Rethinking Fed Policy amid Constraints on Aggregate Supply

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In a futile effort by the Fed to overcome drags on the economy that are beyond the scope of monetary policy to mitigate, the Fed has developed an unhealthy and counterproductive relationship with markets that is actually increasing risks to the expansion.

Over six years of persistently disappointing economic performance make it increasingly apparent that factors other than monetary policy are influencing the economy, and the Fed's stimulative efforts are ineffective. Yet the Fed insists on sustaining negative real rates and brushes off the distorting impacts of its policies. It delays normalizing monetary policy when confronted with each new bout of international financial turmoil, despite little supporting evidence the economy will be harmed.

As planned, since Fall 2012, the Fed's QEII, forward guidance, Operation Twist, QEIII and reinvesting maturing assets have lowered bond yields, encouraged risk-taking and pumped up asset prices (stocks, bonds and real estate), but these policies have failed to stimulate aggregate demand. Nominal GDP, the broadest measure of current dollar spending, has actually decelerated to 3.1 percent in the year ending 2015Q4 from a modest 3.9 percent average pace during the prior five years.

The Fed's assertion that its easy monetary policy has stimulated the economy and generated millions of jobs is a stretch. The Fed's policies have contributed to lower costs of capital and rising wealth while at the same time labor costs have risen. Instead of generating faster capital spending and relatively slower job growth, the opposite has occurred. Business investment has been disappointingly slow and employment gains have been healthy. This has contributed to disturbingly slow labor productivity gains. The unemployment rate has receded to its natural rate but take-home wages have remained modest.

If in 2012 Fed staffers had conducted a simulation based on its FRBUS macroeconomic model, plugging in the lower yields and higher asset prices and higher labor costs that have occurred to the present, and imposed the actual path of nominal GDP, the simulated results would not support the Fed's contention that monetary policy has stimulated the economy and generated several million jobs. The disappointingly weak capital spending and productivity would be unexplained.

Non-monetary influences: post-crisis behavior and policy-induced supply constraints. Since the financial crisis and deep recession, some aspects of economic and financial behavior seemingly have changed. The labor force participation rate has fallen sharply, most notably among younger people. The rate of household formation has fallen. Difficult mortgage financing has constrained housing. Household and business investment spending have been cautious.

Government policies have contributed to the weak economic performance. A growing web of economic and regulatory policies and government mandated expenses imposed on the Federal and state and local levels have effectively constrained aggregate supply and demand. In response to disappointing performance, the Fed has gradually reduced its estimate of potential growth to 2 percent, and these factors have contributed to the dimmed forecast.

These impediments to growth deserve notice in a context of the Fed's efforts to stimulate. The burdens of the widely acknowledged flawed corporate tax system are being accentuated by aggressively administered legal rules while the mounting burdens of regulations extend beyond the financial sector to a wide array of non-financial industries. These result in higher operating costs, inefficiencies in production and distribution, obstacles to start ups and expansion plans and entrepreneurship. They have unintended consequences for competition, and encourage US companies invest more overseas.

New government mandated expenses are pushing up business operating costs. Two visible examples are the Affordable Healthcare Act and minimum wages. These factors influence production, investment decisions and the demand for labor inputs. Some mandated expenses are absorbed in business margins while some are directly or indirectly passed on to consumers and employees. Higher out-of-pocket expenses for health insurance and medical services absorb disposable incomes and squeeze expenditures on non-health care goods and services. Higher employment costs for businesses lower take home pay.

The Fed incorporates into its FRBUS macroeconomic model the expected influences of fiscal policies, inflationary expectations and wage rigidities, but it does not adequately capture the macro impacts of the rising burdens of economic and regulatory policies and mandated expenses. Nor does the FRBUS model capture how expectations of increasing burdens in the future influence current behavior, even though in numerous surveys businesses consistently identify these factors as impediments to growth and additions to uncertainty.

The Fed views supply constrains in conventional terms—such as the unemployment rate bumping up against full employment and high capacity utilization in key industries. When the Fed thinks about the appropriate role of fiscal stimulus, it considers changes in deficit spending. Although quantifying the macro impacts of the growing web of economic and regulatory policies would be difficult, their aggregate impact is real and significant. They explain some of the disappointing trend in capital spending—a sizeable source of economic weakness--and maybe the slow rise in wages.

