December 2017

Fed Thoughts:

Song of the Thin Man

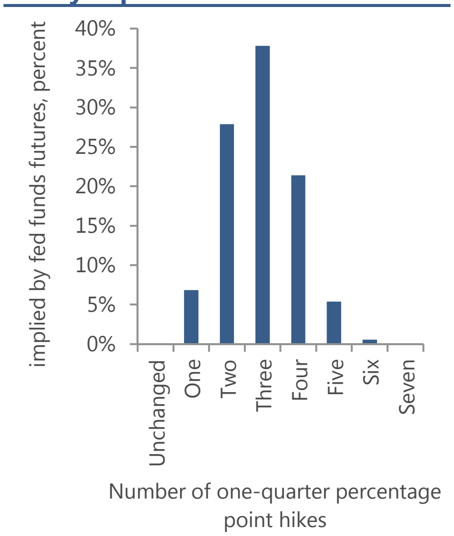
by Vincent Reinhart
Chief Economist

The news that President Trump picked a thoroughly conventional candidate to head the Federal Reserve next year was reassuring. Our initial reaction was that Fed-chair-to-be Powell not only looks the part of a central banker, but also showed financial acumen in "My Man Godfrey," keen insight in "The Thin Man" and its sequels, and a real knack for dealing with difficult colleagues in "Mister Roberts." Those are important qualities for someone guiding members of a committee who are sometimes difficult and always disputatious to a conclusion and then communicating the choice to a wider world. To our initial disappointment, though, someone explained that the actor William Powell died in 1980 and that the nominee is actually Jerome, "Jay", Powell, a current Fed governor and former Bush (senior) Treasury official. The consolation is that the younger Powell showed the same attributes of the elder during his career, but it is disappointing that Myrna Loy will not be at the Fed's Fourth-of-July party. (Someone else subsequently relayed the bad news about Ms. Loy's death in 1993. It is a colder world all-around.)

We were apparently not alone in being initially confused about the choice. Indeed, many market participants still seem confused, in that they assume that Powell will deliver dovish policies and make no more than cosmetic changes in the Fed's monetary policy process. True, Powell did not come across as an agent of change at his confirmation hearing. Rarely does anyone on that side of the green felt table get past anodyne on those occasions. The reality is that Powell is a pick to the right of the incumbent on monetary policy inclination and engineered difficult changes in a hidebound institution in his term at the US Treasury.

As for monetary policy, Chair Powell is likely to follow through on the guidance the Federal Open Market Committee has routinely been providing for 2018. With resource slack probably exhausted and aggregate demand expected to grow at a pace faster than that aggregate supply, three-to-four quarter point firmings currently seem appropriate, as in the Standish forecast. Those moves depend on the data, of course, and are not priced in futures. Indeed, about one-third of the probability chips currently in fed funds futures are placed on fewer actions. Even though the macro forecasts of the Fed and most market participants seem aligned, market expectations track below FOMC guidance for the first year of Chair Powell's tenure in the same manner they did for all of Chair Yellen's leadership. We think that the former is a mistaken extrapolation of the split personality of policymaking that produced the latter.

Policy Expectations For End-2018



Source: Bloomberg, acccessed 12/5/2017.

Say what? Jay Powell will act in 2018 like Janet Yellen in 2017, but market participants discount expectations because of the way Janet Yellen acted from 2014 to 21016. This is not about Janet Yellen, who successfully managed her committee and market expectations. She won, in that a policy maker more dovish than most Fed colleagues got them to enshrine a lower-for-longer path for the federal funds rate in two installments, showing her flexibility to changed events.

Yellen 1.0 reigned from 2014 to 2016 and agreed in principle to the need renormalize monetary policy. Opportunistically, however, events intruded on acting, whether there were bad data prints, elevated market concerns, or elections somewhere looming. She was able to put off her more hawkish colleagues (helped by being right about resource slack and inflation pressures) until the force of promise ultimately weighed. To meet diminished expectations, the FOMC slipped in December actions in 2015 and 2016. The Fed head was able to do so because everyone in the Boardroom, herself included, believed Janet Yellen was a two-term chair, and denying her due would be costly.

Yellen 2.0 recognized that elections have consequences. In 2017, with less heft in pushing back against the ingrained hawkish impulses of main FOMC participants, Yellen employed monetary-policy jujitsu. The chair agreed to firming along extant guidance, but no more and with considerable market forewarning, and meanwhile put in place a glacial path of balance-sheet renormalization. In doing so, Yellen modelled good behavior, as her wont, for her surely more conservative successor.

In the event, her more conservative successor is Jay Powell, making the transition easier as he was present at the creation of this policy. He will deliver Yellen 2.0 and slowly disabuse market participants that Yellen 1.0 remains in the building. The market will correct to a policy path than is tighter than currently expected but still lower for longer for longer than anytime else in Fed history.

Two confusions reign about Jay Powell as an agent of change. Does he see a need of action? Is he too incrementalist to affect meaningful change?

