ECO202 (Macroeconomic Theory and Policy); 2022/23

The 2023 Recession and US Economic Data: A Policy Brief

By Filip Zaleski; 1008241500

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Ins.: Olga Denislamova

T.A.: Catherine Lu

Policy Interpretation

Fears about a looming 2023 recession have long been instilled in the attitudes of economic agents around the world. The concerns began as a consequence of the COVID-19 pandemic and its impact on the global economy; it caused supply chain disruptions, labour shortages, and inflationary pressures attributed to fiscal intervention – all foreshadowing a global economic slowdown (Zahn, 2022). A late entrance of the Omicron variant in November 2021 worsened attitudes by reintroducing lockdowns and travel restrictions (Lynch, 2022). As a means of counteracting the COVID-induced inflation, the Federal Reserve (FED) has raised interest rates, further worrying some economists about a potential hit to investment and consumption. Rates rose by 4.5% since March 2022, a pace unseen since the Carter era (Foster, 2023). The central bank also hiked the federal funds rate (the bank rate) by 0.5 percentage points and declared that it will be 'trimming' its $9 trillion balance sheet (Ernst, 2022).

Contractionary monetary policy in the form of rising interest rates has been the FED's principal tool in attempting to alleviate a looming recession. Some economists, such as the TS Lombard Chief U.S. Economist Steven Blitz, claim that the FED cannot disrupts its cycle of interest rate increases until the nation enters a recession (Smith, 2023). This is consistent with signs of persistent demand and tight labour markets which, while signs of a robust economy, prevent inflation from falling. Employers hired 517 thousand in January, a six-month peak, while unemployment marked a half-century low of 3.4%, and retail sales rebounded from the fourth quartile of last year (Foster, 2023). FED officials – including Chair Jerome Powell – now warn that interest rates will have to rise even further than previously expected and stay so for longer. Goldman Sachs trimmed its estimation of the likelihood of a US recession from 35% to 25%, while the National Association of Business Economics slashed its predictions to 56% from 64% (Foster, 2023). Evidently, what emerged for the FED as a task to slowly ease the economy into a recession has now turned into a difficult challenge of prompting that recession at all.

On the other side of the debate lie experts who claim that the FED's recent rate hikes have already harmed the economy and can quickly overwhelm it. Some share the view that the tightening could particularly damage sectors such as housing where mortgage rates have risen considerably (Lachman, 2022), over double what they were in 2021. Mortgages applications plunged, builder confidence tanked, and home prices declined in 2021 in 50 US cities. Pessimists also note that the FED's decision to withdraw $95 billion a month in market liquidity by not rolling over its bond holdings when they mature exerts "significant downward pressure on the equity and bond markets" (Lachman, 2022). According to this opinion group, such 'unusually rapid' pace of contractionary monetary policy, if continued, will result in an "unnecessarily painful recession." Not just the US is at risk under the FED's hawkish tightening, though – the appreciation of the dollar championed in 2022 added to Europe's inflation problem by increasing its import costs (Lachman, 2022).

Knowledge of intermediate macroeconomic theory is enough for one to decipher that concerns about mortgages and the associated rise in mortgage rates through variable-rate contracts are worthwhile. A case study in the 2008 global financial crisis can reveal that in addition to affecting and displacing individual families, rising mortgage rates can have grave detriments to the wider economy. As mortgage holders default on their contracts, banks' assets become vulnerable and, as evidenced by the recent Silicon Valley Bank collapse, troubled assets spell mistrust and panic in the financial system causing an enormous rippling effect on remaining businesses and individuals. A study of the arbitrage equation adapted to residential investment also clarifies that falling house prices lead to decreased capital gain and therefore falling residential investment.[1] Shrinking investment, in turn, would decrease the steady-state (long-run) level of capital, leading to decreased aggregate output[2] – this would have negative consequences for all agents in the economy. Economists' opinions about the dangerous consequences of escalating interest rates are evidently not baseless.

