Decoding the latest Fed speak

Dr Robert Gay | Fenwick Advisers | 20 April 2017

Central bankers tend to speak in jargon that financial markets can understand - or, at least, can interpret with a modicum of guidance. Clarity has its rewards whereas hyperbole and words in quotation marks are strictly off limits. When new words are introduced into the policy discussion, financial analysts parse the words with unending zeal until their implication for monetary policy is better understood. So, when the latest policy directive from the Federal Reserve was released in March, much attention was directed at the reference to the Fed's "symmetric inflation goal", which seemed to imply a tolerance for running the economy hot or, more precisely, above its inflation-stable potential.[1]

On the surface, this leap of logic makes some sense. After all, FOMC participants have said repeatedly that the US economy is operating close to full employment. Indeed, unemployment fell to 4.5% of the labor force in March, one of the lowest levels in the standard (so-called U3) measure of joblessness since the 1960s. We can debate why other aspects of the job market have changed, including the rise in part-time work and the decline in labor force participation especially among young persons. The bottom line, though, is that employers are struggling to find workers with the requisite skills to fill vacancies. The clear implication would seem to be that a strong economy - abetted by the Fed's still-accommodative monetary stance - will put pressure on costs and prices. In those circumstances, highlighting the inflation goal as symmetric would seem to imply some tolerance for letting inflation drift higher in lieu of applying the monetary brakes more aggressive.

The trouble is that Fed officials do not think of their mandate in these terms. As John Williams, President of the San Francisco Federal Reserve Bank, expressed succinctly regarding the Fed's thinking in a presentation at my club in New York a few weeks ago, the intent of the language is transparency and accountability rather than "a backdoor policy overshooting". Williams said in effect that the word "symmetric" should be taken at face value - that is, that the Fed's goal was centered on 2% inflation in the long run and short-run deviations on either side of that target were tolerable and indeed likely, given the noise in economic data. His message was supposed to be reassuring - the Fed should not be expected to deviate significantly from its current strategy of normalising both the federal funds rate and the size of the Fed's balance sheet in a steady and methodical march to a more neutral monetary stance. One might question the Fed's degree of urgency but not its resolve.

In defense of the use of "symmetrical" in describing the inflation goal, Williams highlighted the other key words that also have been added to the policy directive – what he called the 3 esses (as in words that begin with the letter S): **stabilise, sustained,** and **symmetrical**.

The first word was used to describe the outlook, namely the "Committee expects that, with gradual adjustments in the monetary stance of monetary policy, economic activity will strengthen somewhat further, and inflation will **stabilise** around 2 percent over the medium term". Stable inflation is the Fed's mandate and, on average, they want it to hover around 2%. The Committee also believes that "near-term risks to the economic outlook appear roughly balanced", which means the risk of inflation falling below target is as great as the risk of inflation running above target, in their opinion.

Backtracking into deflation again is not a viable option, so the directive then states "the stance of remains accommodative, thereby supporting some further strengthening in labor market conditions and a **sustained** return to 2% inflation". This may sound repetitive but in essence, the FOMC is saying that getting inflation back to 2% may be the easy part, whereas getting inflation to stay around 2% may be much more difficult and depends, in part, on how gracefully the Fed can exit its QE program. Dallying too long with an oversized portfolio and negative real interest rates is as dangerous as exiting too quickly.

Along those lines, Williams argued that the US economy now faced supply-side constraints rather than inadequate demand as many politicians and Wall Street pundits still proclaim. Under those circumstances, monetary policy is much less effective than it was during the dark days of the Great Financial Crisis. What we need are policies to raise potential growth, which Williams estimates at 1.6% annually.

That is one of the lowest such estimates I have seen and if true, would have serious implications for long-term investment returns. Given these constraints on the efficacy of traditional monetary policy, Williams believes the time is ripe to consider new approaches for future use.

I agree but I do not believe different goals or targets will get the Fed where it wants to go. The great danger to financial markets and, ultimately, the real economy is the inherent instability of the banking system. The temptation to leverage up both the banks themselves and their customers is irresistible. Excessive credit creation is the Achilles Heel of a free market economy, and central banks have not yet figured out how to keep that beast under control.

MARKET IMPLICATIONS

The Fed's talk of a symmetrical inflation goal played well to markets when they were in the throes of the reflation trade. It implied that the Fed would hold rates low for longer in an effort to keep the pedal to the metal. That, however, is not their intent. If anything, the Fed is more determined than ever to exit QE and is setting policy on semi-automatic pilot to get back to normalcy. Their true intent is to be predictable.

Markets are now flipping to the conclusion that transparency amounts to dovish policy. That too is a misperception. The hard reality is that it will take a long time to unwind an extraordinary program of asset purchases, perhaps as long as a decade. And, meanwhile, the more difficult challenge of raising potential output growth is left to an administration without a plan – and, perhaps, not even an intention – to do so. Not surprisingly, the reflation trade seems to be unwinding as quickly as it blossomed.

ENDNOTES

1. The FOMC directive from March 15, 2017 stated "The Committee will carefully monitor actual and expected inflation developments relative to its symmetric inflation goal."

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