Tim Duy's Fed Watch

OCTOBER 16, 2017

Is The Fed Setting Itself Up To Fail In The Next Recession?

The Federal Reserve remains committed to a December rate hike, persistent low inflation not withstanding. With unemployment below Fed estimates of its longer-run natural rate, most FOMC participants do not need evidence of stronger inflation to justify further rate hikes. Ongoing solid job growth will be sufficient cause for tighter policy, especially in what they perceive to be an environment of loosening financial conditions. **The main risk from this scenario is that the US economy enters the next recession with diminished inflation expectations, which could further hobble central bankers already facing the prospect of returning to the effective lower bound in the next cycle.**

The minutes of the September 2017 FOMC meeting exposed central bankers as generally disconcerted with the behavior of inflation this year:

> *...many participants expressed concern that the low inflation readings this year might reflect not only transitory factors, but also the influence of developments that could prove more persistent, and it was noted that some patience in removing policy accommodation while assessing trends in inflation was warranted. A few of these participants thought that no further increases in the federal funds rate were called for in the near term or that the upward trajectory of the federal funds rate might appropriately be quite shallow. Some other participants, however, were more worried about upside risks to inflation arising from a labor market that had already reached full employment and was projected to tighten further.*

Still, despite these widespread worries, it was full steam ahead on a December rate hike:

> *...many participants thought that another increase in the target range later this year was likely to be warranted if the medium-term outlook remained broadly unchanged.*

As always, though, the ultimate decision is data dependent:

> *Several others noted that, in light of the uncertainty around their outlook for inflation, their decision on whether to take such a policy action would depend importantly on whether the economic data in coming months increased their confidence that inflation was moving up toward the Committee's objective.*

What is not said here is the important part. **In general, the economic data necessary to increase their confidence that inflation will rise does not include actual inflation data itself.** The idea that inflation needs to show more life prior to December is a minority view at the Fed:

> *A few participants thought that additional increases in the federal funds rate should be deferred until incoming information confirmed that the low readings on inflation this year were not likely to persist and that inflation was clearly on a path toward the Committee's symmetric 2 percent objective over the medium term.*

The implication is that as long as the rest of the economy remains on a general upward trajectory, the inflation data becomes little more than a minor annoyance.

To be sure, some officials remain more publicly concerned about inflation. Chicago Federal Reserve President Charles Evans, for example, believes, via Bloomberg:

> *that weaker-than-expected U.S. inflation data last month "didn't seem encouraging," as policy makers consider raising interest rates again despite the failure of price pressures to advance as forecast...*
>
> *..."In a lot of our inflation forecasts right now, there's still a lot of hope," Evans said. "It would be nice if we*

> *had more confirmation that inflation was going to pick up."*

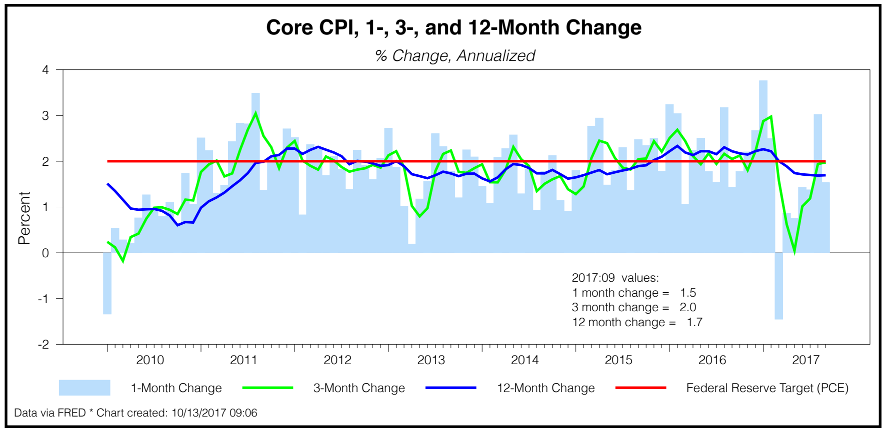
CPI inflation for September rose as expected on the back of higher gasoline prices, which accounted for three-quarters of the gains. Of course, this is just a hurricane-induced phenomenon that will prove to be short-lived. The more important core measure of inflation rose a scant 0.1 percent. Shelter inflation, which had supported the core measure in August, fell back to earth, allowing the underlying weakness in core to reassert itself.