Despite these concerns, the argument that contractionary monetary policy ought to continue does hold some theoretical value. Principally, prolonged bouts of high inflation ought to be mitigated because otherwise

[1] Please consider Appendix I for theoretical evidence.
[2] Please consider Appendix II for theoretical evidence.

high inflation will become ingrained in consumers' and producers' expectations, establishing an inelastic long-run relationship between unemployment and inflation.[3] This would come at a great cost and intense commitments to contractionary policy and possibly austerity would be required to dis-inflate. What must be mentioned, however, is that the opinions pushing for further interest rate hikes do not seem to recognize the peculiar behaviour of aggregate demand. Traditionally, intense hikes to interest rates would have dampened consumption and business investment, decreasing demand and reducing inflation. As cited, though, in this case retail continued to increase and the workforce does not seem to relax at all despite the incentives. This seems to suggest that there is a relatively inelastic relationship between the real interest rate and short-run output.[4]

Analysis and Insights

There are multiple trajectories which the US economy could take from here. Unfortunately, the FED's inability to effectively respond to inflation hurts expectations about the reliability of its policy. In a world where central authorities act reliably to combat inflation, and with individuals that observe information available to them to make forecasts, the FED could bring down inflation by simply lowering the target rate. It could use the sense of high credibility in its policy to prevent a negative output gap solely by impacting expectations, relying on firms to increase prices less in anticipation of FED response. Since the FED proved incapable thus far, however, it will have to resort to more restrictive measures to slow down the economy and reduce the aggregate price level. It is also worth noting that recovering from this induced recession might be troublesome and painful due to the recent re-emergence of financial frictions. For instance, the federal funds rate has vastly exceeded the real interest rate ('FRED', 2023)[5] meaning that although the FED will want to decrease rates during recovery, rates will stay high, hurting demand and prolonging the

[3] Please consider Appendix III for theoretical evidence.
[4] Please consider Appendix IV for theoretical evidence.
[5] Please consider Appendix V for theoretical evidence.

recession.[6] Critics of the FEDs current behaviour are also right to be weary of mortgage defaults – these, when collectivized, have the capacity to entirely collapse the economy.

In general, it is credible to assume that a recession in the US is incoming because cooling the economy from the present high inflation requires considerable contraction in activity. A combination of contractionary fiscal and monetary policies would be ideal to bring the economy below potential output, decrease the inflation rate, and loosen labour markets. The FED for now seems intent on further raising interest rates. This is risky for the reasons outlined earlier. Though progressive, and careful, raises of the nominal interest rate can be helpful, the FED should also increase the tax rate. An increased tax rate will incentivise higher national savings and feasibly cool consumption. Issues that exist with this approach, however, are political unpopularity as well as the associated time lag – it is because of this that action ought to be taken now as to minimize the detrimental long-run consequences of inflation on investment, economic growth, and the standard of living.

[6] Please consider Appendix VI for theoretical evidence.

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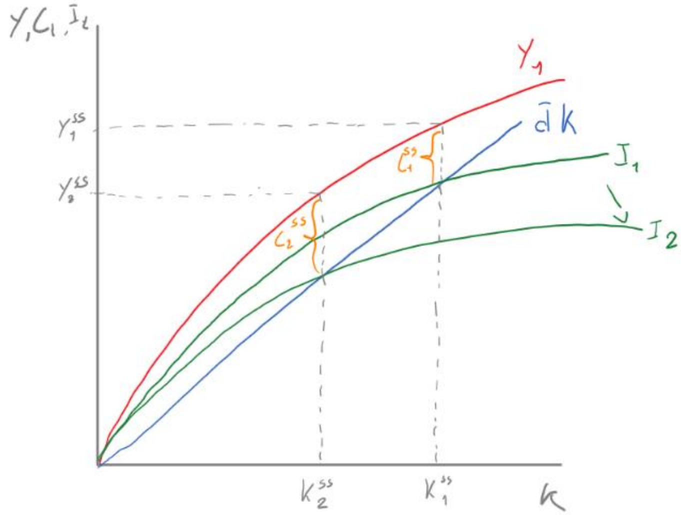
Appendices

