How should recessions be fought when interest rates are low?

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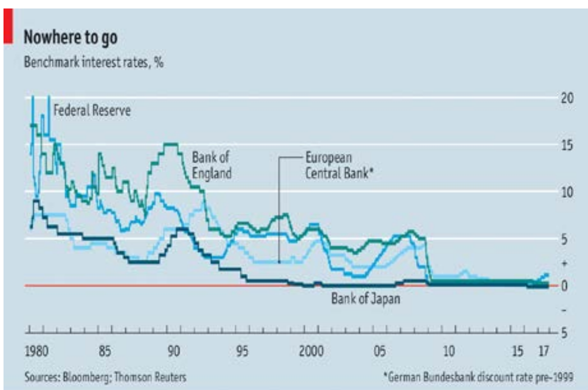
One day, perhaps quite soon, it will happen. Some gale of bad news will blow in: an oil-price spike, a market panic or a generalised formless dread. Governments will spot the danger too late. A new recession will begin. Once, the response would have been clear: central banks should swing into action, cutting interest rates to boost borrowing and investment. But during the financial crisis, and after four decades of falling interest rates and inflation, the inevitable occurred (see chart). The rates so deftly wielded by central banks hit zero, leaving policymakers grasping at untested alternatives. Ten years on, despite exhaustive debate, economists cannot agree on how to handle such a world.



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During the next recession, the "zero lower bound" (ZLB) on interest rates will almost certainly bite again. When it does, central banks will reach for crisis-tested tools, such as quantitative easing (creating money to buy bonds) and promises to keep rates low for a long time. Such policies will prove less potent than in the past; bond purchases are less useful, for instance, when credit markets are not impaired by crisis and long-term interest rates are already low. In the absence of a solid policy consensus, the use of any unorthodox tool is likely to be too tentative to spark a fast recovery.

Broadly, economists see two possible ways out, both aired at a recent conference run by the Peterson Institute for International Economics, a think-tank. One is to change monetary strategy. Ben Bernanke, chairman of the Federal Reserve during the crisis, proposed a clever approach: when the economy next bumps into the ZLB, the central bank should quickly adopt a temporary price-level target. That is, it should promise to make up shortfalls in inflation resulting from a downturn. If a recession causes below-target inflation for a year, the central bank would promise to tolerate above-target inflation until prices reach the level they would have attained without the slump.

If credible, that promise should buck up animal spirits, encourage spending, and drag the economy back to health. Raising inflation targets would reduce the frequency and severity of ZLB episodes. It would, however, force households to accept higher inflation all the time, rather than just in the aftermath of a severe downturn. A permanent price-level target, for its part, would force central banks to respond to an inflation-increasing blow to the economy—such as a big natural disaster—with rate rises, piling on pain in such cases. Less clear is whether a central bank could fulfil its promise. The Fed has failed to hit its 2% inflation target for the past five years, after all. Mr Bernanke's proposal would do little good if markets doubted a central bank's ability to fulfil its promise to deliver catch-up inflation.

The constraints facing central banks suggest better hopes for the second way forward—greater reliance on fiscal policy. This was the theme of a contribution to the conference from Olivier Blanchard and Lawrence Summers, crisis veterans from the IMF and the American administration, respectively. Before the crisis, economists used to dismiss fiscal policy as a recession-fighting tool. Stimulus was clumsy, slow and, given the control exercised by central bankers, unnecessary. But with interest rates near zero, stimulus might be the most effective way to boost demand—so long as the central bank is willing to play along. Recent history, however, suggests that it could certainly not be relied upon to do so. In 2013, the Fed announced it would begin reducing its asset purchases, despite low and falling inflation and an unemployment rate above 7%—conditions which might elicit a fiscal stimulus from an anxious government. More government spending in such cases, if deemed likely to raise inflation, might simply prompt a central bank to move forward its timetable for tightening. That would dampen—and perhaps offset entirely—the effect of the fiscal stimulus.

The dawn of a new error

So fiscal and monetary policy would have to be closely co-ordinated—amounting, in all likelihood, to a loss of central-bank autonomy. A central bank that stood by as fiscal stimulus pushed inflation above its target has in effect relinquished its independence. One that stubbornly raised rates as elected leaders sought to boost growth would quickly find its position politically untenable—much as the Federal Reserve did after the election of Franklin Roosevelt in 1932. Just how troubling a loss of independence would be is intensely debated. Messrs Blanchard and Summers are themselves at odds on it: Mr Summers is open to relaxing independence; Mr Blanchard worries that politicised central banks might have been too timid during the crisis, just as many governments turned too quickly to austerity. Other economists cite a more common fear: that governments would inevitably push for too much monetary stimulus, accelerating inflation.

Central-bank independence was an institutional response to the inflation of the 1970s, just as government business-cycle management was a response to the Depression. But the rules that underpinned the conditions of the 1970s seem no longer to apply. For a decade (more, in Japan) inflation and interest rates have limped along at historically low levels, even as government debts ballooned and central banks created piles of new money. That presents a significant problem for prevailing institutions, but also for conventional macroeconomic wisdom.

In the 1970s, an intellectual shift within economics took place in tandem with the change in policy practice. The discipline could explain why predictable monetary policy set by independent central banks was preferable to a government's attempts to spend its way to full employment. Yet things need not unfold that way this time. With economists at odds as future ZLB episodes loom, the example of the 1930s might be more apt. Then populist politicians struck out in unorthodox new directions, for better and occasionally much worse. It was only later that experts could settle on a coherent narrative of the crisis and recovery. That is not the ideal way forward. Yet it may be the only option available.