Economics

Macro news

FED CHAIR POWELL'S TESTIMONY: BULLISH ON ECONOMIC MOMENTUM

Fed Chairman Jerome Powell, in his first semi-annual testimony to Congress, struck a balanced tone, emphasizing continuity in the conduct of monetary policy as the Fed pursues its Congressional dual mandate of 2% inflation and maximum employment. Powell's emphasis on the Fed's pursuit of the dual mandate reflects the Fed's tricky position of satisfying the Congress and its two key committees that supervise the Fed — the House Financial Services and Senate Banking Committees. His testimony drew heavily on the "Semiannual Monetary Policy Report to the Congress" that the Fed had already submitted.

Financial markets were eyeing the testimony for indications of whether the Fed under Powell's leadership would change the course of monetary policy relative to the Yellen-led Fed. While Powell's testimony clearly indicated that the economy significantly strengthened in the second half of 2017 and had healthy momentum leading into 2018, with inflation below 2%, there was no reason for Powell to provide any insight as to how the Fed may respond if inflation were to rise above 2%. However, for 2018, Powell indicated that the Fed will be reassessing its December forecasts in light of the passage of the Tax Cut and Jobs Act and recently enacted Congressional spending package. This will involve a reassessment of the FOMC's appropriate path of the federal funds rate. While Powell's testimony and Q&A were even-handed, markets read his characterization of solid economic momentum and inflation rising to 2% as raising the probability that the Fed may need to raise rates more than it currently forecasts as appropriate, and bond yields rose in response.

Economic performance. Powell clearly characterized economic performance as strong. He noted that real GDP grew at a 3% annualized rate in the second half of 2017 — that is significantly faster than the Fed's estimate of 1.8% longer-run potential growth — and that momentum has sustained: "some of the headwinds the U.S. economy faced in previous years have turned into tailwinds. In particular, fiscal policy has become more stimulative and foreign demand for U.S. exports is on a firmer trajectory." The Fed's assessment in its Semiannual Report characterized labor markets virtually at full-employment. Powell noted in testimony that the Fed's assessment is that the recent financial market turmoil would have little impact on the economy.

This overall assessment suggests that the Fed anticipates growth to continue to exceed its estimate of potential growth at a time when labor markets are operating at virtually full employment.

A critical issue for economic performance and monetary policy is whether the sustained solid economic growth is driven by growth in business investment and productivity gains, or involves primarily an acceleration of consumption that involves excess demand. The former is solid, sustainable, and non-inflationary; the latter is inflationary and ultimately unsustainable. The acceleration of business investment in 2017 has contributed to a measured pickup in productivity gains. Faster productivity gains will fuel further increases in real wages and mitigate the impact of the higher wages on unit labor costs. Productivity-driven growth will not generate underlying inflation pressures or "overheating." The Fed's monetary policy deliberations will involve close scrutiny of the composition of economic growth and what it implies for underlying inflation and the future.

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Inflation. Powell noted that inflation had dipped in 2017 in part due to temporary factors and that the Fed projects inflation to approach its 2% target in 2018. The Fed also indicated that it expects a pickup in wage gains. There was little discussion of inflation running above 2%. We point out that, if nominal GDP continues to grow at 5%, its growth pace during the second half of 2017, either real growth or inflation will be higher than the Fed's forecast.

The near term. Remember the starting point for assessing the monetary policy deliberations of the Powell-led Fed is inflation below the Fed's 2% target, which provides flexibility, but very easy monetary policy with the federal funds rate negative and a very large balance sheet, and strong economic momentum and tightening labor markets. Powell indicated that his aim is continuity of Yellen's gradual monetary policy normalization to a new normal. The critical issue is whether economic performance and inflation will continue to provide sufficient flexibility for the Fed to continue on this gradual path.

At the Fed's scheduled March 20-21 meeting, the FOMC is expected to raise rates 25 basis points, signal it will continue with its gradual balance sheet unwind, and further revise up its forecasts of economic growth in both 2018 and 2019. In addition, the median FOMC member forecast of the appropriate path of federal funds rate may rise.

In December 2017, it raised its 2018 forecast to 2.5% from 2.1% and increased its 2019 forecast slightly to 2.1% from 2%. This suggests that the Fed at the time perceived the Tax Cuts and Jobs Act to have only a modest and temporary economic impact and also seemed to neglect any influences of the shift toward an easing of burdensome regulations that have boosted confidence. Our forecasts have been 3% and 2.7% in 2018 and 2019, respectively, based on the assessment that some of the corporate tax reforms will add to sustainable growth and the shift in regulatory regime has boosted confidence and contributed to the pickup in business investment. (Consensus of private forecasters have been lifting their forecasts but remain below our forecasts.) In a nod to this possibility, the Fed may raise its decidedly downbeat 1.8% forecast of longer-run potential growth.

The Fed will continue to be data-dependent in its monetary policy deliberations. That's nothing new, but amid stronger economic growth and an upward drift in the inflation measures, this will be a tricky task. In its assessment of how consumer spending is responding to increases in take-home pay and how businesses are responding to the corporate tax reforms, it will be very difficult in real time for the Fed to determine how much of the expected pickup in growth is temporary and how much is sustainable. As inflation rises toward 2% — reflecting a rolling-off of some of the temporary factors that reduced inflation in Spring 2017 — and economic growth continues above potential at the same time wages are picking up, will the Fed continue to forecast that inflation levels off at 2%, even as it characterizes labor markets as operating at virtually full employment and real GDP growing significantly faster than the Fed's estimates of potential? The FOMC median inflation forecast will stay at 2%, primarily because the Fed is anchored to its target…but bond markets will see through the Fed's forecasts, and yields will rise. We expect the Fed to raise its Fed funds rate target again in June and a total of four times in 2018. We also expect the Fed to raise its estimates of longer-run potential growth modestly.

The intermediate term. As 2018 proceeds and 2019 unfolds, if inflation rises to or above 2%, the Powell-led Fed may begin to distinguish itself from the Yellen-led Fed. If stronger economic activity is productivity-driven, Powell may allow the economy to run, insofar as it would not be over-heating. This would lead the Fed to raise its estimates of potential growth and its longer-run estimate of the appropriate federal funds rate — thereby moving away from its current "new normal" vision of the economy and monetary policy. But that monetary policy strategy may be risky and will depend critically on inflationary expectations and how they are influencing wages and price-setting behavior. Rising inflationary expectations would force the Fed to hike rates faster.

Concluding observation. Chairman Powell provided an even-keeled testimony and Q&A to the House Financial Services Committee and proved to be a knowledgeable and thoughtful central banker. His goal is continuity of monetary policy. That continuity — and maintaining the Fed's pursuit of the Congressional dual mandate of maximum employment and 2% inflation — may eventually involve higher interest rates than the Fed and financial markets currently perceive.

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