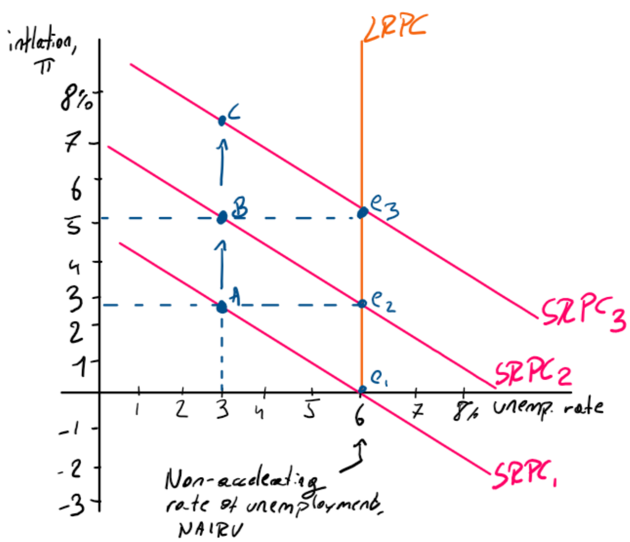
Appendix I

$$P^{house} = \frac{rent}{\tau\bar{x}R+(1-\tau)R+\bar{d}-\underbrace{\Delta P^{house}/_{P^{house}}}_{\text{Capital gain}}}, \text{ where } \bar{x} = \frac{down\ payment}{P^{house}}, \tau = tax\ rate, R = interest\ rate$$

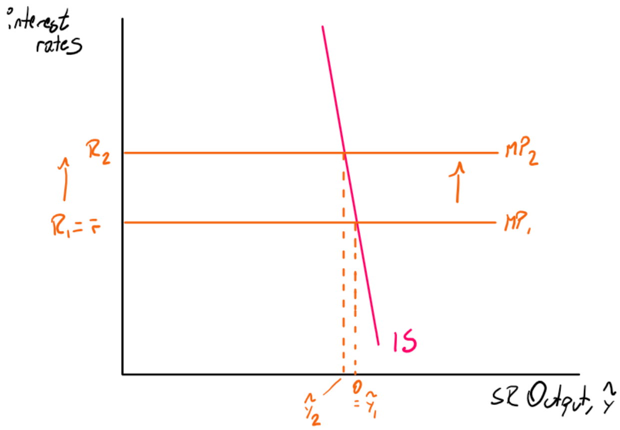
Appendix II



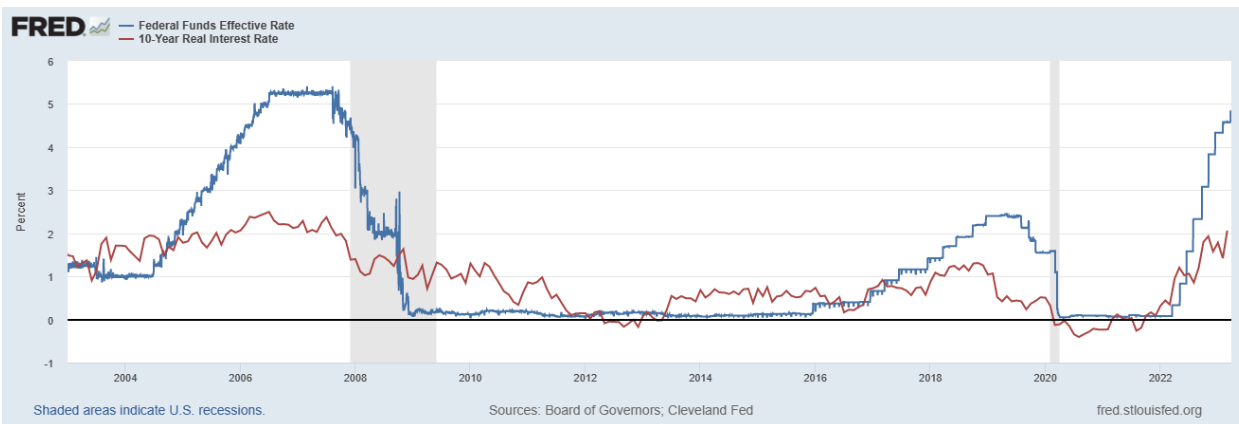
Appendix III



Appendix IV



Appendix V



^A severe disparity between the federal funds rate and the real interest rate has generally been observed during recessions – the last time the disparity was this large was during the 2008-9 deep recession.

Appendix VI