Why printing more money could have stopped the Great Recession

By Timothy B. Lee

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For the last five years, economists and policymakers have been debating what caused the Great Recession and what America should do to recover from it. Liberals argued that massive deficit spending was needed to boost demand and pull America out of its economic slump. Conservatives have countered that too much government spending and regulation was to blame for the crisis in the first place, and that spending cuts and deregulation were the key to getting the economy going again.

In recent years, a third perspective has been gaining ground. Known as market monetarism, it holds that the Great Recession happened because America's central bank, the Federal Reserve, didn't do enough to support the economy in the wake of the 2008 financial crisis. And it argues that Fed has had the power to accelerate growth and bring down unemployment all along. It just needed to create more money.

Bentley University economist Scott Sumner has emerged as the most prominent advocate for this view. Since 2009, he has been telling anyone who would listen that the conventional wisdom on both the left and the right is wrong. Most conservatives thought the Fed had done too much already; many liberals thought the Fed was "out of ammunition." Sumner has persistently built the case that the Fed should — and could — do more.

And he has been surprisingly successful. His preferred monetary policy, known as nominal GDP targeting, earned a wave of high-profile endorsements in 2011. In 2012, the Federal Reserve took a big step in a market monetarist direction when it announced a new program to boost economic growth by creating more money.

Sumner argues that the results have vindicated the market monetarist point of view. The US economy has grown steadily over the last 18 months, despite spending cuts and tax hikes that economists such as Paul Krugman warned would be a drag on the economy.

"Krugman himself said that 2013 was going to be a test" of market monetarist ideas, Sumner notes. Sumner argues that market monetarists were vindicated by the strong performance of the US economy in 2013.

And he says that events overseas provide further support for the power of money creation to boost economic growth. In Japan, an aggressive program of money printing has started pulling that country out of its two-decade-long economic slump. In contrast, Sumner says, too little money creation in 2011 pushed the Eurozone into a double-dip recession.

Sumner argues that it's essential that we learn the right lessons from the last six years. "If we hit low interest rates again, the Fed needs a better backup plan than they had in 2008," Sumner says. He argues that his ideas provide the key to avoiding another 2008-style meltdown.

Monetary policy is a complex and subtle topic. Read below for a primer on monetary policy and the market monetarist viewpoint. Then click the "interview" tab to read Sumner in his own words. The transcript has been edited for length and clarity.

What's monetary policy and why does it matter?

Monetary policy is how a central bank such the US Federal Reserve controls the amount of money in circulation. While managing the nation's money supply might seem like a dry, esoteric subject, economists believe it has a powerful effect on the health of the economy.

The Federal Reserve chooses between two basic options. It can expand the money supply by creating new dollars and introducing them into circulation. This is known as an "easy," "loose," or "expansionary" policy. The alternative is to pull dollars out of circulation, known as "tight" or "contractionary" policy.

When the Fed eases, it uses freshly-created dollars to purchase assets — most often government bonds. That puts more cash in the pockets of businesses and consumers. Some of them will spend it, boosting demand for goods and services. Businesses respond by hiring more workers and expanding production, creating an economic boom.

But there's a natural limit to the quantity of goods and services the economy can produce. If the Fed injects more cash into an economy that is already close to the limit, it will push up prices without significantly increasing output. This is called inflation.

Monetary policy is all about striking the right balance between these two extremes. Two little money leads to idle resources — a recession. Too much money leads to rising prices — inflation.

I thought monetary policy was about raising and lowering interest rates.

It's true that central banks talk a lot about interest rates. That's because the traditional way to inject money into the economy is by purchasing short-term government bonds. That lowers the interest rate the government has to pay for short-term loans and exerts downward pressure on other interest rates.

This mechanism for expanding the money supply has become so ingrained in central banking culture that central banks prefer to think about interest rate targets instead of the size of the money supply.

For example, if you were reading a newspaper in October 2008, you might have seen a story about the Fed cutting interest rates to 1 percent. This meant that the Fed was committing to buy as many government bonds as it took to reduce a key interest rate to 1 percent. Conversely, when the Fed wants to remove money from the economy, it will "raise interest rates," selling previously-purchased bonds until the rate rises to a target level.

But don't be fooled: "lowering interest rates" and "expanding the money supply" are two different ways of describing the same process of buying government bonds with freshly created dollars.

The economy was terrible in 2008. So the Fed needed to pursue easy money, right?

That's right. When the economy begins to contract, as it did in 2008, the Fed's job is to expand the money supply to help offset the downturn.

But there was a problem: the Fed normally conducts monetary policy by setting interest rate targets. But by the end of 2008, the Fed had pushed interest rates all the way to zero. They couldn't go any lower, and the economy was still deep in recession.

