TAKE FIVE with Bill Emmons

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Fighting a Two-front War: Fed Battles Shrinking Economy

Transcript

Bill Emmons: Hi, this is Bill Emmons and I'd like to talk about the FOMC meeting that occurred April 28 and 29. Today's Friday, May 1. So I'm going to characterize the Fed's operations these days as fighting a two-front war. The Fed is battling a shrinking economy and financial turmoil. I think the key takeaways from this meeting include the economic outlook. The FOMC foresees a severe economic contraction with recovery likely to begin in the second half of 2020, although there's a great deal of uncertainty. There will be downward pressure on inflation making it unlikely that the Fed will be able to hit the 2% target this year.

Now, I'm going to divide the actions of the Fed right now into two parts. First, the monetary policy actions. The Fed kept the Fed funds target range at a 0 to .25% range. The interest rate on excess reserves will remain 10 basis points. And the FOMC revealed that they will continue large-scale asset purchases, but they will taper in size. The second group of policies are what I'm going to call financial market policies. These directly affect individual institutions and markets. And as I'll show you, the Fed now operates 12 different emergency facilities, some in the cooperation with the Treasury Department and the SBA.

So first, let's talk about the economy and what the Fed's trying to do there. So monetary policy affects broad financial conditions in the economy and the Fed operates under a so-called dual mandate. We try to hit a 2% inflation target over the medium term and maintain employment at its maximum sustainable level. That's obviously very difficult at this point. So the conventional policy tools the Fed uses primarily is the short-term interest rate, the Fed funds rate target. And then, there's also unconventional policies that were begun during the financial crisis of 2008 and 2009. These include, first, large scale asset purchases, which are sometimes called quantitative easing, and also, forward guidance on the path of interest rates.

Well, as we know, the FOMC exhausted its conventional policy tools and then turned to the unconventional tools, just as we saw back in 2008. The Fed hit the zero lower bound on interest rates on March 15. At that point, the tools left for monetary policy are unconventional. And in the last six weeks, the Fed has purchased $1.7 trillion dollars of treasury and agency, residential and commercial mortgage backed securities, an incredible acceleration of that purchase program.

So how bad is this economic contraction? This picture shows you annual changes in real gross domestic product. That is how fast the economy is growing each year from 1902 through 2019. The first thing that's obvious is that in the first half of the 20th century, economic volatility was much higher. We've had a much calmer, more steady growing economy after that. So the forecast by the IMF, which is in line with many other forecasters, is that for the entire year 2020, the US economy may shrink about 6% after adjustment for inflation. Compare that to the worst year during the last financial crisis, 2009, it was about a 2.5% decline. To see anything like this, you'd have to go back to 1946, which was the demobilization after WWII with an 11.6% decline.

If you look at the very real time data which the New York Fed tracks in their weekly economic index, we are currently running, according to their estimates, at about that 12% year over year rate of decline. So this is the most severe since 1946. And of course, before that, you have to go back to the 1930 to 1932 period for anything quite this severe. So this is a very, very serious contraction.

The second front in this two-front war is the Fed is trying to prevent another financial crisis, and the reason for that is that historical and international evidence shows very clearly that a financial crisis makes a recession much worse. Typically makes it last longer, too. And as we recall, there were severe disruptions appearing in financial markets in early March of this year. So the Fed, at that point, stepped in and played its role as the economy's lender of last resort to try to prevent those early disruptions from turning into a full-fledged financial panic and then a financial crisis.

Traditionally lender of last resort interventions fought panics in the form of bank runs by depositors. But importantly, back in 2008 and 2009, the Fed expanded its definition of a financial panic to include sometimes what are called "shadow banks", not commercial banks, but other financial institutions very important to the financial system, and financial markets, more broadly. And at that time, the Fed rolled out many emergency lending facilities that were completely new. And as I'll show you, some of those have been reestablished and there are new ones that have been brought up this time, too.

An easy way to show to date when that financial disruption really started to become a problem, just look at the interest rate on one-month double-A rated nonfinancial commercial papers. So these are highly rated businesses issuing short-term securities. That's the red line. The blue line is the one-month Treasury bill, the very lowest credit risk. Prior to early March, you can see those rates were virtually identical. So investors considered these double-A rated short-term investments almost as safe as a Treasury. But that clearly changed in early March while the Treasury bill yield went down following the Fed moves to cut rates to zero. The commercial paper rate did not follow; in fact, it spiked up.

Looking at the spread between the commercial paper and the T-bill, you can see the expansion of that spread. And I've marked where the Fed began rolling out these emergency programs on March 17. It didn't immediately quell that panic in this market or in some of the other markets, but you can see over the next couple of weeks it did. And by April, those spreads, although not completely back to normal levels, are much, much reduced.

Here's a list of the 12 emergency Fed funding credit, liquidity, and loan facilities. Some of these are old from the 2008 crisis; some of them are new. The first four listed here were used either back in 2008 or in first case already in 2019, and then those indicated with the new are ones that just started up in March and are in the process, in some cases, like the Main Street Funding Program, of being rolled out. So this is an incredible array of inventions to try to address problems in financial markets.

Comparing the progress the Fed has made on the two fronts, I would say greater progress is visible in the financial markets than in the economy so far. One way to think about that is to look at the stock market. This picture shows on a monthly basis the year over year change in the S&P 500 adjusted for inflation. This goes from 1922 all the way through April this year. Again, those first half of the 20th century, some of the volatility there is much greater than we've seen more recently, although that's certainly the case that we have seen some very sharp declines in the last couple of decades.

But what's really notable is that through April of this year, the decline in the real S&P 500 is only about 5.7%, way below what you would have expected for what seems to be a very, very severe crisis brewing in the economy.

So, what are the implications for banks? Well, I think first and obviously, the economy is in dire shape and many of borrowers will be under severe stress for the next few months, at least. Financial markets appear to have stabilized suggesting the Fed successfully averted a financial crisis at least for now. And short term interest rates are pinned at zero and financial markets suggest there's little prospect of an increase for months or even years into the future.

So, what should we expect next? Well, be prepared for a severe recession in 2020. It's probably already begun. Worse than 2008 to 2009 and possibly the worst since 1946. States in our district will not be spared. There seems little prospect that this recession will be concentrated only in some parts of the economy. Economic recovery may begin in the second half of 2020, but this remains very uncertain at this point. And finally, the Fed will continue to act aggressively and creatively to support financial markets in the economy.

Thanks for listening and we'll see you next time.

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