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TRENDMACRO LIVE!

On Yellen at Jackson Hole

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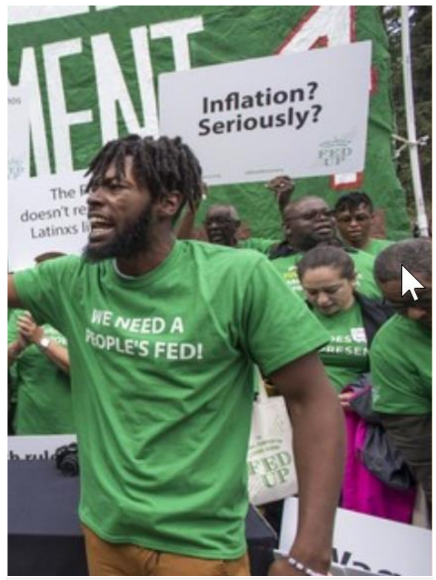
Donald Luskin

Some rote hawkishness. But she's hearing Leftist critics who say a hike is "a terrible idea."

The immediate market and media reaction to Fed chair Janet Yellen's speech this morning at Jackson Hole was to treat it as hawkish, pointing to her phrase in the preamble that "the case for an increase in the federal funds rate has strengthened in recent months." *But that phrase says only that the case for a rate hike has gone from zero-probability right after Brexit to at least something we can have a sane conversation about.*



Source: Fed Up

Part of that conversation has become political. Far be it from us to agree with a Leftist pressure group like Fed Up, an alliance of union-funded and Soros-funded activist organizations. But they have it exactly right when they say in their mission statement,

> *"Some members of the Federal Reserve think that the economy has recovered. They want to raise interest rates to slow down job growth and prevent wages from rising faster. That's a terrible idea."*

The Obama-appointed Fed is taking this group seriously enough for Vice Chair Stanley Fischer, Governor Lael Brainard, New York Fed President William Dudley and eight other officials to have met with Fed Up last night in Jackson Hole. Again, Fed Up got it exactly right yesterday when one representative reportedly told the assembled Fed dignitaries,

> *"I don't want to be sacrificed in your war against an inflation enemy that isn't here."*

Bingo! This is exactly the crux of the matter – although it's a little more complex than Fed Up's slogan.

- The Fed Up critique reveals how the central bank finds itself

Update to strategic view

US FED: Yellen's Jackson Hole speech began with a rote phrase that "the case for an increase in the federal funds rate has strengthened in recent months." But the "strengthened" case is still no case at all, with inflation expectations at the lowest in the history of the data, and millions dropped out of the labor force and the labor statistics. Such rote phrases seem to be part of a campaign of forward guidance, perhaps to prevent "risky imbalances." But now the Fed faces political pressure coming from the Left, arguing, quite rightly, "I don't want to be sacrificed in your war against an inflation enemy that isn't here." Deeper in the speech, Yellen admitted that the neutral rate may be zero, in which case current policy is not especially accommodative. We reiterate that December is the very soonest for a hike, and very probably not even then.

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tangled up in an untenable position in the low-inflation Not So Great Recovery following the Great Recession (see "The Agony of Victory at Jackson Hole" August 18, 2016).

- On the one hand, the Fed constantly harps on the need to raise rates to pre-emptively keep inflation under control. *But why? Steady-state long-term inflation expectations are at the lowest in the history of the data.*
- On the other hand, the Fed always gripes that inflation is too low. *But why? To Fed Up's point, low inflation is about the only really good thing about the economy now.*
- And in the background to all these considerations is headline unemployment, which gives the impression that the economy is about at maximum employment. But this is merely measurement error, ignoring the vast gray-market army of unemployed persons who have dropped out of the labor force and out of the statistics.

So with all that in mind, let's move into Yellen's speech beyond the rote phrase about "the case for an increase in the federal funds rate," or the stale *pro forma* assurance that "the FOMC expects…inflation rising to 2 percent over the next few years."

- Far more revealing of her deeper thinking is this phrase, which came soon after in the speech:

> …the level of short-term interest rates consistent with the dual mandate varies over time in response to shifts in underlying economic conditions…

- Yellen here is getting at the idea of "the marked decline over the past decade, both here and abroad, in the long-run neutral real rate of interest." She goes so far as to admit that by "some calculations, the real neutral rate is currently close to zero, and it could remain at this low level."
- *If that is true, then current policy is not especially accommodative. This, in essence, is the point that Fed Up is making.*

So we ask: why, dear God why, would the Fed even be discussing the possibility of raising interest rates now?

- According to the *Financial Times* this morning, officials told Fed Up that the Fed "needed to act to prevent risky imbalances from emerging down the road."
- Remember, "to act" encompasses the entire "toolkit," including forward guidance. *The incessant warnings of imminent rate hikes by Fed officials – even from seeming doves such as San Francisco Fed President John Williams, who has argued for easing by raising the Fed's inflation target – surely constitute a conscious program of forward guidance.*
- The best we can do to guess at a rationale for it is that it is intended, as the Fed told Fed Up, "to prevent risky imbalances" – but without paying the price of actually hiking rates.

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- But this interpretation implies that the Fed's thinks its "toolkit" is highly fine-grained – that the various tools are not merely interchangeable, but have unique attributes. *In this case, it would seem the Fed believes that hawkish forward guidance, as a unique tool, has a better cost/benefit ratio that actually hiking rates.*

So for now we are going to see Yellen's speech as just more of this forward guidance – all talk, but when push comes to shove no action. This won't be the first time this year, even after the disastrous results of last December's liftoff, that Yellen indicated it was time for more hikes (see "Is the Fed Stuck on Stupid?" May 20, 2016). Yet the hikes never came.

- *Once again, we say that December is the very soonest for a hike, and very probably not even then.*

Bottom line

Yellen's Jackson Hole speech began with a rote phrase that "the case for an increase in the federal funds rate has strengthened in recent months." But the "strengthened" case is still no case at all, with inflation expectations at the lowest in the history of the data, and millions dropped out of the labor force and the labor statistics. Such rote phrases seem to be part of a campaign of forward guidance, perhaps to preventing "risky imbalances." But now the Fed faces political pressure coming from the Left, arguing, quite rightly, "I don't want to be sacrificed in your war against an inflation enemy that isn't here." Deeper in the speech, Yellen admitted that the neutral rate may be zero, in which case current policy is not especially accommodative. We reiterate that December is the very soonest for a hike, and very probably not even then.