Keynesian economists such as Paul Krugman call this a "liquidity trap." They argue that once short-term interest rates reach zero, monetary policy becomes ineffective. Printing more money can't lower interest rates, they argue, and lower interest rates are the primary way that central banks stimulate the economy.

This is why President Obama sought a massive stimulus package from Congress in early 2009. Believing the Fed to be impotent, Obama and his advisors argued that only massive budget deficits could pull the economy out of its slump.

What is market monetarism?

In February 2009, Bentley University economist Scott Sumner created a blog called The Money Illusion and began to argue that the conventional view of monetary policy was all wrong. His key arguments:

- **Monetary policy was too tight in late 2008.** With interest rates at 0 percent, many people believed that monetary policy was as loose as it could be. But Sumner argued that monetary policy should be judged based on results rather than interest rates. With prices falling and unemployment skyrocketing, he said, it made no sense to say the Fed was doing all it could.
- **Liquidity traps are a myth.** Sumner rejected the conventional focus on interest rates as the key lever for monetary policy. In his view, the Fed can always do more, even when interest rates are zero. If buying short-term bonds becomes ineffective, the central bank can always purchase other assets.
- **Market expectations matter.** Sumner argued that the market doesn't just respond to the Fed's current actions, but also to its statements about future policies. While the Fed took some aggressive actions to cushion the economic downturn in late 2008, Sumner argued that it didn't commit strongly enough to continuing expansionary policies in the future. That made businesses reluctant to invest.
- **Stimulus spending is unnecessary and probably counterproductive.** Given that the Fed already had the ability to provide as much stimulus as was needed, Sumner

> thought the Obama stimulus package wasn't needed. He predicted that if deficit spending succeeded in boosting economic output, that would simply lead the Fed to proportionally reduce its own stimulus efforts.

While Sumner became the best-known advocate for this point of view, a community of like-minded economists and bloggers soon developed. In 2011, the economist Lars Christensen coined the phrase "market monetarism" for this school of thought.

Why is it called market monetarism?

Market monetarism builds on monetarism, a school of thought that emerged in the 20th century. Its most famous advocate was Nobel prize winner Milton Friedman. Market monetarists and classic monetarists agree that monetary policy is extremely powerful. Friedman famously argued that excessively tight monetary policy caused the Great Depression. Sumner makes the same argument about the Great Recession. Market monetarists have borrowed many monetarist ideas and see themselves as heirs to the monetarist tradition.

But Sumner placed a much greater emphasis than Friedman on the importance of market expectations — the "market" part of market monetarism. Friedman thought central banks should expand the money supply at a pre-determined rate and do little else. In contrast, Sumner and other market monetarists argue that the Fed should set a target for long-term growth of national output and commit to do whatever it takes to keep the economy on that trajectory. In Sumner's view, what a central bank *says* about its future actions is just as important as what it does.

What's nominal GDP and why are market monetarists obsessed with it?

Nominal gross domestic product (frequently abbreviated NGDP) is a measure of the total output of the economy. ("Nominal" means not adjusted for inflation.) Nominal GDP in the United States is currently around $17 trillion:

Ordinarily, NGDP grows at about 5 percent per year. The growth rate slows a bit during recessions and rises during booms, but its growth is pretty steady overall.

But in the fall of 2008, total economic output fell drastically. And in the view of market monetarists, that was the telltale sign that the Federal Reserve wasn't doing enough to boost the economy.

Sumner argues that NGDP should be the first, last, and only criteria a central bank uses to decide if monetary policy is too tight or too loose. He wants central banks to print less money when NGDP goes above its long-term trend line and print more money when it falls behind.

More important, Sumner wants the Fed to publicly commit to doing this in the future. He believes that a credible commitment to do whatever it takes to hit pre-defined NGDP targets will give businesses confidence that the Fed will act decisively in the face of the next downturn, helping to prevent another 2008-style meltdown.

That just sounds like wishful thinking. Is there evidence that central bank statements can be so powerful?

After each meeting, the Federal Reserve issues a statement known as "forward guidance," which provides the market with guidance about the central bank's future plans. Every word of these statements, which the Fed issues about once every six weeks, is scrutinized by the markets for clues about future Fed policies. In Sumner's view, the contents of these statements can actually matter more than short-term decisions about the money supply.

"We just saw a powerful example in Japan," Sumner says. For the last 20 years, Japan has been stuck in an economic slump similar to — but worse than — the one the US has suffered since 2008. For years, the Japanese central bank had been trying and failing to boost the economy using easy money.

But early last year, Japan did something it hadn't done before: it explicitly said that its goal was to raise the inflation rate — and that it would do whatever it took to achieve that goal. The result was a dramatic improvement in the Japanese economy. "The yen fell sharply in the foreign exchange markets," Sumner says. That made Japanese products cheaper on the world market, boosting exports.

"Stocks increased sharply," Sumner says. "Then GDP started rising — both nominal and real [inflation-adjusted] GDP. Inflation started rising."