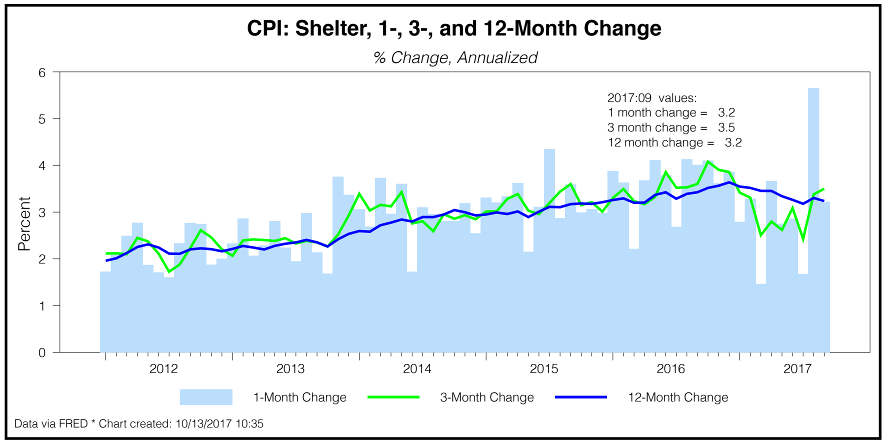
Inflation remains the odd man out in the data, which drives the Fed to focus on everything else. Federal Reserve Chair Janet Yellen provided an upbeat assessment of the economy this weekend. Regarding the job market:

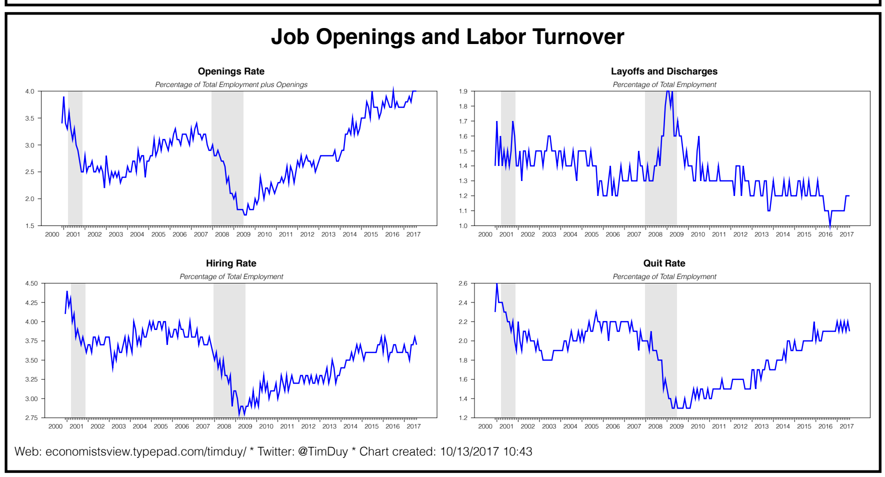
> *In September, payrolls were reported to have declined 33,000, but that weakness reflected the effects of Hurricane Irma, which hit Florida during the reference week for the September labor market surveys. I would expect employment to bounce back in subsequent months as communities recover and people return to their jobs. Other aspects of the jobs report for September were strong.*

Yellen highlights low unemployment, solid labor force participation, high rates of job openings, and low rates of quits. Moreover, on wages:

> *Wage indicators have been mixed, and the most recent news, on average hourly earnings through September, was encouraging. On balance, wage gains appear moderate, and the pace seems broadly consistent with a tightening labor market once we account for the disappointing productivity growth in recent years.*







The overall economy looks bright as well:

