Ethics and Economics Making Cyclical Downturns Less Severe

By Eric S. Rosengren

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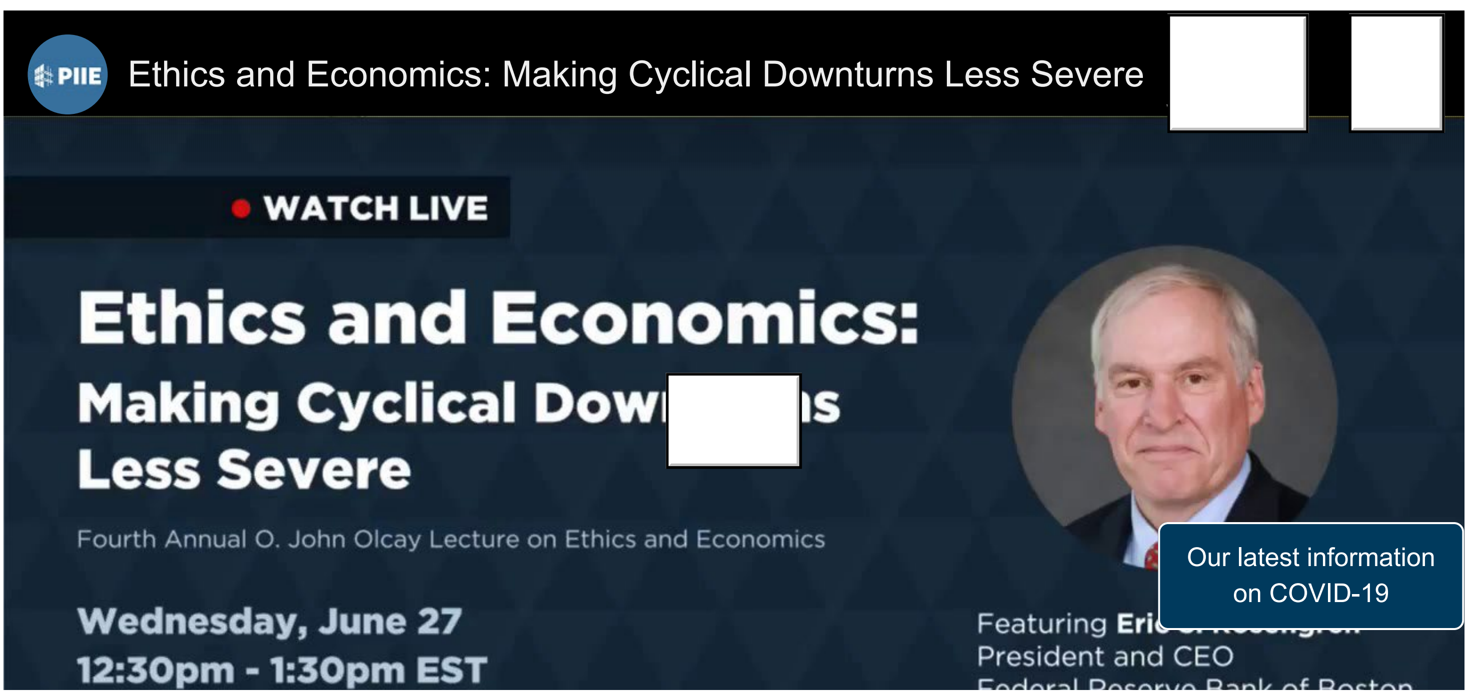

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Boston Fed President Eric Rosengren said today the costs of high unemployment are disproportionately borne by those that can least afford them, and a variety of actions could be taken by policymakers to make periods of high unemployment less likely.

This ethical dimension of economics "is not just about thoughts or feelings," Rosengren said, while exploring ways to manifest such ethical decisions in "very tangible" policymaking: state and local government spending; bank regulatory policy; and monetary policy.

"The sad reality is that unemployment disproportionately affects minorities, the less educated, and children whose families are experiencing unemployment," Rosengren said, acknowledging that the costs to both the entire economy and to parts of our population are significant.

"In my view, if policies could mitigate the severity of economic slowdowns, some of those costs could be avoided – and taking actions now, when the economy is strong, could be particularly important to lessening the severity of a hypothetical future downturn and its impact on individuals."

In exploring state and local government financing, Rosengren said it should be designed to buffer the economy during recessions, or at a minimum "should not reduce the stimulative effects of spending when the economy is most troubled."

State and local governments likely reduce spending in recessions for good reasons, he said, but a number of steps can be taken that would lessen the problematic impact. "Ideally, a time like now – when the national economy is growing and employment is robust – would be an opportunity, it seems to me, to prepare for the next downturn," Rosengren said. "This would perhaps include shoring up state finances, reducing unfunded pension liabilities, and significantly increasing 'rainy day' funds. I am not suggesting it would be easy, even in these economic times. But progress could be made."

Banking regulation can also amplify the business cycle, and policymakers can look for ways to lessen these effects, Rosengren said. For example, lenders' losses on loans tend to increase significantly during economic downturns. When their capital-to-assets ratio gets too low, banks can choose to either raise their capital level, or shrink assets, to restore the ratio. Loans are key assets for banks, so restoring the capital-to-assets ratio can mean less lending at just the time the economy may need stimulus.

Given the overall health of the economy and the relatively rich asset valuations now prevailing, it is Rosengren's view that this would be the ideal time to build up capital buffers in the U.S., which he says could help address the incentive that banks will have to pull back on lending to shrink assets in a future economic downturn.

Turning to monetary policy, Rosengren said it is appropriate to consider ways to avoid hitting zero with short-term interest rates. One possibility, he said, is to consider more flexibility with the inflation target, perhaps focusing more on an inflation range than a specific number. "One might allow the inflation target to rise within the range during periods of low real rates, thus providing more room for the funds rate to fall during an economic downturn." He also noted that a policy path that does not overshoot the sustainable unemployment rate likely increases the probability of a longer recession-free period.

"The costs of economic downturns – and the uneven distribution of their impact – are, in fact, ethical issues," Rosengren concluded. "Policymakers could continue and perhaps expand their efforts to make cyclical downturns – and resulting periods of high unemployment – less severe."

Rosengren was speaking at the Fourth Annual O. John Olcay Lecture on Ethics and Economics at the Peterson Institute for International Economics, in Washington, D.C.

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