The first observation is that he has already told us there is room for improvement in Fed communication. We were on the same program one year ago at the Brookings Institution about "Fedspeak."[1] The governor was brave to appear in a forum predisposed to criticism and he mostly was defensive. However, Powell admitted, "I have come around to the view that focusing too much on the precise timing of policy moves may be adding to confusion and frustration about our communications." Moreover, "In my view, communications should do more to emphasize the uncertainty that surrounds all economic forecasts, should downplay short-term tactical questions such as the timing of the next rate increase, and should focus the public's attention instead on the considerations that go into making policy across the range of plausible paths for the economy."

The second observation is that Powell worked at the Carlyle Group in between stints in the government. An important part of their value added is restructuring businesses. We presume that the first two bullet points they read from on the first day after acquisition is that this is a well-performing entity and that any enterprise can perform better. The third point, unwritten, is that there is a takeover window in which change at the outset is easier to implement and more understandable from the outside. Sensing a need to change, he has the private-sector experience to do so.

The argument recurs that the public sector is different, and change can be harder, especially when vested interests obstruct. In our experience, no force of stasis is more formidable than primary dealers of US Treasury securities. After infractions of bidding rules in 1992, a modest proposal to move toward a more resilient auction technique was put forward **(here)**. Recognize that Milton Friedman, not a shrinking violet, had pushed for this reform, with no traction, for three decades[2]. Jay Powell in a senior position at the Treasury helped make that change possible.

What sort of changes are on the table for the Fed? The FOMC is starting from a low enough place in its communications that most ways look up. Fed officials have to reconcile their relationship with:

The Congress. This is a tough row to hoe, as legalistic interaction for twelve years has made Hill staff hostile toward the Fed and Fed staff suspicious of the Hill. Given the reception at his nomination hearing, Jay Powell apparently walked the corridors of the Senate to assuage concerns. As an additional easy fix to broken oversight of the Fed, Chair Powell can invite the Congress to authorize two (and only two) reviews by the Governmental Accountability Office of Fed monetary policy to be delivered just before his semiannual testimonies. The GAO can work out the prescriptions on policy from standard rules, consult with the usual expert suspects, and produce a script for Hill staff to draw from in asking questions at the hearings. Those hearings might actually become more effective.

Themselves. Fed officials created orphan meetings—the four times they gather without press conferences and seem completely reluctant to act. They have also heaped responsibility on the chair to explain their actions at those press conferences so they do not have to agree in writing in their press statements. The alternative is to have press conferences after every meeting, reduce the number of meetings to reduce the burden, and share the responsibility of presenting monetary policy views. Six meetings a year, each with a press conference, fit nicely into the calendar and allow time to prepare for the press. Every meeting is therefore "live." To emphasize the commonality of the decision, the chair could co-present with a colleague from the FOMC who otherwise does not get prime time. There are twelve FOMC members, three of which have vice-chair designations to get their days in the sun (vice chairs of the Board and of supervision at the Board and of the FOMC—the president of the Federal Reserve Bank of New York). Let the

[1] "Understanding Fedspeak" event cosponsored by the Hutchins Center on Fiscal and Monetary Policy at the Brookings Institution and the Center for Financial Economics at Johns Hopkins University, Washington, D.C.

[2] Friedman, M. (1963). Price determination in the United States treasury bill market: A comment. The Review of Economics and Statistics, 318-320.

others rotate on the podium at the press conference with the chair, the four Bank presidents on the FOMC each year and two of governors (on a two-year cycle). Even better, follow the European Central Bank and hold one of those six meeting a year at a Reserve Bank, reaffirming the regional diversity inherent in the Federal Reserve Act. September is a good time of year to travel to one of the twelve districts, where monetary policy makers could hear a special topic for committee consideration and also remind Board staff that they are not the center of the universe.

The public. The FOMC statement is too complicated, too filled with jargon, and almost never changes. This is a document written for the elite, who have forgotten they serve the public. Go back to three paragraphs and start from scratch every time. If monetary policy really was data dependent and made meeting by meeting, its summary would change every time. And, if members cannot agree to put it into writing, they have not agreed. To the extent that the press conference was made less chair-centric, the FOMC might actually have to speak with its own voice.

Enough about unsolicited advice, there is a December FOMC meeting, which everyone has reasonably assumed will bring a quarter-point higher policy rate. The Fed told us, told us again, and the data have thus far not thus far proved an obstacle. There is great irony that an institution preaching data-dependence has denuded meaning from the incoming employment data. That is the world the Fed has made, and absent a horrendous breakdown of the political system, they raise the funds rate another quarter point at the upcoming meeting. As opposed to prior meetings, they might actually mark up their economic outlook and, dare we say it, raise some of the dots on interest rate expectations.

STANDISH
A BNY MELLON COMPANY℠

Standish Mellon Asset Management Company LLC
Boston • Pittsburgh • San Francisco

Standish Mellon Asset Management (UK) Limited
London

www.standish.com • info@standish.com

WP/12-6-17/BR