ECONOMIC INSIGHTS

The End of an Era: The Fed Lifts Off

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After months of speculation and debate, the Federal Reserve has, by raising the fed funds rate, decided that the U.S. economy has recovered from the Great Recession.

The Federal Reserve has finally acted. After months, nay years, of promising to raise interest rates, it did so on December 16, pushing up its benchmark federal funds rate by 25 basis points (bps) from a target range of 0–25 bps. The process has strung out over such a long time and had become such a part of market expectations that it is not apparent in this agonizing time who has had more fear of a rate increase, policymakers or investors. A recent piece of internal Fed criticism from the Federal Reserve Bank of St. Louis[1] suggests that it is the policymakers themselves. In making its case, this article offers a perspective on how things likely will fare from here.

At base, the nub of this analysis stems from a demonstration of how recent monetary policy has deviated from past patterns. Initially, it was similar to the past, if more extreme. The Fed eased policy aggressively in the recessions of 1981–82, 1990–91, and 2001, driving rates down quickly on the first signs of economic weakness. Because unemployment tends to lag in the cycle, the rate cuts began even before the rates of unemployment rose. The Fed then held rates low until it had ample evidence that a recovery had taken hold. Those patterns held true during the more recent Great Recession. The Fed actually cut rates during the financial crisis of 2008–09, anticipating the recession by months. And, as in the past, the Fed then held down rates through the recession and into the recovery.

The difference has emerged only as the recovery has matured. In the past, the Fed began to raise rates fairly promptly once economic growth reemerged, not to restrain the economy or to push up unemployment but to normalize rate levels from the lows maintained during the recessionary emergency. In the recovery of the 1980s, for example, policymakers made their first move, "liftoff" in today's popular jargon, only seven months after the cyclical trough. They waited longer, almost three years, in the 1990s' recovery and the one in the first decade of this century. However long the lag, the liftoff in each case occurred well before the economy had recovered its pre-recession highs or unemployment had returned to its pre-recession lows. The Fed's rate hikes never stopped at one, and the recoveries all proceeded for years after rate hikes began, eventually reaching higher levels of economic activity than the previous peak. Contrary to this well-established practice, the Fed this time has hesitated to raise rates for over six years after the recovery began.

In trying to explain this "fear of liftoff" among Fed policymakers, the St. Louis Fed analysis uses a number of angles. One relies on what economists call the "natural rate of unemployment." This kind of Goldilocks concept[2] tries to identify the lowest unemployment rate achievable before the economy begins to overheat. Policy would surely normalize rates up from recessionary lows as the actual rate of unemployment approaches the natural rate and that the delay this time might suggest a still vast difference. But when the analysis uses various estimates of this natural rate for comparison, it becomes clear that the hesitations among policymakers this time cannot find a justification in this way. Quite to the contrary, the economy today, it discovers, is actually closer to its natural unemployment rate than it was at the point of liftoff in past recoveries. It also tries to explain the delays in a more cynical light, suggesting that, perhaps, policymakers might have a personal reason to shying away from liftoff. It quotes the great economist Milton Friedman, when he described policymakers as less concerned with unemployment and inflation than with "avoiding accountability" and "achieving public prestige."[3]

Such commentary seems too tender to pursue in a professional setting such as this. It is harsh even by New York much less St. Louis standards. But if this analysis cannot open windows into the souls of Fed policymakers, it does raise questions of what they are about these days. The analysis concludes that the best way to avoid such inconsistencies is for the Fed to abandon discretion in making policy and set a transparent rule to guide the timing and size of rate moves, up or down. Leaving this suggestion, useful as it may be, to one side, the analysis offers three additional, important insights: 1) Past experience argues forcefully that the "one and done" argument is misplaced. 2) Because past recoveries clearly proceeded long after the Fed began raising interest rates, the Fed need not fear liftoff as much as it seems. 3) For the same reasons, neither should investors fear it.

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[1]Athanasios Orphanides, "Fear of Liftoff: Uncertainty, Rules, and Discretion in Monetary Policy Normalization," Review of the Federal Reserve Bank of Saint Louis, Third Quarter 2015.

[2]Goldilocks concept: An economy that is not so hot that it causes inflation, and not so cold that it causes a **recession**. There are no exact markers of a Goldilocks economy, but it is characterized by a low **unemployment rate**, increasing asset prices (stocks, real estate, etc.), low interest rates, brisk but steady GDP growth and low inflation. (Source: Investopedia)

[3]Quoted in Stanley Fischer, "Rules versus Discretion in Monetary Policy," in Benjamin M. Friedman and Frank H. Hahn, eds., *Handbook of Monetary Economics* (1990).

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