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How Uncertainty Is Holding Back The Recovery

One of the most common explanations you see on the right for the slow pace of the recovery is "uncertainty." On this view, when the average American businessman is deciding whether to expand output and hire new workers, he looks at the regulatory changes coming down the pike—Obamacare, higher tax rates, Dodd-Frank—and decides it makes sense to wait until the future tax and regulatory climate is more clear.

While many Republicans in Congress say they believe this, most of them don't act like it. After all, if uncertainty were the primary culprit, the right solution would be to cut a long-term budget deal with the White House, even at the cost of higher taxes on the wealthy, to remove uncertainty about future tax rates. And if you were worried about uncertainty, you *certainly* wouldn't provoke periodic confrontations over the debt ceiling. Obviously, Republicans think that Obama's tax and regulatory policies are bad for the economy, but they don't seem to actually believe that uncertainty about the direction of those policies is a serious problem.

With that said, I think uncertainty actually *is* a major cause of the slow recovery. To go back to our hypothetical businessman, when he's deciding whether to build a new factory, the most important consideration for him will be whether enough people will buy his products when the factory opens a few years from now. And while many factors contribute to that, one of the most important factors is the overall macroeconomic climate. If he knew for certain that the years 2014 to 2016 were going to be years of rapid economic expansion, then he'd be much more likely to invest than if he thought we were in for a decade-long economic slump.

And, of course, every corporate executive is making a similar calculation. They all face trade-offs between investing more or keeping more cash in the bank, and all of them are more likely to invest if they think the economy will be booming in the future. Which means that, paradoxically, economic expansion today depends in part on peoples' predictions about economic expansion tomorrow. If people expect the economy to be growing next year, they're more likely to take actions to make it grow this year.

Indeed, if you could hypnotize the nation's businessmen and cause all of them to be certain that we were about to enter a rapid economic expansion, this would become a self-fulfilling prophesy. Instead, businesses are uncertain about the course of the business cycle over the next few years, so they're sitting on their cash.

This is why, as Matt Yglesias says, what the Fed says after today's meeting wraps up is ultimately more important than what the central bank "does." "Quantitative easing"—injecting more money into the economy—would help to boost demand in the short run. But it would be the third time the Fed has done that, and the previous moves didn't seem to be part of any broader strategy. What's needed for sustained economic growth isn't just more demand in the fall of 2012, it's more demand in 2013, 2014, and 2015. If the Fed can convince the market that it will continue easing until the economy starts expanding rapidly, then businesses will have more reason to invest even if the Fed doesn't do very much in the short run.

This was the theory behind the Fed's pseudo-promise to keep interest rates near zero percent until 2014. But as Milton Friedman taught us, low interest rates don't necessarily mean easy money. What's needed is a clear and predictable policy of supporting economic expansion, so that businesses know that demand will be growing in the next few years.

I agree with Scott Sumner's view that the Fed should set an explicit target for nominal incomes. But assuming that's too dramatic a shift from current policy, there are other options. For example, the Fed could promise to ease until either the unemployment rate drops below seven percent or the inflation rate rises above three percent. That kind of pledge would provide businesses with some certainty about the direction the economy is headed.

Instead, we have a situation where the economy is driven by which side of the bed Ben Bernanke gets up on the morning of each Fed meeting. Even if the Fed announces "QE3″ today, that won't give the market any information about how the Fed will behave in 2013 or 2014. And if past behavior is any guide, the most likely Fed policy will be that after a few months of half-hearted easing, it will go back to the tight-money default we've been in since QE2 ended. So businesses, in anticipation of an erratic and anemic recovery, will keep their cash in the bank.

Update: It looks like my pessimistic prediction was wrong. Here's the Fed's new statement:

The Committee will closely monitor incoming information on economic and financial developments in coming months. If the outlook for the labor market does not improve substantially, the Committee will continue its purchases of agency mortgage-backed securities, undertake additional asset purchases, and employ its other policy tools as appropriate until such improvement is achieved in a context of price stability… the Committee expects that a highly accommodative stance of monetary policy will remain appropriate for a considerable time after the economic recovery strengthens. In particular, the Committee also decided today to keep the target range for the federal funds rate at 0 to 1/4 percent and currently anticipates that exceptionally low levels for the federal funds rate are likely to be warranted at least through mid-2015.

The Fed's immediate actions are a round of "quantatative easing" similar to those the central bank has undertaken before. But the difference is that the bank has committed to not only continue those actions indefinitely, but also to escalate them if necessary, to ensure that the economy starts growing more robustly. And the Fed will continue with loose money for a period of time even *after* the recovery begins. This should give businesses some assurance the Fed won't change its mind and stop easing as soon as the recovery starts to accelerate.

I'd prefer a policy that had clearer and more explicit targets, but this seems like a huge step in the right direction.