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How to Avoid Recession? Let the Fed Work

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THE economy is teetering on the edge. Many economists, as well as online betting sites, put the risk of recession next year at about 50 percent. Once we get the final numbers, we might even learn that a recession has already begun.

The question on the minds of many in Congress and in the White House is this: What should they be doing now to keep the economy on track? The right answer: absolutely nothing.

This advice isn't easy for politicians to follow. Because economic downturns mean fewer jobs and falling incomes, they are painful for many families. Voters can confuse inaction with nonchalance and send incumbents packing. But just as patients should avoid doctors who recommend radical surgery for every ailment, voters should be wary of politicians eager to treat every economic ill. Sometimes, bed rest and wait-and-see are the best we can do.

Congress made its most important contribution to taming the business cycle back in 1913, when it created the Federal Reserve System. Today, the Fed remains the first line of defense against recession.

The Fed's control over the money supply is a powerful lever to move overall demand for goods and services. When its trading desk buys bonds and expands the money supply, it lowers interest rates and encourages the private sector to borrow and spend more. The influence of interest rates on the economy is particularly strong in housing, where buyers are rate-sensitive. Because housing woes are the source of the current slowdown, the Fed's tool kit is well suited for the task at hand.

The recession-fighting effects of monetary expansion, however, are not limited to the housing market. When lower interest rates make fixed-income investments less attractive, investors turn to the equity market and bid up stock prices. Higher stock prices, in turn, make consumers wealthier and more eager to spend. They also make it easier for corporations to expand their businesses with equity financing.

By making United States bonds less attractive to world investors, lower interest rates from a monetary expansion also weaken the dollar in currency markets. A depreciation of the currency is not in itself to be feared. Treasury secretaries often repeat the mantra of favoring a strong dollar, but these pronouncements are based more on public relations than hard-headed analysis.

A weak currency is a problem if it results from investors losing confidence in an economy. The most damaging cases are the episodes of sudden capital flight, as occurred in Mexico in 1994 and several Asian countries in 1997. This outcome is unlikely for the fundamentally sound American economy, but fear of it is one reason that Treasury secretaries maintain public fealty to a strong dollar.

But if a weakened currency comes about because the central bank is trying to stimulate a lackluster economy, the story is very different. In that case, depreciation is not a malady but just what the doctor ordered. A weaker currency makes domestic goods more competitive in world markets, promoting exports and bolstering the economy. The dollar's falling value is one reason exports of goods and services have grown more than 10 percent in the past year.

The Fed constantly monitors all these developments to ensure that the economy has the stimulus it needs, but not too much. William McChesney Martin, the Fed chairman in the 1950s and 1960s, famously joked that the Fed's job is "to take away the punch bowl just as the party gets going."

As the economy flirts with recession, we need to remember that this aphorism has a flip side. The Fed also has the job of spiking the punch with grain alcohol when the party starts to flag, and that is exactly what it has been doing.

The Fed has cut its target for the benchmark federal fund rates to 4.25 percent from 5.25 percent last summer. It is a good bet that we will see further cuts over the next few months. And if the chance of a recession turns into a real recession, you can count on it.

Admittedly, monetary policy can sometimes use an assist from fiscal policy. If an economic downturn is deep, if a recovery is anemic or if the Fed is running out of ammunition, Congress can help raise aggregate demand for goods and services. In 2003, the Fed had cut its target interest rate all the way to 1 percent, the economy was still suffering from the lingering effects of recession, and there were increasing worries about deflation. A tax cut was a good complement to monetary expansion to get the economy going again, even though it increased the budget deficit.

Today’s situation is different. The Fed has plenty of room to cut rates further, if it deems such cuts necessary. At the moment, recession is only a possibility, and inflation is a bigger worry than deflation. In this environment, there is no need for a short-run fiscal stimulus. Congress is better off focusing on longer-term problems, like the looming entitlement crunch or fundamental tax reform. (But don’t hold your breath.)

IN creating the Fed, Congress wisely made it a technocratic institution free of many of the political pressures that accompany other policy decisions in Washington. Subsequent experience in the United States and abroad confirms that more independent central banks lead to better economic outcomes. That’s why, in recent years, many nations have passed reforms to insulate central banks from politics.

The Fed’s independence was created by statute and could just as easily be taken away. The Fed is now coming under heat for not having prevented the subprime crisis, for not fully anticipating it once it was inevitable, and for not responding more vigorously now that it has occurred. Daniel Gross, a financial journalist writing for Slate, has gone so far as to liken the Fed and its chairman, Ben S. Bernanke, to FEMA and its erstwhile head Michael Brown.

The truth is that the current Fed governors, together with their crack staff of Ph.D. economists and market analysts, are as close to an economic dream team as we are ever likely to see. They will make their share of mistakes, but it is too easy to find flaws when judging with the benefit of hindsight. The best Congress can do now is to let the Bernanke bunch do its job.