International Monetary Monitor

Can the Fed Bring Down Inflation without a Recession?

7th July 2022

Introduction

In the week following his press conference after the March 15-16 meeting of the FOMC, Federal Reserve Chair Powell cited three historic examples of the Fed tightening monetary policy without tipping the economy into recession or without raising unemployment.

The three tightening cycles he referenced were 1964, 1984 and 1995-96. In effect he was arguing the Fed could achieve a soft landing in 2022-23, even while hiking rates.

Currently the US economy is performing extremely strongly. The labour market is very tight, incomes are growing at a healthy rate, household balance sheets are strong, and on the corporate side inventories are low while margins are at near-record levels.

To cap it all, inflation is about three times the target rate, suggesting demand remains very firm. What could go wrong?

In this brief note I review those three past episodes of monetary tightening to see whether the speed and magnitude of rate hikes holds the key to the outlook for 2022-23, or whether some other factor is critical.

John Greenwood

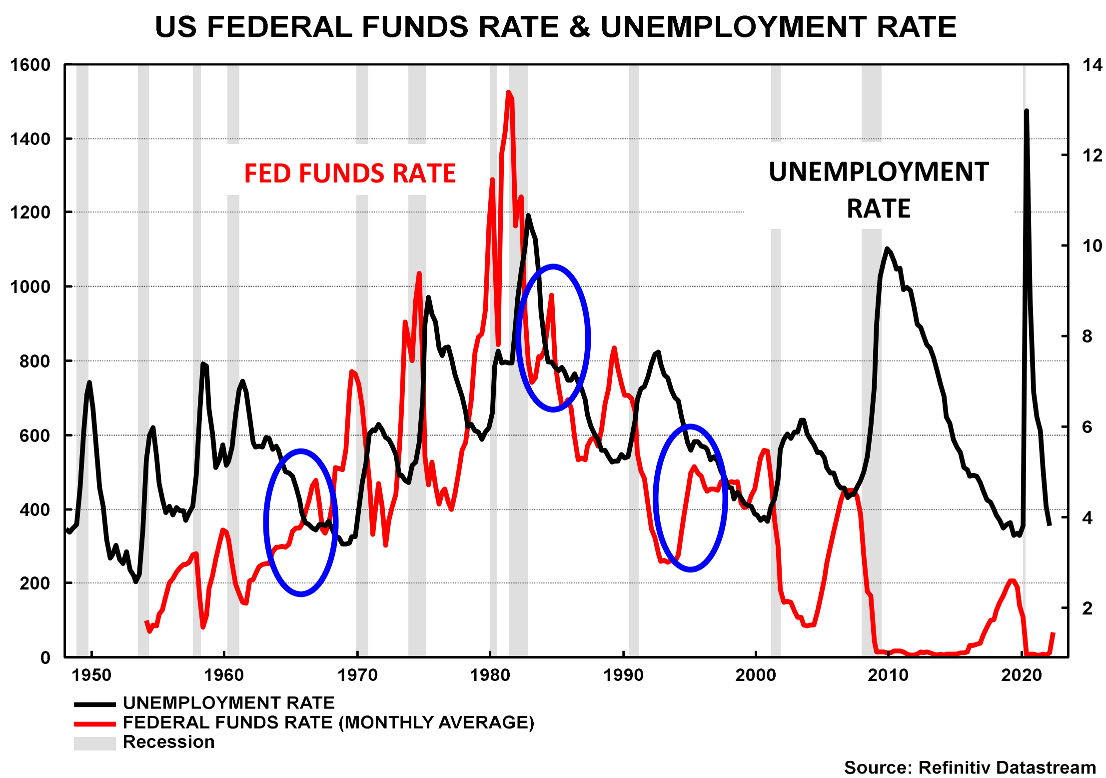
International Monetary Monitor Ltd

The IMM Newsletter is an economic research publication written by John Greenwood, founder and Chief Economist of International Monetary Monitor Ltd.

John was also the publisher, editor and lead author of **Asian Monetary Monitor**, a bi-monthly publication that he operated for 20 years from Hong Kong between 1977 and 1996. He was a pioneer of monetary research in Asia.

From 1999 to 2021 he was Chief Economist at Invesco, based in London.

Figure 1: Can the Fed Raise Interest Rates without Increasing Unemployment?



