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Yale Program on Financial Stability

Lessons Learned

Claudia Sahm

By Mercedes Cardona

Claudia Sahm was a principal economist in the Division of Research and Statistics of the Board of Governors of the Federal Reserve System from 2007 to 2017 and section chief for the Consumer & Community Development section in the Division of Consumer and Community Affairs from 2017 to 2019. Her work focused on macro forecasting; she also researched household behavior and responses to fiscal stimulus. While at the Fed, she proposed the Sahm Rule, a gauge to call the start of a recession, based on an average of the unemployment rate. The rule is part of Sahm's work on the use of automatic stabilizers to improve fiscal policy response in times of economic crisis. In 2019, Sahm left the Fed and advised Congress on fiscal policy. In 2021, she became a senior fellow at the Jain Family Institute, where she now serves as director of macroeconomic research. This Lessons Learned is based on an interview with Sahm that occurred in December 2020; [the full transcript can be accessed here](#).

When addressing a crisis, make the response big and do it early for the most impact.

One of the most important lessons that Sahm learned from the Global Financial Crisis (GFC) was that countermeasures work best when they are applied aggressively and early in a crisis. Said Sahm:

Whatever you think you need to do, do at least twice as much. Go big, go fast. You must move as quickly as possible when you think there's a crisis, because that's your best chance of short circuiting it. And you need to go broad as well. Don't think, "If I just take care of this one market, that will be enough." If you see distress, backstop five markets, not just one.

She and Jason Furman, who had been chair of the Council of Economic Advisers during the second Obama administration, shared this advice when they briefed the House Democratic Caucus in the early days of the COVID-19 pandemic. And Sahm believes that Congress did absorb the lessons of the GFC when, in March 2020, it put together the CARES Act in response to the pandemic. The \$2 trillion package of assistance had a variety of measures and facilities to bolster different parts of the economy. Additionally, the Fed, under Chairman Jay Powell, rolled out a dozen lending programs in those first days and pushed back against pressure to shift interest rates or worry about inflation, choosing instead to focus on the health of the economy instead.

Once the crisis is tempered, it is important to stay the course through the recovery.

According to Sahm, a lesson that may not have been learned was to stay the course after addressing the initial economic shock. Both in 2008 and in 2020, she thinks, policymakers retreated after the first ambitious steps. That led to a long, labored, recovery in 2010–11. Sahm noted a similar dynamic played out after the CARES Act. After the pandemic recovery

did not materialize in mid-2020 as initially expected, a divided Congress failed to pass a strong follow-up recovery bill, leaving the recovery to hinge on the arrival of a vaccine.

It's really sad, because that was the lesson that they should have learned from the prior recovery, that there are real costs to stepping away. If you make Americans pick themselves up by their bootstraps, it'll take a long time, and a lot of people will be very hurt. Then the whole economy will be hurt because there's less productivity, there's less growth.

A slow recovery will come back and hit all of us, but it hits some people really hard, and there is no reason for that to happen. The federal government can borrow money. They can help people, and they're just not doing it to the extent they could. Somehow, they didn't quite learn that from the GFC recovery, and I'm not even sure they're going to learn it from this time because they're so tied up in the partisan warfare.

The Fed needs to learn to work better with and communicate to Main Street.

One of the legacies of the GFC was a somewhat virulent Wall Street (helped by the government) versus Main Street (not helped by the government) dichotomy. At times, this is viewed as just a communications issue, but Sahm also sees it as an important operational issue—"Now, where they continue to have lots of struggles is in being able to communicate to Main Street. In addition to communicating to Main Street, figuring out how to serve Main Street."

While she acknowledges that the Fed's main purview is in supervising banks, and that it now also monitors systemic risk issues, Sahm would also like to see the central bank focus more on its full-employment mandate and become more efficient at assisting Main Street when needed. She said:

You can't rely on—"By helping Wall Street, we indirectly help you on Main Street, because now you can go to your bank. If we didn't help the banks, then you couldn't go to the bank." Okay, fine. This is true. But the reverse logic would also work. If the Fed just directly helped Main Street, if they actually did their job and kept us at full employment—guess what?—it would indirectly help Wall Street.