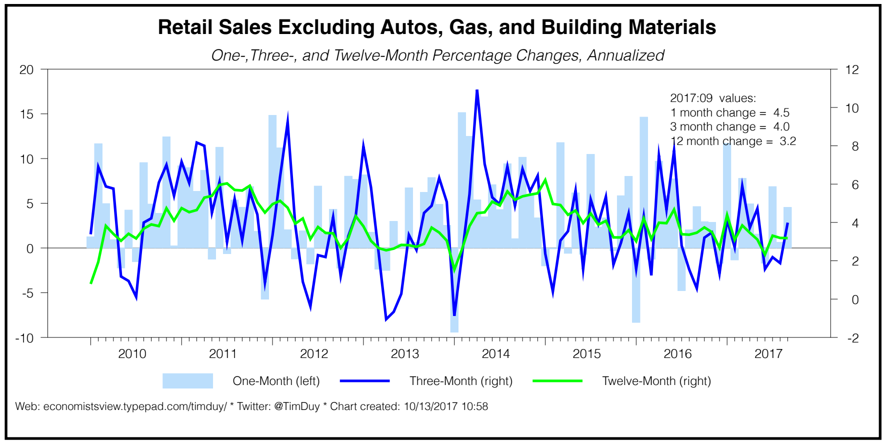
> *...Growth of consumer spending has been supported by the ongoing job gains and relatively high levels of household wealth and consumer sentiment. Business investment has strengthened this year following surprising weakness in 2016. The faster gains partly reflect an upturn in investment in the energy sector as oil prices have firmed. But the gains have been broader than that, and some measures of business sentiment remain quite strong. Exports also have risen this year, as growth abroad has solidified and the exchange value of the dollar has declined somewhat...*

Retail sales data for September generally supported this argument. While the headline number rose 1.6 percent, hurricane-related spending drove the number, with particularly strong showings for auto sales, building materials, and gasoline. Stripping out these factors, spending growth looks consistent with the pattern of the last year.

On inflation, Yellen repeated recent remarks regarding possible sources of uncertainty, but still views the situation as largely transitory:

> *The recent softness seems to have been exaggerated by*

> *what look like one-off reductions in some categories of prices, especially a large decline in quality-adjusted prices for wireless telephone services. More generally, it is common to see movements in inflation of a few tenths of a percentage point that are hard to explain, and such "surprises" should not really be surprising. My best guess is that these soft readings will not persist, and with the ongoing strengthening of labor markets, I expect inflation to move higher next year.*



Federal Reserve Governor Lael Brainard also spoke last week. She discussed a new paper by former Federal Reserve Chair Ben Bernanke, and stated that her comments were "not intended to address current policy." In Bernanke's paper he also emphasizes that the paper should not be viewed as a criticism of current policy. That said, Bernanke's paper and her comments do have implications for policy, albeit perhaps not explicitly intended.

Bernanke's paper can be found here (blog post here). It is a discussion of the conduct of monetary policy in an era of low neutral interest rates and, consequently, an era in which policymakers can expect to hit the effective lower bound during recessions. Bernanke suggests that policymakers adopt a temporary price level target during periods when the economy falls into the effective lower bound, explicitly allowing for approve target inflation to make up for lost an extended period of low inflation. The benefits:

> *I am using the recent episode to illustrate my suggested rule, not to make a recommendation about what the FOMC should do now. Note though, that if this policy rule had been in place prior to 2008, and if it had been understood and anticipated by markets, then longer-term yields would likely have been lower and the effective degree of policy accommodation during the past decade might have been significantly greater. In that counterfactual world, inflation might have been higher and the average-inflation criterion might have already been met. This is because the Fed would have already communicated their intention to be more accommodative going into the ZLB episode.*

Bernanke is in a difficult position here. He wants to advance policymaking techniques but, understandably, does not want to be seen as a critic of the current Fed. And, after all, this is only a policy proposal that still needs some fine-tuning.

That said, it is hard not to extrapolate that, assuming Bernanke is indeed correct that a temporary price level targeting is the preferred approach, the Fed has fallen far short of that approach these past four years and is positioning itself to make it difficult to adopt the preferred approach in the next recession.

