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US recession jitters stoke fears of impotent Fed and fiscal paralysis

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Debt terrifies people but the paradox of macro-economics is that sometimes borrowing even more is the best way out CREDIT: JON ELSWICK

An ominous paper by the US Federal Reserve has become the hottest document in high finance.

It was intended to reassure us that the world's hegemonic central bank still has ample firepower to overcome the next downturn. But the author was too honest. He has instead set off an agitated debate, and rattled a lot of nerves.

David Reifschneider's analysis - 'Gauging the Ability of the FOMC to Respond to Future Recessions' - more or less concedes that the Fed has run out of heavy ammunition.

The Federal Open Market Committee had to cut interest rates by an average of 550 basis points over the last nine recessions in order to break the fall and stabilize the economy. It could not possibly do so right now, or next year, or the year after. Quantitative easing (QE) in its current form cannot compensate, and nor can forward guidance. They are largely exhausted in any case.

"One cannot rule out the possibility that there could be circumstances in the future in which the ability of the FOMC to provide the desired degree of accommodation using these tools would be strained," he wrote.

This admission is painfully topical as a plethora of data suggest that the US economy may have hit a brick wall in August. The ISM gauge of manufacturing plunged below the boom-bust line to 49.4, and the services index dropped to a six-year low, with new orders crashing nine points.

My own tentative view is that these ISM readings are rogue surveys. The Atlanta Fed's 'GDPNow' tracker points to robust US growth of 3.6pc in the third quarter. The New York Fed version is coming in at 2.8pc.

Yet the US expansion is already long in the tooth after 87 months, and late-cycle chemistry is notoriously unpredictable. Warning signs certainly abound. Corporate profits have been slipping for six quarters, the typical precursor to an abrupt slump in business spending. "The only thing keeping the US out of recession is the US consumer. If consumption stalls then we really are in trouble," says Albert Edwards from Societe Generale.

I am willing to bet against him for now. The M1 money supply - often a good leading indicator - has picked up after a weak patch earlier this year and is now surging at a rate of 10.1pc. This pace would normally signal burst of torrid growth a few months later. It is in stark contrast to the monetary contraction before the Lehman crisis.

My presumption is that the day of reckoning has been pushed well into 2017, but in the dead of the night I have a horrible sweaty feeling that Mr Edwards may be right. It is not a time to be chasing stock markets already at vertiginous levels.

The Reifschneider paper argues that the Fed can probably muddle through, so long as it succeeds in pushing interest rates back up to 3pc or so before the next recession hits. Even then it might have to launch a further $4 trillion of QE and stretch its balance sheet to a once unthinkable $8.5 trillion.

Whether a Republican Congress would tolerate this is far from clear. It would probably elicit howls of protest and threats of legislation. This is why former Fed chairman reluctantly prefers the alternative poison of negative interest rates, in extremis.

In any case, the Fed may not be able to push rates to 3pc. It has taken three years of drama and repeated retreats to nudge it up a single quarter point to 0.50pc. Futures contracts suggest the Fed may struggle to get above 1pc by end of the decade.

Larry Summers, the former US Treasury Secretary, said the implication of the Fed paper is that the rates would have to be anywhere from minus 6pc to minus 9pc to extract the US from a deep recession, and there is no plausible way to mimic such rate cuts with other monetary weapons in the Fed's armoury.

"I find the idea that forward guidance and QE could do anything like the work of 600, let alone 900, basis points of rate-cutting close to absurd," he said.

The Fed acknowledges that fiscal policy will have to come to the rescue when push comes to shove. Keynesian tax cuts and spending will be the last line of defence. Yet there is no political consensus whatsoever for the sort of New Deal blitz that may be required.

US federal debt is already 105pc of GDP - up from 54pc in 2000, and 31pc in 1980, as austerity hawks are quick to point out. The 'Reinhart-Rogoff thesis' that things start to go awry once a country passes a loose threshhold of 90pc of GDP has lodged in political thinking and done enormous damage, though it has recently lost some of its ferrous grip over Western political ideology.

There is no such threshold for a mature developed country with deep bond markets, able to borrow in its own currency. Britain's public debt was over 200pc after the Napoleonic Wars. Japan is over 250pc today, and the sky has yet fall in Tokyo.

It is perfectly plausible - perhaps likely - that the US will end up in the much the same place over the next fifteen years. Trying to avoid this with deflationary fiscal policies that lead to falling nominal GDP merely makes matters worse, since the denominator effect pushes up the debt ratio even faster.

The nagging question is what happens at the onset of the next recession. If elected, Hillary Clinton is likely to be the first Democratic president to take office in modern times without full control of Congress, and House Republicans already seem determined to shoot down her budget plans. The party's platform is to "significantly reduce federal spending".

"We have to contemplate the rather alarming possibility that Congress will fail to act. There is so much animosity, and that is what is scary," said David Wessel, director of the Hutchins Center on Fiscal and Monetary Policy at the Brookings Institution.

"If we had a huge exogenous shock like Lehman Brothers or 9/11, they would act. But what if it were not quite that bad? We would have prolonged argument," he said. It would be paralysis all too like 1931 and 1932.

It is even worse in Europe where Germany is still running a budget surplus despite a current account surplus of 8pc of GDP, and is inflicting its destructive nostrums on the whole of the eurozone through the mechanisms of monetary union.

Budget austerity is built into the EMU system by treaty law and the contractionary ratchet of the Fiscal Compact. The rigid structure makes it impossible to jetisson a policy regime that amounts to slow suicide in the current macro-economic circumstances.

The eurozone needs a complete demolition of the Stability Pact in order to break out of its bad equilibrium before the next recession, with a €3 trillion spending blitz over the three years to buttress the brave but increasingly folorn efforts of the European Central Bank.

No such thinking is remotely on the cards even though Germany and Holland can borrow at negative rates for ten years, France and Belgium for nine, Austria and Finland for eight, Spain for four, and Italy for three.

An new orthodoxy is emerging in elite global circles that the only way to escape of the liquidity trap and soak up excess savings is concerted fiscal stimulus on a world scale. The International Monetary Fund has become the fiscal cheerleader, yet even the IMF cannot seem to marshal its own staff.

Brad Setser from the Council on Foreign Relations says the Fund isstill pushing the old contractionary view in aggregate, if you tot up its 'Article IV' advice to each country. Follies die hard.

History will judge that those nations best able to weather the next global downturn are those that grasp the essential character of our desperate deflationary age, and can cast aside deeply-ingrained and totemic beliefs about debt. The losers will be those spooked by shadows on the wall.

The winners - or survivors - will be those most willing to seize on the cheapest borrowing costs in history to fight back, preferably combining fiscal and monetary in a radical fashion. Call it helicopter money if you want, or 'overt monetary financing' of deficits. The accounting terminology is irrelevant.

Since no country can risk watching its precious national stimulus leak away to free riders in the austerity camp - at least in a crisis - this may imply some degree of calibrated protectionism. The twin liberal pieties of progressive public policy and global free trade may ultimately come into conflict. That is tomorrow's battle.