"These are things that the skeptics said should never happen," Sumner says. "The skeptical view that the Fed couldn't do more has I think been decisively rejected by the Japanese example."

The key to Japan's success, Sumner argues, was the central bank's pledge to do "whatever it takes" to reach its inflation target. The Bank of Japan can create an infinite number of yen, so there's no doubt it can raise prices if it really wants to. But previous efforts were too half-hearted. The Bank of Japan would inject money into the economy only to abandon the effort later.

But ordinary people don't pay attention to the Fed's statements. How can they have such a powerful effect on the economy?

"I know the average person doesn't pay attention to the Fed and they don't really think forward guidance is going to matter that much," Sumner says. "But forward guidance affects a lot of things that *do* affect average people."

"When long term interest rates fall, or the stock market booms, or the dollar falls in the foreign exchange market, that sets in motion changes in corporate America that do affect average people."

Who favors nominal GDP targeting?

In 2011, the concept of nominal GDP targeting attracted a wave of influential endorsements:

- Michael Woodford, a widely respected monetary economist who wrote a leading monetary economics textbook, endorsed NGDP targeting at a monetary policy conference in September.

- The next month, Christina Romer wrote a New York Times op-ed calling for the Fed to "begin targeting the path of nominal gross domestic product." Romer is widely respected in the economics profession and chaired President Obama's Council of Economic Advisors during the first two years of his administration.
- Also in October, Jan Hatzius, the chief economist of Goldman Sachs, endorsed NGDP targeting. He wrote that the effectiveness of the policy "depends critically on the credibility of the Fed's commitment" — a key part of Sumner's argument.

How has market monetarism affected economic policy in the United States?

In late 2012, the Fed announced a new program of monetary easing that was widely interpreted as a step toward market monetarist ideas. The program was dubbed "quantitative easing" (QE) because it focused on the quantity of money created rather than on interest rates.

This wasn't the first time the Fed had tried this kind of unconventional monetary policy. Twice before — the first time between 2008 and early 2010, the second time between late 2010 and mid-2011 — the Fed had purchased hundreds of billions of dollars of assets. But the Fed made clear that these were temporary measures, and that they would be halted if inflation started to rise above the Fed's 2 percent target.

"They went out of their way to say *don't worry about inflation*," Sumner says. "*We'll pull this money out of circulation if there's any sign of inflation picking up*. That guidance was a mistake." The first two rounds of QE did have some effect, but as in Japan their effectiveness was undermined by muddled communication about the Fed's future plans.

With QE3, which started in late 2012 and continues today, the Fed took a different approach. Instead of announcing a time limit, the Fed made the program open-ended, promising to buy tens of billions of dollars of assets per month for as long as it took for the economy to start growing again. The Fed said it was willing to tolerate inflation as high as 2.5 percent — above its 2 percent target. And the bank said it would keep interest rates at 0 percent for an extended period even after the economy began picking up.

QE3 wasn't Scott Sumner's ideal policy. But it was a big step toward the kind of policy he has advocated. And Sumner argues that the results have vindicated the market monetarist viewpoint.

Sumner points to an April 2013 blog post in which Paul Krugman — a Sumner critic — argued that "we are in effect getting a test of the market monetarist view right now." One reason the Fed launched a new round of QE was that it knew Congress was about to hit the "fiscal cliff," a combination of tax cuts and spending hikes that could slow the economy. Krugman predicted that this would lead to a slowdown despite the Fed's efforts. Sumner, by contrast, predicted that the Fed would be able to offset the effects of these policies.

"Keynesians predicted a slowdown in growth from all this fiscal austerity," Sumner says. "Market monetarists like myself didn't think it would have much effect. And if you look at growth in 2013, it was actually higher than in 2012. Growth picked up a little bit. So we don't really see much evidence of fiscal austerity slowing the economy as the Keynesians predicted."

Is there other evidence for the effectiveness of monetary policy?

Sumner argues that comparing the US to the Eurozone provides further support for his thesis. He notes that from 2008 to 2010, the two regions experienced similar economic performance — a severe recession producing unemployment of almost 10 percent. But then the two regions diverged. The US economy slowly emerged from its recession. Meanwhile, things got worse in Europe.

"The Keynesians blame fiscal austerity [e.g. spending cuts and tax hikes] for the Eurozone's double-dip recession," Sumner argues. "But the US did as much or slightly more. The big difference was monetary policy."

Two rounds of quantitative easing have helped to keep the US out of recession, while a poorly timed interest-rate hike undermined Eurozone economies.

How would nominal GDP targeting work in practice?

Sumner's proposal is deceptively simple: the Fed should announce a target growth rate for nominal GDP of around 5 percent. And then it should do whatever it takes to achieve that result. Of course, that might be easier said than done.

