Will the U.S. Spray Water, the Next Time Expansionary Flames Expire?

Preparing for the next crisis, in a world with a consistent history of crises, makes good sense. The fact that global central banks have limited scope for traditional short rate easing requires that we contemplate all possible macroeconomic responses to a downturn.

What can policy makers do? Until they hit zero, they can lower short rates. Via quantitative bond purchases, or via bond price targeting, they can lower long rates. They can cut taxes and/or increase government spending. They can relax regulatory restrictions. All of these actions, most agree, tilt economies toward higher short-term trajectories, but carry longer term risks.

Asking whether or not we have room to exercise such policies, however, ignores a more troubling point. Except for monetary policy, the history of the past ten years is one of policy makers administering perverse policies, time and again.

In mid-2010, the Dodd-Frank Act became law. Designed to prevent a repeat of the financial system that led to the Great Financial Crisis, a laudable goal, it nonetheless restrained credit flow, with risk taking at once in a generation lows. Over time risk appetites returned, and by mid-2017, credit spreads and P/E ratios were back to near the levels in place in 2006. Right on cue, policy makers relaxed Dodd Frank in ways that will make it harder for bank regulators to act when banks find new ways to evade capital rules. Maybe Dodd/Frank was a good idea. Maybe it was a bad idea. But putting it in place when the economy was weak in 2010, only to weaken it in 2018? Perfectly perverse.

The 2010 arrival of the Tea Party kept U.S. fiscal policy in gridlock, for six years. Despite a faltering recovery and near zero inflation, the Obama White House contemplated tightening fiscal policy, in a proposed deal with House Speaker Boehner. That deal fell through, but successive continuing resolutions ensnared Federal spending in a straightjacket, amid fiscal tightening from state and local entities. In late 2017, however, with state and local belt tightening over and the jobless rate at 4%, a major tax cut was enacted alongside substantial defense and non-defense spending increases. There is a case to be made – not a persuasive one in my opinion, but a defensible one -- that high U.S. debt levels justify fiscal rectitude. But fiscal restraint amid widespread economic weakness, followed by fiscal largess just as the economy nears full employment? Perfectly perverse.

What about the imposition of a trade war? Herein, one cannot argue about timing. Instead, consider that more than 1,100 economists, including 15 Nobel Prize winners, signed a May 2018 letter protesting tariff impositions. For the vast majority of economists imposing tariffs is perverse, nearly *all of the time.* Nonetheless, aggressive tariff imposition kicked off a trade war soon thereafter.

All of which suggests that policy makers may well extend perverse policy selection during the next downturn. Who can be sure we will not react to ballooning deficits by imposing a serious round of austerity. And amid newfound evidence of financial system excesses, populist rage might drive elected officials to rediscover the need for aggressive financial market regulatory restrictions. For good measure, we may also bemoan import levels and ramp up tariffs.

Is our toolkit limited? Perhaps. But wholesale policymaker rejection of deeply held macroeconomic precepts is the current state of affairs. In such circumstances, policy responses to the next crisis wielded by demagogues, even when crafted with access to the best tools, are just as likely to make things worse as they are to make things better.