She also noted that in the CARES Act Congress offered direction to the Fed to set up emergency lending facilities for middle-sized businesses and municipalities. In her estimation, "These facilities, they kind of worked, but they really didn't work." One of the problems is that many medium-sized firms and municipalities do not have the financial sophistication of a huge Wall Street hedge fund. She thinks the Fed should learn from this experience and go back to the drawing board so that next time they are better prepared.

Congress should consider putting some types of relief on automatic pilot to make crisis response more efficient.

One way to divorce economic relief from political pressure is to create some mechanism to offer relief on an automatic basis. Based on her research, Sahm proposed the "Sahm Rule," a

formula that uses unemployment rates to serve as an early warning system for recession; the rule would trigger certain automatic payments at the beginning of a recession. Traditionally, said Sahm, economists rely on metrics that look backward at the past performance of the economy and this has delayed making a recessionary call and providing relief.

Sahm's research correlated increased unemployment with the onset of past recessions and concluded that the unemployment rate, which is released promptly after every month, would serve as a reliable gauge. Using that guardrail to trigger automatic stabilizers such as direct payments to households, posits Sahm, would take politics out of those measures—measures which she observed being frequently used anyway—and free policymakers to focus on tackling the unique sources of the recession, whether it is a mortgage market meltdown or a pandemic. It will “clear up bandwidth”; she noted,

Congress gets to decide what's in that bucket of standard relief in every recession. Then take that bucket of policies—which will never be enough in a recession, because every recession has its own special crisis—and put the standard policies on autopilot. Then, Congress can focus on discretionary relief packages that they need to do in the moment and answers questions specific to the moment at hand. In the current crisis, they could ask, what extra help is needed? Do state and local governments need more, different relief because they're handling the public health? With the public health, should we be changing regulations in terms of liability shields?

There are all kinds of things that will come up in one recession that wouldn't in another. Automatic stabilizers would let Congress focus on the special help needed instead of hashing out details about the things that they've always done in a recession and that they'll just do a little differently. It adds complexity, and it drains the scarce resource of attention.

Attention to the recovery can slip, especially in the increasingly divided government now operating in Washington. Policymakers need to see the recovery as a marathon, not a sprint, said Sahm. She is now working on new research to find a comparable trigger to the Sahm rule that will help policymakers make the call to shut off the automatic stabilizers once recovery takes hold.

Valuing diversity and questioning conventional wisdom might help the Fed improve in its mission.

Sahm would like to see more diversity of opinion at the Fed because she believes it will bring a richness to deliberations:

We just have such a narrow focus. In terms of expertise, the economists listen to themselves. In terms of lived experience, we don't have a lot of people coming from low-income backgrounds. I worked with only three Black economists in my 12 years at the Fed. Recently, there was one Black economist at the Fed in the economics groups that inform the staff forecast, and she just retired among the 400 economists.

So, it's just hard when you have such a closed, homogenous system to really get it when things are happening out in the world.

She thinks eroding this disconnect can only improve the Fed's performance. She urges the Fed to "listen to the non-economists at the board" and less centric groups, such as employees of the Division of Consumer and Community affairs.

Sahm would also encourage employees that "it's okay to be different." However, she recognizes that it can be difficult to actually be that contrarian voice. Sahm says that she was more able to make calls that ran against Fed orthodox thinking because she was a relatively new economist at the Fed when the GFC broke out. As a new PhD, she may not have been as affected by the perceived groupthink in the system as her more seasoned colleagues.

It can be really hard to swim against the consensus. It can be really hard to stand up and say, "Those models you've been using for 20 years, I'm not sure they're working."

The thing is, the time when you're able to see that most, and I was able to see it most, is when you just start out. In my first few years at the Fed, that's when I figured out where we had our problems. But in your first few years at the Fed, this is not an easy time to raise your hand and say, "Excuse me. I don't think this is right."

Dated: December 2022

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