Monetary Policy on a War Footing

Comments on Fed Chairman Powell's June 4th Speech

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The equity markets moved sharply higher in response to yesterday's comments by Chairman Powell. We believe the markets have interpreted his comments correctly and view this latest communication as signalling a significant shift toward a more stimulative monetary policy.

Fed Chairman Jerome Powell has just put US monetary policy on a war footing. Fortunately, we are only talking about a trade war. Nevertheless, speaking at a 'Fed Listens' event on June 4th, Powell made it clear that he sees it as the Fed's duty to use monetary policy to counteract any negative effects of the current round of trade conflicts:

"I'd like first to say a word about recent developments involving trade negotiations and other matters…We are closely monitoring the implications of these developments for the U.S. economic outlook and, as always, we will act as appropriate to sustain the expansion, with a strong labor market and inflation near our symmetric 2 percent objective."

This was a significant intervention in that it suggests Chairman Powell is likely to lend support to President Trump's efforts to renegotiate America's major trade relationships. That said, the remainder of Powell's comments were potentially even more significant.

Powell was at pains to draw a comparison between yesterday's Fed meeting and another held almost exactly 20 years previously titled *"Monetary Policy in a Low Inflation Environment."*, making it clear that he viewed the Fed's current challenge as handling policy in an environment with low and potentially falling inflation. In this, Powell was further emphasising the degree to which he has changed direction from his hawkish comments of Q4 2018 which sent equity markets sharply lower. He then went on to explain that interest rates should be expected to return to the ELB, or Effective Lower Bound:

"The next time policy rates hit the ELB [Effective Lower Bound]—and there will be a next time—it will not be a surprise."

"The combination of lower real interest rates and low inflation translates into lower nominal rates and a much higher likelihood that rates will fall to the ELB in a downturn."

And explained that he believed tight labour markets were no longer the potent inflationary force they once were:

"inflation has become much less sensitive to tightness in resource utilization."

This comment is significant in that it puts the market on notice not to expect a tightening in monetary policy even if the already low unemployment rate falls even lower:

"it means that much greater labor market tightness may ultimately be required to bring inflation back to target in a recovery…. the proximity of interest rates to the ELB has become the preeminent monetary policy challenge of our time"

Powell then went on to build the case for the Fed adopting a new approach to inflation targeting involving a "makeup" strategy. This is the idea that, if inflation falls below target for a period, the Fed should not just seek to drive the inflation rate back toward target but should engineer an inflationary overshoot so as to 'makeup' for the inflation that was lost during the low inflation period.

The implications of operating a 'makeup' strategy is that the longer and deeper the period of below target inflation the more the market should anticipate a period of aggressive monetary stimulus. The theory being, if the markets anticipate the stimulus then they will help avert the undesirable disinflation in the first place:

"My FOMC colleagues and I must—and do—take seriously the risk that inflation shortfalls that persist even in a robust economy could precipitate a difficult-to-arrest downward drift in inflation expectations….The first question raises the issue of whether the FOMC should use makeup strategies in response to ELB risks…what if the central bank promised credibly that it would deliberately make up for any lost inflation by stimulating the economy and temporarily pushing inflation modestly above the target?... the prospect of future stimulus promotes anticipatory consumption and investment that could greatly reduce the pain of being at the ELB."

The 'makeup' strategy gives the Fed considerable wiggle room to continue monetary stimulus into an extended period of above target inflation.

The 'makeup' strategy taken together with the comments downplaying the inflationary significance of low unemployment suggests Powell is building a narrative to justify sustained monetary stimulus while being free to disregard inflation, labour market strength or economic growth.

To this end Powell follows up by repositioning asset purchase programs from 'unconventional' to 'conventional' monetary policy:

"Perhaps it is time to retire the term "unconventional" when referring to tools that were used in the crisis."

We have noted previously that academic thinking, in the form of Modern Monetary Theory (MMT), is moving rapidly toward a much laxer approach to fiscal discipline. Powell's comments yesterday position the Fed to accommodate large scale deficit spending for an extended period.

US equity markets rallied sharply in response to Chairman Powell's comments. We believe the market interpretation was correct.

Investors always have plenty to worry about, but for the foreseeable future it looks like US monetary policy can be safely removed from the list of concerns.

After a rocky start, Chairman Powell and President Trump now appear to be on the same policy page.

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