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TRENDMACRO LIVE!

On the December FOMC

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Donald Luskin

Powell again calls for stimulus, but the Fed didn't follow up on its hint it would provide more.

The Fed's massive emergency lending programs (see "On the Fed's Massive Intervention" March 23, 2020) will be closing their doors to new borrowers on December 31 as scheduled. Chair Jerome Powell wanted to extend them, but Treasury Secretary Steven Mnuchin withdrew the equity capital for them (see "Do We Need More Stimulus?" December 14, 2020). At today's FOMC meeting, Powell did extend the one emergency program under his sole authority, the dollar swap-lines to other central banks.

- *But considering all this, and that Powell takes every opportunity to say he believes more stimulus is needed, it's odd that today the FOMC did nothing but tweak its forward guidance concerning asset purchases. There was more that could have been done.*
- *It's also odd that while Powell alluded at the top of the post-meeting press conference to the recent softening of macro data, it wasn't mentioned in today's FOMC statement*. Indeed there was not a single word changed versus last month's with respect to the committee's appraisal of economic conditions (for a complete red-line mark-up, see "Data Insights: Federal Reserve" December 16, 2020),
- *The only statement change was the widely expected forward guidance that asset purchases would continue "until substantial further progress has been made toward the Committee's maximum employment and price stability goals."*
- This is a pale version of what had been clearly signaled in the minutes of the prior FOMC meeting, released November 25 (see "Data Insights: FOMC Minutes" November 25, 2020):

  "Many participants judged that the Committee might want to enhance its guidance for asset purchases fairly soon. Most participants favored moving to qualitative outcome-based guidance..."

- That's not a very specific "outcome," is it? The very first question thrown at Powell in the press conference sought more specificity, and all Powell did was repeat the word "substantial" several times. We hardly see the point…
- The November minutes also indicated the FOMC might change the language about asset purchases to "*place a greater emphasis on*

Update to strategic view

US FED, US MACRO: No statement language changes, except weak forward guidance that asset purchases would stay in place until the economy makes "substantial progress." That had been signaled clearly in the minutes of the prior meeting, but there was no action on the hint that the Fed might extend maturities of its asset purchases, which would have been more stimulative. We don't understand how the "dot-plots" can have fallen again, and how Powell can continue to call urgently for stimulus, and yet the Fed does not supply all the stimulus it might. Powell acknowledges that a pent-up demand surge next year could lead to a transitory bump in inflation, but that it would be unlikely to shift long-term inflation expectations or require tightening by the Fed.

[Strategy dashboard]

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fostering accommodative financial conditions…" That simply means that new guidance was to be more clear that the Fed's intent is stimulus, not just lubrication of the banking system. It didn't happen.

- Another possibility hinted in the November minutes was "…to … lengthen the weighted average maturity of the Federal Reserve's purchases…" *If Powell really wants stimulus, this is what the FOMC should do – and this month, it didn't.*
- Former Chair Ben Bernanke has said that "The problem with QE is it works in practice but it doesn't work in theory." But he once clearly explained that quantitative easing – large-scale asset purchases – works through what he once called the "portfolio balance channel." That simply means *the Fed's purchase of securities takes duration risk out of private markets and puts it on the Fed's balance sheet – it's like a fixed-for-floating swap*. In times of stress such as early 2009, this assumption of risk by the Fed breaks self-feeding "risk off" manias that can lead to debt-deflation spirals. In more normal times, at the margin, it leaves private markets with more of a "risk budget" that can be reinvested in growthier investments than Treasuries.
- Powell understands that. He said as much in today's press conference – "asset purchases provide accommodation by removing duration risk from the market."
- So why not do it?
- To be sure, short-term debt securities have some duration risk, so if the Fed buys enough of them, the "portfolio balance channel" will function as stimulus. But the effect is amplified by buying longer-term securities, which take more duration risk out of the market per dollar of purchases. *If Powell think stimulus is so needed now, why didn't he do this? Perhaps he, or staff, believe that this creates too much of a long-term commitment to a large balance sheet – yet that commitment itself would be a form of stimulative forward guidance, wouldn't it?*

For all Powell's talk about the need for stimulus (in the presser, he even evoked an over-the-top imagery of people having to live in their cars) the fact is that the FOMC as a whole is both becoming more confident about its visibility on the economy, and less worried about downside risk.

- *We can see this attitude shift clearly in new diffusion indexes included for the first time in the Summary of Economic Projections*. They show the share of FOMC participants whose forecast uncertainty has increased (or decreased), and whose forecasts have become more optimistic (or pessimistic). The raw data to create these indices has been available for the last several years on a three-week delayed basis, as though the FOMC believed that the uncertainty of its participants was too much truth for the public to handle on decision day. We have always calculated the diffusion indices ourselves, presented in "Data Insights: FOMC Minutes" as scatterplots, which the SEP still does not.
- Starting with today's SEP, the truth is laid bare in real time. As you'd expect this crazy year, the forecast uncertainty is very high,

