summer, investors became more willing to lend money to the United States, viewing its economy as a safer bet than most others. After the Fed's announcement on Wednesday, many of the hawks who warned about inflation earlier this year repeated those warnings anew. The Cato Institute, citing a former vice president of the Dallas Fed, said the new program would "sink" the economy. Mr. Hoenig provided the lone vote inside the Fed against the bond purchases. It's always possible that the critics are correct and that, this time, inflation really is just around the corner. But there is still no good evidence of it. The better question may be whether the Fed is still behind the curve....
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> "I'm a little disappointed," said Joseph Gagnon, a former Fed economist who has strongly argued for more action. The announced pace of bond purchases appears somewhat slower than Fed officials had recently been signaling, Mr. Gagnon added, which may explain why interest rates on 30-year bonds actually rose after the Fed announcement.
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> One thing seems undeniable: the Fed's task is harder than it would have been six months ago. Businesses and consumers may now wonder if any new signs of recovery are another false dawn. And although Mr. Bernanke quietly credits the stimulus program last year with being a big help, more stimulus spending seems very unlikely now.
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> Unfortunately, in monetary policy, as in many other things, there are no do-overs.

Brad DeLong on November 04, 2010 at 08:30 AM in Economics, Economics: Federal Reserve, Obama Administration | Permalink

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ISLM said...
Just curious... when are you going to admit that supporting Bernanke's re-appointment was a big mistake from liberals like you who ensured us that, despite being a conservative Republican, Bernanke was, first and foremost, a technocrat concerned about fine-tuning monetary policy to suit the needs of the day? Bernanke's announcement of QE2 the day after