Should the Fed Do More to Boost the Economy? Part II

Joseph E. Gagnon says that the US Federal Reserve could take a number of steps to boost the economy, especially the purchase of mortgage-backed securities to make mortgages more affordable for Americans.

Steve Weisman: Joseph Gagnon, Senior Fellow at the Peterson Institute, continues his discussion of what he sees as an anemic response by the Fed to the anemic economic recovery. We have just discussed why the Fed might be timid in the face of the difficulties. Now let's hear from you, Joe, on what specifically they could be doing now that they're not.

Joseph Gagnon: I think they have a number of options. I would urge them to use their power to buy mortgage-backed securities guaranteed by the Federal Housing Agencies, which form the basis for most of the U.S. mortgage market. They can buy those things in sufficient quantity to drive the mortgage rate pretty much wherever they want it, within limits, and they should aim for a mortgage rate below 3 percent and should give people some confidence that they will keep it there for 12 months -- so that banks can staff up their mortgage departments, and so that homeowners can start shopping for a house with some confidence that the financing will be there when they finally find the house they want and buy it.

I think that removing that uncertainty for a fixed period of time would have extra beneficial effects and they can do this. This is something they can do. The mortgage rate is currently at a record low of 3.7 percent, but you know if it was even lower it would be even more stimulative and beneficial, not just for home buyers but for people who can refinance. Now, the administration could help by really getting the housing agencies to stop dragging their feet on free financing, but that's a whole other topic we could go into.

Finally, I think the Fed could also reassure markets by saying, "Look, we're not going to withdraw all this and jack up interest rates quickly just because inflation goes up to 2 percent or even a little more." They should be willing to trade off a little bit of inflation for faster reduction of unemployment. They have two goals, not just one. It's not just inflation, its inflation and employment. And the optimal policy should be to be willing to trade off a little on one goal to get a lot more benefit on the other goal. They haven't been willing to do that. I just don't understand it.

The purpose of that would be to reassure markets that these low rates would continue even if inflation does rise, and moreover, if inflation does rise, that actually lowers the real interest rate that people are paying, so it makes it more attractive again to spend and to buy a house.

Steve Weisman: There have been some signs of a turnaround in housing. Do you think they're just a little complacent at the Fed?

Joseph Gagnon: Sure they're complacent. I mean, I don't know. Their forecast is horrible. So I'm not sure complacent is the right word for it.

Steve Weisman: What parallels do you see between the Feds cautious approach and what we're also seeing in Europe with the European Central Bank and the financial authorities?

Joseph Gagnon: I do see that a number of Central Banks around the world, not just the Fed, but the European Central Bank and The Bank of Japan, especially, have been way too timid for a long time now, and I just don't understand it. The Bank for International Settlements just came out with a statement, which I just thought, was defensive, timid, which I thought was pretty outrageously bad. But I think Europe has its own difficulties in the sense that the lack fiscal union there, lack of banking union, the political negotiations to try to fix their problems at a dimension that we don't have, fortunately.

Steve Weisman: Joe, thank you very much.

Joseph Gagnon: You're welcome.