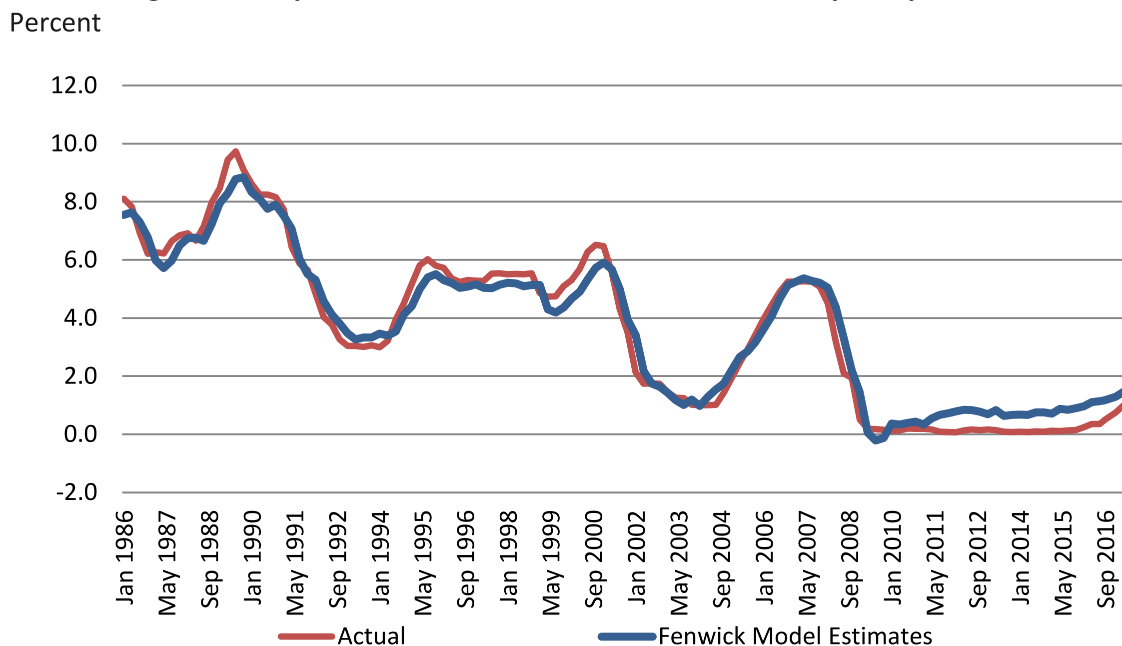
**Is the Fed Behind the Curve?**

I have addressed many of the issues concerning the question of whether or not the Fed is behind the curve in two recent commentaries[1]. There are two dimensions to being 'ahead' or 'behind' the curve. The first dimension is the traditional perspective on the federal funds rate. The second is the bloated state of the Fed's balance sheet that imparts monetary stimulus via its effect on long term interest rates.

Many observers are focused on the real Fed funds rate and conclude that the Fed is behind the curve because a central bank supposedly should not persist with a negative real policy rate at full employment. That is correct, but the question remains as to 'how much?" The answer to that question depends critically on what the neutral policy rate is and the prospective risks to financial stability. My fed funds model, which includes a proxy for systemic risk to address the Fed's foremost priority of safety and soundness of the financial system as well as measures of the Fed's other two objectives of price stability and full employment, gives a new perspective on how much the Fed might be behind the curve. Figure 3 from my paper entitled "Policy Rules Versus Discretion: Lessons from History", is reproduced below. Over the past year, the Fed has closed the gap behind the funds rate and its estimated value in this model to about 35 basis points. Granted, the model expects the funds rate to rise further now that the economy is a full employment and inflation is inching up to its target of 2%. But the ultimate nominal neutral rate in this model is 2% to 2-1/2% - far lower than most observers perceive it to be yet a target consistent with staff and IMF studies on the new neutral rate. In this context, the Fed would be judged to be a little behind the curve, albeit not as much as they often are at full employment.



Sources: Bloomberg and estimates from Fenwick Advisers' proprietary model

[1] See Robert S Gay, "Policy Rules Versus Discretion: Some Lessons from History", Fenwick Advisers, June 24, 2017 and "The Quandary on Inflation", Fenwick Advisers, July 17, 2017.

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mobile: (914)522-0210

The second dimension of the Fed's policy stance is its bloated balance sheet that undeniably adds to monetary stimulus. Most studies estimate that the Fed's asset purchases have reduced the yield on the 10-year US Treasury bond yield about 115 basis points. In my opinion, the asset purchase program never was intended to be permanent but rather was an expedient measure to combat systemic risk. That risk has passed for now thanks to increased bank capital requirements and limits on leverage ratios, so the Fed is obliged in a sense to remove that aspect of stimulus because it is no longer applicable to current circumstances. Hence, normalization of the balance sheet has become an immediate priority, more so than the policy rate.

The Fed does not need to normalize the balance sheet quickly, as its stimulus operates indirectly and rather weakly via long term interest rates. A five to seven year horizon for normalization of the balance sheet would be appropriate, and indeed that seems to be the FOMC's horizon. The urgency only centers on getting started. Once they begin, presumably at this month's meeting, the focus will begin to shift back to normalization of the policy rate. If financial markets are able to calmly assimilate the plan for shrinking the balance sheet, as I expect they will, then the FOMC will be free to revisit the issue of the new neutral rate and what it means for future policy adjustments. Even here, the Fed does not face an immediate risk of reigniting inflation because prices and wages are much less responsive to tight product and labor markets than they were in the past. I discuss these issues in my second paper entitled "The Quandary on Inflation". To stay on track and ahead of the curve, however, the Fed will need another rate hike perhaps as soon as December.

Many observers presume that a higher funds rate will translate – quite immediately and directly into tighter monetary conditions. Neither of those presumptions is necessarily true. Banks often increase their lending and lower their lending standards at full employment when the Fed is hiking rates. Only when banks belatedly tighten lending standards do monetary conditions become truly 'tight', and then of course recessions invariably ensue. Central banks are thought to cause this chain of events, whereas in reality excessive lending to increasingly vulnerable borrowers who waste the money on ill-advised ventures or acquisitions usually proves to be the undoing of economic expansions.

Dr Robert S Gay
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96 Mendota Avenue • Rye, New York 10580 • (914) 967-4684
mobile: (914)522-0210