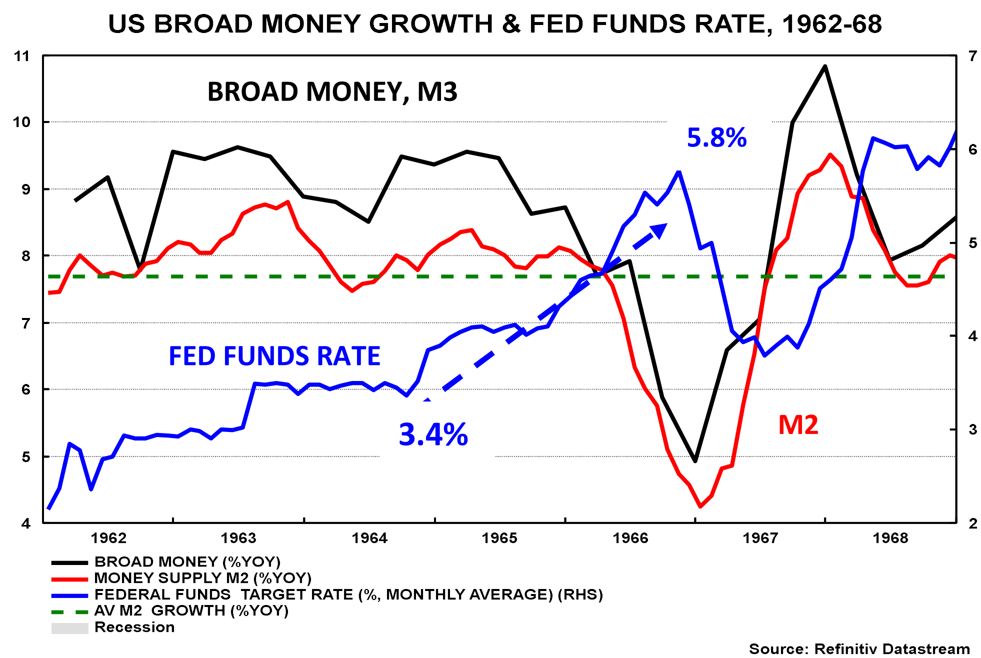
In the chart above I have circled the three episodes cited by Chair Powell when the Fed raised rates, but unemployment fell and there was no recession.

As the chart shows, the Fed did indeed “tighten” monetary policy significantly in 1965, 1984 and 1994-95 without precipitating a recession. Also, in each of these episodes, instead of rising, the unemployment rate actually fell. Here is the detail for each episode:

- 1964: The federal funds rates rose from 3.4% in October 1964 to 5.8% in November 1966, while the unemployment rate declined from 5.1% to 3.6%.
- 1984: The federal funds rate rose from 9.6% in February to 11.6% in August, while the unemployment rate declined from 7.8% to 7.5%.
- 1993: The federal funds rate rose from 3% in December 1993 to 6% in April 1995, while the unemployment declined from 6.5% to 5.8%.

In the remainder of the paper we will consider why the rate hikes might not have had the effect of slowing economic growth, precipitating a recession, or raising the unemployment rate. First, however, a general observation: each episode of “tightening” came relatively early in the business cycle upswing, and in some cases (e.g., 1994-95) would be better classified as rate normalization rather than a tightening episode.

Figure 2: Despite Rising Interest Rates, a Short-Lived Decline in Money Growth during 1965-66 did not Result in Recession