Sumner argues that two things are needed to make NGDP targeting work. One is called level targeting. Under this approach, the Fed would commit to make up any under- or over-shooting. So if the target is for NGDP to grow at a 5 percent annual rate, but NGDP only grows at 4 percent in one year, then the Fed would seek a 6 percent growth rate the following year to make up the shortfall.

Level targeting makes the economy more predictable. And Sumner believes it can act as an insurance policy against economic meltdowns like the one that occurred in 2008. Even if the Fed can't halt an economic contraction in the short run, the commitment to make up lost ground later will make businesses more willing to make long-term investments. And that investment, in turn, will actually make downturns less severe.

The second principle for effective NGDP targeting is called "targeting the forecast." Currently, the Fed has an official 2 percent inflation target. Yet in recent years the Fed has often published predictions that inflation would be below 2 percent. Sumner argues that this is a mistake. If your forecast says you're going to under-shoot your inflation target, that means your monetary policy is too tight.

The same principle would apply in an NGDP targeting regime. Market monetarists would have the Fed use projections about future NGDP growth as the primary indicator for whether monetary policy was too loose or to tight. If Fed economists were forecasting NGDP growth below 5 percent, the Fed would ease. Forecasts above 5 percent would lead to tightening.

To improve the accuracy of the Fed's NGDP forecasts, Sumner advocates the creation of an NGDP futures market. There are already futures markets that help economists forecast the future price of commodities like oil and pork bellies. A similar market could be set up to help forecast the growth of the overall economy.

In the long run, Sumner argues that monetary policy could be almost completely automated by tying Fed policy directly to the NGDP futures market. Under his proposal, the Fed would

automatically buy or sell bonds until the NGDP growth rate forecast by the market was equal to the Fed's target, almost completely eliminating the discretion of Fed officials.

Is market monetarism a conservative viewpoint or a liberal one?

Market monetarism doesn't have a clear place on the political spectrum. Right now, most conservatives are monetary hawks, believing that the Fed is already doing too much to try to boost the economy. Most liberals share Paul Krugman's view that the Fed has done everything it can to boost the economy, and that deficit spending by Congress is a more effective way of ending the recession.

Sumner views himself as a free-market thinker, though he concedes that he isn't an orthodox conservative. He favors carbon taxes and a modest amount of income redistribution. And his arguments for monetary activism will rub some conservatives and libertarians the wrong way.

While no one called themselves market monetarists before 2011, elements of the market monetarist view have long been held on the right. When he was asked about Japan's economic slump in 2000, the free-market economist Milton Friedman sounded a lot like Scott Sumner talking about the Fed today. Friedman argued that the Japanese central bank should buy as many long-term government bonds as it took to get the economy growing again. Bill Niskanen, the late chairman of the libertarian Cato Institute, advocated an approach to monetary policy similar to NGDP targeting.

More recently, Sumner's ideas have influenced writers at the conservative American Enterprise Institute. AEI scholars James Pethokoukis and Ramesh Ponuru have both argued that monetary policy has been too tight in recent years. Both have endorsed nominal GDP targeting as an alternative.

Sumner argues that there are two reasons thinkers on the right ought to embrace his point of view. First, he emphasizes that NGDP targeting would drastically reduce the discretion of Fed officials.

"I favor NGDP futures markets where monetary policy is set at the level where the market expects it to be on target," Sumner says. "I believe that's a very market-oriented system that takes a lot of discretion away from government bureaucrats."

Second, he argues, bad monetary policy is a major source of hostility toward the capitalist system. When the economy is growing robustly, people are more open to free-market reforms.

He points to the 1990s as an example. "All over the world, there was lot of deregulation, privatization of companies, cuts in marginal income tax rates, welfare reform," he says. "Things that were at least modestly in the right direction from a free-market perspective." But since the Great Recession, he says, "capitalism has gotten a negative reputation, and things haven't gone well. It looks like capitalism doesn't work but it's really a failure of the monetary system."

What's the future of market monetarist ideas?

Sumner says he's optimistic that people inside the Federal Reserve have learned the right lessons from the Great Recession.

"Even though I don't think the Fed has learned everything they could have learned from [the 2008 crisis], I think they've learned something," Sumner says. "In recent years, they've started to move a little bit in the direction of what the market monetarists like myself have been talking about in terms of doing more QE, doing more forward guidance. It suggests to me that they realize now that they weren't aggressive enough in 2008-9."

In the long run, the success of market monetarism depends on developing a following among younger economists. And economists in their 20s and 30s have proven receptive to Sumner's ideas. Sumner says the middle-aged economists who are running the Fed today came of age during the high-inflation 1970s, and as a result they're still obsessed with fighting inflation — even though inflation hasn't been a serious problem in decades.

Younger people, are forming their views now, in the midst of the worst economic slump in generations. They're likely to be more receptive to Sumner's argument that the Fed should have done more.