Why is the Fed essentially setting itself up to fail next time around? The Fed has been following the standard playbook. And what is that playbook? Back to this from Brainard:

> *...the standard approach is typically designed to achieve "convergence from below," in which inflation gradually rises to its target. Given the lags in the effects of monetary policy, convergence from below would necessitate raising interest rates preemptively, well in advance of inflation reaching its target. Moreover, particularly in the early stage of a recovery, this kind of preemptive approach tends of necessity to rely on economic relationships derived from pre-crisis observations, when policy rates were comfortably above the lower bound.*

This the situation the Fed finds itself now, and finds itself potentially challenged by one of the risks commonly cited against any overshooting of the inflation target. Brainard again:

> *One risk is that the public, seeing elevated rates of inflation, may start to doubt that the central bank is still serious about its inflation target. It is worth noting that the policy is motivated by the opposite concern--that convergence from below, following an extended lower bound episode, may lead to an unanchoring of inflation expectations to the downside.*

Note that in an earlier speech Brainard said:

> *To the extent that the neutral rate remains low relative to its historical value, there is a high premium on guiding inflation back up to target so as to retain space to buffer adverse shocks with conventional policy. In this regard, I believe it is important to be clear that we would be comfortable with inflation moving modestly above our target for a time. In my view, this is the clear implication of the symmetric language in the Committee's Statement on Longer-Run Goals and Monetary Policy Strategy.*

Bernanke makes the case for explicit temporary overshooting of the inflation target when near the effective lower bound, and Brainard says she views the symmetric language as consistent with explicitly begin comfortable moving above the inflation target, yet the current policy approach relies on hitting the inflation target from below. And note that the latter is believed to own one of the four low dots in the Summary of Economic Projections, already by itself something of a criticism of the status quo.

Explicit criticism or not, it is fairly easy to see that if the optimal approach to monetary policy is to allow for overshooting of the target, the Fed has not followed that approach, and via the sustained undershooting of the current target a.) risks a sustained drop in inflation expectations that inhibits policy effectiveness in the next downturn and b.) erodes the Fed's credibility if they should want to later claim that they intend to overshoot the target in the next recession. Why should we believe them in the future when they clearly did not even want to hit their target in the wake of the Great Recession?

In my opinion, the main error the Fed made in the wake of the Great Recession is that they did not see the risk to inflation expectations as two-side, but instead view the risk of anchoring to the upside as much, much greater than to the downside. They continue to make the same error, and I think this will have consequences in the next cycle.

Both the Bernanke and Brainard pieces are worth reading as the Fed may find itself moving into a new framework in the next recession.

Bottom Line: Fed remains committed to a framework of hitting the inflation target from below. That leaves central bankers positioned to continue raising rates. Is this a mistake? One rate hike would not be a mistake if the Fed were to quickly correct should it become evident that their subsequent expected rate hikes were too aggressive. But that just addresses the near-term risk. The longer-term risk is more fundamental. Do they want to head into the next recession with soft inflation? So far, it seems they are very willing to risk doing so.

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Professor Duy received his B.A. in Economics in 1991 from the University of Puget Sound, and his M.S. and Ph.D. in Economics in 1998 from the University of Oregon. Following graduate school, Tim worked in Washington, D.C. for the United States Department of Treasury as an economist in the International Affairs division and later with the G7 Group, a political and economic consultancy for clients in the financial industry. In the latter position, he was responsible for monitoring the activities of the Federal Reserve and currency markets. Tim returned to the University of Oregon in 2002. He is the Senior Director of the Oregon Economic Forum and the author of the University of Oregon Statewide Economic Indicators, Regional Economic Indicators, and the Central Oregon Business Index.

Tim has published in the *Journal of Economics and Business* and is currently a member of the Oregon Governor's Council of Economic Advisors and the State Debt Policy Advisory Commission. Tim is a prominent commentator on the Federal Reserve. MarketWatch describes his blog as "influential." The Huffington Post identified him has one of the top 26 economists to follow on Twitter, and he is listed on StreetEye as one of the top 100 people to follow to discover finance news on Twitter. Major national and international news outlets frequently quote him, including the *New York Times*, the *Washington Post*, the *Financial Times*, the *Wall Street Journal*, and *Bloomberg*. He also writes a regular column for *Bloomberg Prophets*.

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