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Is Fed policy in the eye of the beholder?

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The US central bank will likely continue its tightening cycle with caution, with an eye on market expectations about future policy actions and financial conditions. BY LEO KRIPPNER AND THOMAS LAM

THE US Federal Reserve chair Jerome Powell delivered his much-anticipated speech, "Monetary Policy and Price Stability", at the annual Jackson Hole symposium on Aug 26. In just 1,301 words, about one-third of the usual chair speeches and the shortest since the time of Alan Greenspan, Powell essentially indicated that bringing high US inflation down to the Fed's 2 per cent target would require further interest rate increases and perhaps for rates to stay higher for longer once they had reached their peak. Markets reacted accordingly – that is, bond yields rose, more so for shorter maturities; credit yield spreads widened, equity prices fell, market-based inflation compensation declined, and the US dollar appreciated.

The latest message added to a series of deliberate "tightening shocks" that the Fed has delivered since it started reversing its ultra-easy policy stance implemented in the wake of the Covid-19 economic disruption in 2020, composed of the policy interest rate (the federal funds rate, or FFR) set near zero, forward guidance for it to remain so for several years, and a large bond purchase programme.

To briefly recap the tightening shocks, in December 2021 Powell shifted from the previous Fed view that elevated inflation was transitory, and in January 2022 the Fed announced an early end to bond purchases and indicated that raising the FFR would soon be appropriate. It increased the FFR by 25 basis points (bps) in the subsequent March meeting, upped the pace to 50 bps in May, and then to 75 bps for June and July (to the present range of 2.25-2.50 per cent). And Powell's latest speech indicated that forthcoming data would determine whether a further 75 bps hike in the September Fed meeting would be delivered. Our calculations show that markets have already upped the chances from roughly 60 per cent to around 75 per cent (up till Aug 30). In addition, from June, the balance sheet has been reduced by US$47.5 billion a month, and the pace of reduction will be increased to US$95 billion from September.

However, the Fed's settings of the FFR and announced balance sheet reductions provide a very narrow view of the tightening of monetary policy since March and its potential impact on economic activity and inflation. One reason is that the settings themselves do not embed expectations of future Fed monetary policy actions. A second reason is that the transmission of monetary policy settings and their expectations into wider financial markets is not accounted for. It is ultimately financial conditions – that is, the combination of lending rates, exchange rates, equity prices etc throughout different sectors of the economy – that lead consumers and businesses to change their spending, borrowing, and investment decisions. That in turn influences economic activity and inflation towards the goals that the Fed is trying to achieve.

We know from the Fed minutes, since at least the March 2022 meeting, that the Fed has increasingly been paying attention to market expectations about future policy actions and financial conditions when considering the likely economic impact of its actions. The clearest comment is perhaps from the June minutes: "Many participants noted that the Committee's credibility with regard to bringing inflation back to the 2 per cent objective, together with previous communications, had been helpful in shifting market expectations of future policy and had already contributed to a notable tightening of financial conditions that would likely help reduce inflation pressures by restraining aggregate demand."

In reaction to Jerome Powell's speech on Aug 26, US stocks saw sharp falls, and analysts reckon more downsides will persist. PHOTO: AFP

Not easy to disentangle

Given the importance of monetary policy expectations and financial conditions, it is useful to directly quantify how they have evolved over time. Indeed, given that the interactions between monetary policy settings and their expectations, financial conditions, and the economic outlook are complex and not easy to disentangle, it is best not to assume that they are mechanically related to each other.

Regarding monetary policy expectations, it is possible to distil various information from the interest rates of different maturities using yield curve models. For example, up to late 2021, negative Shadow Short Rates (SSRs) estimated from yield curve data and a shadow/lower-bound model that we have available in-house usefully summarised the ultra-easy stance of Fed policy. The SSR reversed from a low of -2.5 per cent in November 2020, following Covid vaccine developments in December 2020, and the date for FFR "lift-off" estimated from the yield curve model was progressively brought forward 10 months – that is, from January 2023 to March 2022. The longer-term path of the FFR estimated from the yield curve moved higher over 2021, while estimated risk premiums rose from December 2021, when an early end to the Fed's bond purchase programme was foreshadowed.

As for financial conditions, these are typically summarised as indices created from weighted aggregates of financial data. Like pasta, such indices come in many different shapes and forms. The Financial Market Conditions Index (FMCI) that we produce in-house uses only market-quoted variables, while the Chicago Fed's National Financial Conditions Index (NFCI) also includes non-market data, such as credit indicators and selected leverage variables. The Covid shock initially led to an abrupt and significant tightening in financial conditions starting in March 2020. As the Fed responded with its substantial easing of monetary policy, financial conditions moved into easier territory through 2021. Of late, financial conditions have tightened again, consistent with firmer monetary policy settings from the Fed.

Still, according to the NFCI, financial conditions only tightened to near-neutral levels recently (around 0.2 standard deviation below the mean). Similarly, yield curve model results show that market expectations for Fed tightening remain fairly moderate compared to history. For example, the SSR estimate has so far only risen to 3.4 per cent, and the inferred average expected path of FFR over the coming 5 years remains only about 0.5 per cent above the neutral rate proxy. And the risk premium for the 5-year bond is around zero. All of these have been materially higher in the past.

On the face of it, the Fed could arguably be even firmer with its monetary policy settings and its conditioning of market expectations to create even tighter financial conditions. That path seems broadly consistent with Powell's remarks at Jackson Hole that "restoring price stability will take some time and requires using our tools forcefully to bring demand and supply into better balance".

However, the outlook is conceivably more two-sided, for several reasons. One is that the Fed has already firmed policy quickly and by a larger magnitude, that is, around 6 percentage points according to the rise in the SSR from -2.5 per cent to 3.4 per cent. Also, our FMCI suggests that financial market conditions tightened reasonably through the middle of 2022, reversing partially in recent months, but it continues to hover at relatively tight levels (roughly 1 standard deviation above the mean).

A second reason is that financial conditions affect economic activity over a long stretch of time. Our analysis with the FMCI suggests that tighter financial market conditions tend to slow the economy with a lag of more than 1 year. Indeed, as recently as last month, some market commentators were already more concerned about future recession risks in the US than prevailing inflation.

Third, the Fed has an established track record of credibility on inflation, so it should not need to tighten as much as in the 1970s/early 1980s to bring present inflation back down again.

In summary, even while the Fed remains suitably vigilant on inflation, uncertainties associated with the cumulative lagged effects from the rapid and continued policy tightening will likely lead the Fed to continue its tightening cycle with caution. Doing so will leave it well-placed to respond to the intricate upside and downside risks in the future.

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