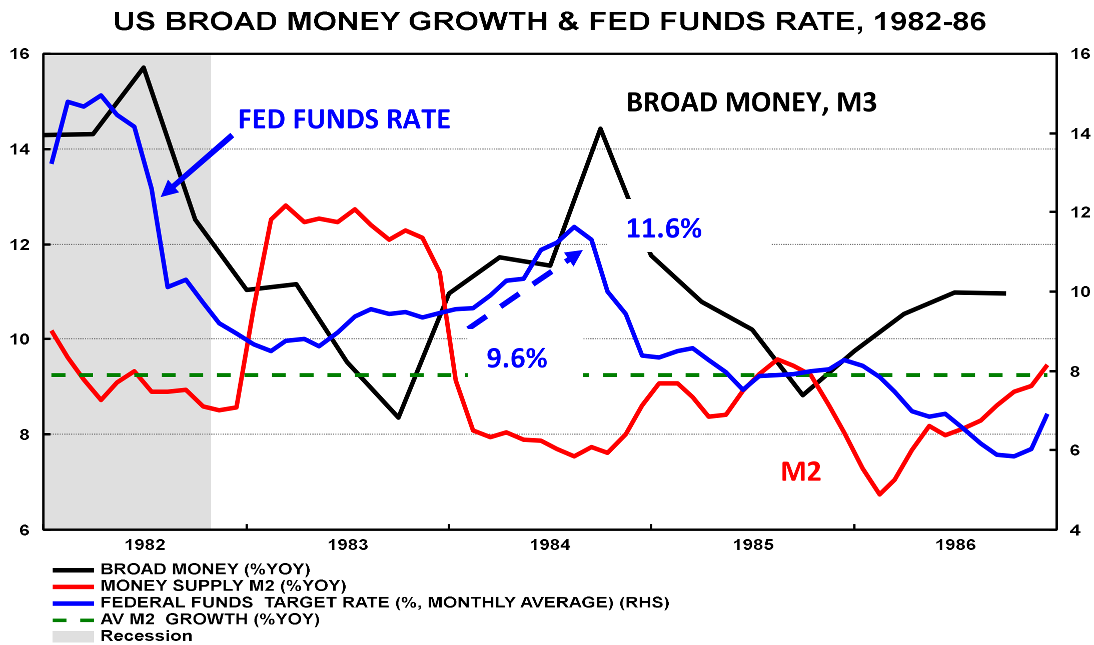


In each episode I shall compare money growth with the effect of the rate hikes. As I will show, interest rates are a fundamentally unreliable indicator of the stance of monetary policy, whereas money growth is usually a much better indicator. This is because, using a broad measure of money, the ratio of money to spending (the inverse of income velocity) is normally fairly stable, and therefore the amount of new money created gives a reasonable estimate of the amount of new purchasing power injected into the economy. By contrast, any change in interest rates may or may not be associated with a change in spending in the opposite direction, and the magnitude of the effect is highly variable.

The first case cited by Chair Powell refers to the rate hike ahead of the "mini-recession" or economic slowdown of 1966. Between 1964 and 1966 the federal funds rate rose from 3.4% in October 1964 to 5.8% in November 1966. (Note that in this era there was no Fed funds target announced.) However, as Powell correctly claimed, there was no recession. Moreover, the unemployment rate *declined* from 5.1% to 3.6%. Why?

The reason there was no recession was that there was no slowdown in M2 or M3 until 1966 Q3, and even then the slowdown from 8% to 4% only lasted two quarters (1966 Q3 & Q4) before being reversed. **In effect, rapid growth of money in 1965-66 neutralised or more than fully offset increases in the Fed funds rate, with the monetary slowdown being mild and only lasting for two quarters.**

Figure 3: The 1984 rate hikes were undermined by continued rapid money growth



Source: Refinitiv Datastream

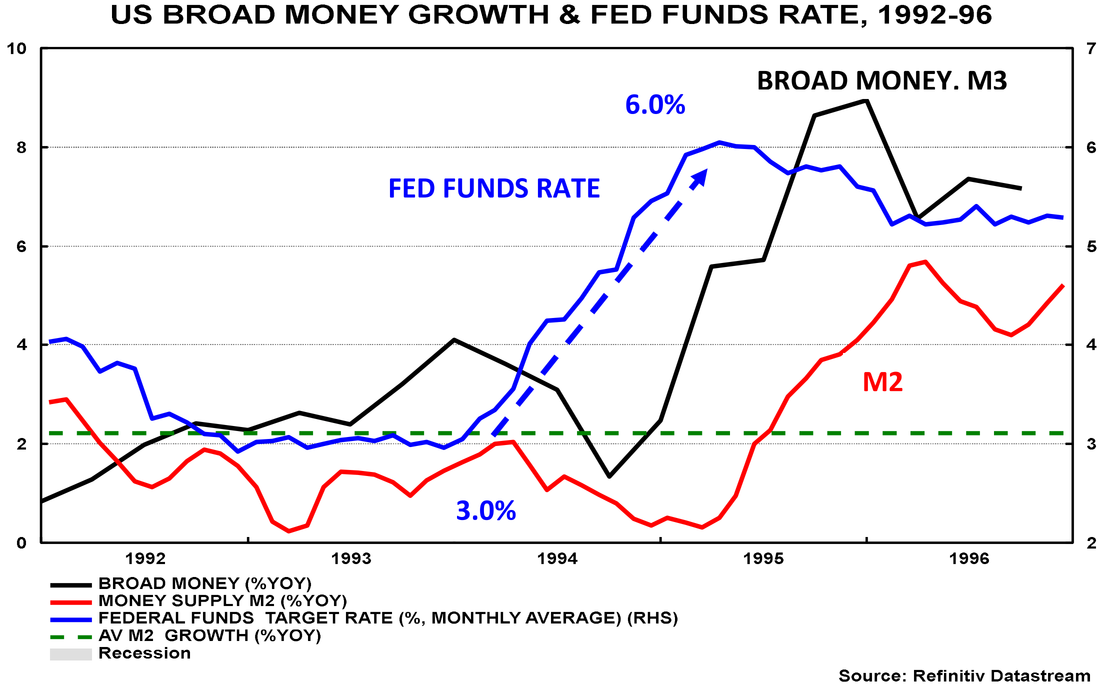
The second case cited by Chair Powell concerns the brief series of rate hikes in 1984 under Paul Volcker. Following an intense monetary squeeze in 1980-81 there had been a reduction of rates from September 1981 to early 1983, and then a stabilisation until February 1984. Starting in that month the federal funds rate rose from 9.6% to 11.6% in August 1984 (blue dashed arrow), while the unemployment rate declined from 7.8% to 7.5%.