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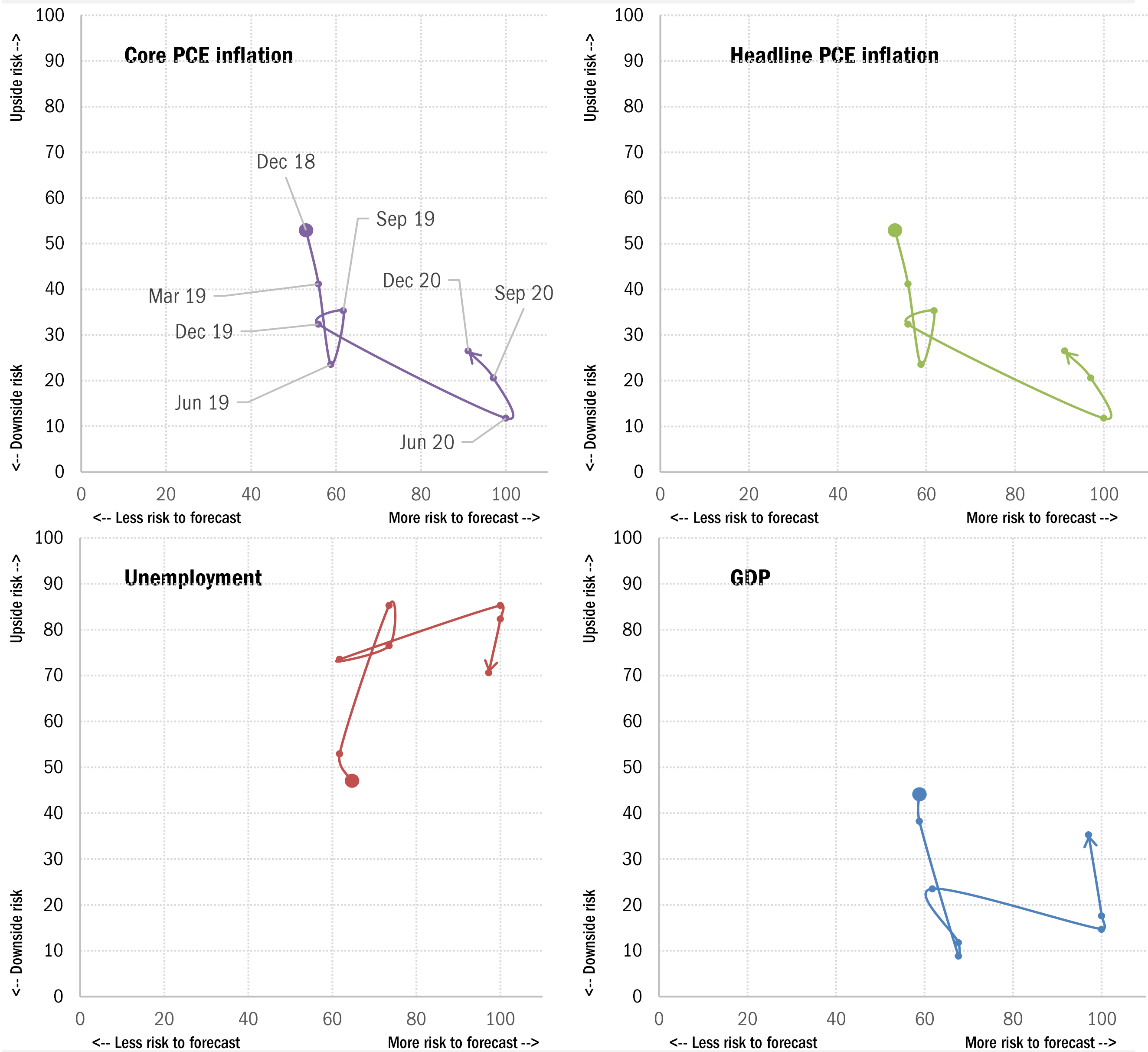
[About us]

Direction and quantum of uncertainty in Summary of Economic Projections by FOMC members   Diffusion indices of participants



Source: Federal Reserve Board, TrendMacro calculations

and the risk is all on the downside, but forecast uncertainty is decreasing, and the sense that it's all on the downside is decreasing too (please see the charts above).

- For all that, FOMC participants made no upward adjustments in the "dotplots" showing expected "optimal" policy rates. Indeed, the average "dot" for 2022 fell by 3 bp. The average was unchanged for 2023, but the highest single dot fell by 25 bp.
- *We note that toward the end of the press conference, Powell was asked about whether a surge of pent-up demand in 2021 – very much what we are forecasting* (again, see "Do We Need More Stimulus?") – *would have inflationary consequences*. We are delighted to report that Powell answered exactly as we said we

would expect – that any inflation uptick associated with a demand surge would be a one-time transitory affair, linked to the one-time enhancement of personal income driven by this year's stimulus checks. Powell agrees with us that such an inflation uptick would not drive a secular upward shift in inflation expectations, so *the Fed would unlikely have to make any policy changes toward tightening*.

Bottom line

No statement language changes, except weak forward guidance that asset purchases would stay in place until the economy makes "substantial progress." That had been signaled clearly in the minutes of the prior meeting, but there was no action on the hint that the Fed might extend maturities of its asset purchases, which would have been more stimulative. We don't understand how the "dot-plots" can have fallen again, and how Powell can continue to call urgently for stimulus, and yet the Fed does not supply all the stimulus it might. Powell acknowledges that a pent-up demand surge next year could lead to a transitory bump in inflation, but that it would be unlikely to shift long-term inflation expectations or require tightening by the Fed.