As growth has remained disappointing but the unemployment rate has fallen and core inflation has risen toward the Fed's 2 percent target, the Fed has delayed normalizing rates and effectively has changed its dual mandate targets numerous times. The Fed is seeking higher wages and is implicitly targeting broader measures of labor force underutilization like U-6 and the number of part-time workers for economic reasons.

The Fed wants inflation to rise and statements by Chair Yellen and several other members have suggested that they may tolerate inflation above 2 percent. The Fed's thinking is that inflation is generated and preceded by stronger real growth and employment that would benefit wages and labor market conditions, and the Fed would be able to raise rates in a timely fashion to restrain inflation.

But what if the higher inflation is driven by impediments to aggregate supply rather than accelerating aggregate demand? The Fed may now be facing that reality. In the last year, core inflation has drifted up while real growth has remained disappointing and nominal GDP has decelerated. The Fed must reconsider its approach of sustaining monetary stimulus in an attempt to achieve further labor market improvements.

The Fed's unhealthy relationship with markets. As a consequence of the Fed's evolving targets, US and global markets have come to rely far too much on the Fed's actions—its policies, forward guidance and forecasts—as well as unofficial statements by its members. At the same time, the Fed bases its actions too much on how it perceives the markets will react to what it does and says. The markets send signals to the Fed and the Fed sends signals to the markets. Sometimes markets overreact, which elicits a Fed retraction or overreaction.

Lost in the posturing is that the Fed's dual mandate has been achieved, economic underperformance stems from factors beyond the Fed's scope, and by over-extending monetary policy the Fed is adding to economic and market risks.

Since early 2015, the Fed has adjusted monetary policy to the strength of the US dollar, China's stock market correction and associated declines in emerging markets, and in early 2016 to the US stock market correction. The US macroeconomic effects of these global financial fluctuations are relatively small (as acknowledged by Fed Vice Chairman Fischer and others). These Fed efforts to fine-tune markets and market psychology are inappropriate and convey the wrong signals.

By responding to every financial market ripple, the Fed has reinforced market perceptions that it is reticent to raise rates or allow its balance sheet to decline. This is reflected in the very flat Fed funds futures curve (which is way below the path the Fed perceives is appropriate, the so-called Fed's "dots") and abnormally low yields on inflation-adjusted 10-year Treasury bonds and break-evens on TIPs, and high stock valuations. Meanwhile markets are becoming weary of the Fed's economic influence.

The Fed has delayed raising rates because it is afraid of markets. It fears any jarring effect stemming from a reversal of the so-called portfolio balance effect that former Fed Chairman Bernanke touted as the Fed rolled out QEII and its formal forward guidance initiative. In August 2012, Bernanke described how monetary policy could be used to push down bond yields, encourage risk-taking, push up asset prices that would stimulate aggregate demand.

This deepening uncomfortable relationship between the Fed and markets is tying monetary policy in knots, prolonging monetary policy normalization and sending the wrong signals to the public.

The Fed has always paid attention to financial markets. Volcker railed against high bond yields, arguing publicly that the market expectations of inflation were too high. Greenspan was notorious for closely monitoring the stock market, estimating the wealth impact on the economy, and establishing the "Greenspan put".

The current Fed seems to be carrying the importance of markets to new and uncomfortable extremes. There would be less concern if the real Federal funds rate were already near zero and the Fed had already begun the process of unwinding its bloated balance sheet. But that's not the case.

The problem is sustaining negative inflation-adjusted yields amid healthy economic performance encourages excess reliance on debt and risk-taking. That is evidenced in many ways: rising corporate debt, in part to finance stock repurchases; rising risky bank lending practices (in sub-prime auto loans and elsewhere); squeezed insurance companies being forced to raise premiums and alter their insurance policies; the adverse impact on older households who rely on interest income; rising wealth inequality; and more financial burdens on lower income renters whose rents are rising to reflect higher home values (that primarily benefit higher income homeowners). These policy-induced behaviors run counter to the Fed's macro prudential stability objectives.

The Fed needs to reassess why the economy has continued to underperform despite unprecedented monetary ease and be more circumspect about the effectiveness and proper role of monetary policy. Financial markets always fluctuate. The Fed must not allow short-term market behavior dictate monetary policy.