Turning to money growth, although M3 had slowed from 15.7% year-on-year in 1982 Q3 to 8.3% in 1984 Q3, it then accelerated to 14.4% by 1984 Q4 even while the Fed funds rate was being raised from 9.6% to 11.6%. M2, which had been subject to a one-off increase in Jan-Feb 1983 (which was reversed in the percentage year-on-year declines in early 1984), only slowed marginally in 1984 while the Fed funds rate was being raised, maintaining an average growth of 9.3% p.a. between 1982 and 1986 (green dashed line).

The 1984 episode is therefore a case where rapid growth of money neutralised or more than fully offset any increases in the Fed funds rate.

International Monetary Monitor

Figure 4: The 1994-95 rate hikes were also undermined by rapid money growth



The third case cited by Chair Powell refers to the "mid-course correction" implemented by Alan Greenspan in 1994-95. Although the US recovery of the early 1990s had been somewhat lacklustre, the east Asian economies had been booming, and by 1994 the US economy was starting to be much more vigorous. Starting in January 1994 the federal funds rate was raised by 300 basis points over thirteen months from 3% to 6% by February 1995, while the unemployment rate declined from 6.5% to 5.8%.

On the monetary side, both broad money and M2 slowed marginally in 1994 during the period of rate hikes, but both accelerated in 1995 -- in the case of broad money from 0.3% in March 1995 to 5.7% in April 1996, and in the case of broad money from 1.3% in 1994 Q4 to 9.0% by 1996 Q1.

Again, as in 1984-85, the key to the 1994-95 episode was that rapid growth of money neutralised or more than fully offset any tightening effect of increases in the Fed funds rate.

International Monetary Monitor

Summary and Conclusion

- **Much attention has recently been focused on whether, in 2022-23, the Fed can raise rates without tipping the economy into recession or without raising unemployment. Chair Powell himself has commented on this -- in March this year, and again to a conference in Lisbon in July.**

- **Numerous analysts have therefore examined episodes of past rate hikes to see whether there have been exceptions to the rule that Fed tightening (in the sense of rate hikes) always leads to recession or increases in unemployment.**

- **It turns out that this question cannot be satisfactorily answered only by looking at rate hikes. To obtain a complete answer we need to examine whether rate hikes in each episode were associated with slowdowns in the rate of growth of broad money, M3 or M2.**

- **In the case of the three episodes of rate hikes cited by Chair Powell as being accompanied by no recession or no increase in unemployment, there was another factor in the background which helps to explain why the rate hikes did not have the damaging effect that most people might have expected.**

- **In every case the growth of money (broad money, M3 or M2) either maintained its momentum or accelerated, effectively offsetting or neutralising the effect of the rate hikes.**

- **The evidence in these three cases supports the view that *"Monetary policy is not about interest rates; it is about the rate of growth of the quantity of (broad) money."* (Milton Friedman)**

- **The key variable to watch, therefore, during 2022-23 will not be interest rates but money growth.**

Registered office: c/o PKF Littlejohn, 15 Westferry Circus, Canary Wharf, London E14 4HD, UK.