TAKE with Bill Emmons FIVE

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FOMC CUTS RATES AGAIN, LEAVING TWO IMPORTANT QUESTIONS UNANSWERED

Transcript

Bill Emmons: Hi. I'm Bill Emmons and it's Friday, September 20. I'd like to talk about the FOMC meeting that took place September 17 and 18. At that meeting the Fed cut rates again, another 25 basis points. But I think they left at least two important questions unanswered.

First, the meeting takeaways. The FOMC signal, in its statement, a favorable economic outlook driven primarily by household spending. And they showed little concern about inflation. The Fed funds target range was cut by a quarter percentage point to a range now of 1 ¾% to 2%. The Fed also reduced the interest rate on required and excess reserves to 1.80%. At the same time, the Fed's open market's test this week intervened in money markets using overnight repos. That is the Fed lending cash against securities. This is the first such intervention since the financial crisis of a decade ago.

It was also notable in that there were three dissents. Presidents Eric Rosengren of Boston, Esther George of Kansas City. Both wanted no change in the target range. Where St. Louis Fed President James Bullard wanted a 50-basis point reduction. So, dissents went both more and less than what the committee actually did.

So, the first unanswered question, I think, remains, why is the Fed cutting the Feds fund rate if the economy still looks good? The FOMC, I think, has offered three explanations while rejecting at least three other, possibly plausible stories. The reasons the FOMC says it is making the rate cuts include a mid-cycle correction, weak global growth and rising trade tensions, meaning tariffs. The reasons that the FOMC says are not making them cut rates include; pressure from the White House. And Chairman Powell was pressed on that again at the press conference. Whether it's influencing the Feds thinking and he dismissed that out of hand. Also, there's no indication the Fed believes there's increasing US recession risk. That's not why they're cutting. Nor is the inverted yield curve, apparently, driving this decision.

So, let me take a closer look at the explanations that the FOMC has offered. First, the mid-cycle correction. Now, as you recall, the switch from raising rates last year to cutting rates this year was unusually rapid. The last increase in December of 2018, the first decrease in July of 2019. This might suggest that the Fed went too far raising rates in 2018. And, how could we know so quickly to change our orientation? How could we know in real time? Except through market reactions. Which, according to the discussions from Chairman Powell and others, is not driving the FOMC's decisions.

So, let me make a few personal observations. Only my own views, not those of anyone else that the St. Louis Fed or elsewhere. I think it's not clear how the mid-cycle correction maps into this sequence of two rate cuts. We could ask, why not make all of those adjustments at one time? And I think President Bullard has made comments to that effect. It's also the case that the FOMC has not stated that we went too far in 2018. And so, at least the circumstantial evidence suggests maybe that violent market reaction we saw late last year could have had a more significant impact on this adjustment this year.

As for the weak global growth, that is, in fact, a very consistent argument for why the Fed would be cutting right now. This is what economists would call a negative demand shock. So, let me take a quick look at this. Bring you back to school. In this picture of aggregate demand and aggregate supply, before a shock hits the economy, there's a certain level of growth, a certain level of inflation. Shown here as the output level and the price level. Then, a negative demand shock hits the economy. Examples could be; a decline in US business confidence or consumer confidence or, in fact, a large recession overseas. Which could have a downward effect on US exports. That's shown in this diagram as a leftward, downward shift in the aggregate demand curve. That puts downward pressure on output and on prices.

So, the textbook response of monetary policy is to ease financial conditions. Typically lowering interest rates but also talking about a lower path of rates going forward. Which would tend to increase some spending, interest rates sensitive spending, pulling demand forward. And that would shift that demand curve backup and restore the original levels of output and prices. So, this is the classic explanation of exactly what monetary policy is trying to do. So, that is logically consistent, why the Fed might be cutting. But it's not as clear if the overseas growth slowdown has been big enough or rapid enough, really, to explain why there's been a 50-basis point reduction. Typically, in the past, the Fed has not been looking at foreign economies very much at all, really focusing much more on the US economy which continues to be pretty strong.

So, the other explanation I want to look at is trade. Rising trade tensions and uncertainty about this trade war. This is what economists would call a negative supply shock. And that would be in effect when those tariffs hit. So, again, going back to the economy before any shock hits us, we see a certain level of output and inflation. Then the negative supply shock pushes the supply curve left and up. This, in effect, reduces the efficiency of our economy. That has the effect of putting downward pressure on output, upward pressure on prices or inflation.

So, in this case the Fed faces a dilemma. Monetary policy can either fight the recessionary tendencies. That would be within an expansionary monetary policy action. Or it could fight the inflation and that would actually be a contractionary move. And this is what we saw back in the 1970s and 1980s. That the Fed reacted to oil shocks with tightening of policy, not loosening. So, the supply shock explanation is not as clear about what the Fed should be doing in response.

So, I think the tariff's also, have not been large enough to make a big difference in our growth. That's evident by the fact that the economy continues to grow at over 2%. And, as I said, this supply shock presents a dilemma for monetary policy and so, it's not so clear whether the Fed should be cutting or increasing or neither. And I would say also, with the trade policy uncertainty that this cuts two ways. The Fed could offset what at this point still are probably relatively small negative effects on business sentiment. But it's also true that the cuts could expand the scope for more trade warfare, increasing the scale of any eventual negative supply shock. So, it's a little bit hard to map directly those trade tensions into policy. Which, of course, Chairman Powell has been at pains to explain. That we don't have a real playbook for this situation.

So, I think the second unanswered question is, why now? And have been for some time, why are the rate paths of the FOMC and the financial markets so far apart. At this meeting we got projections from all of the FOMC members of where they would see the path of the Fed funds rate over time, under appropriate policy as they see it. The median FOMC member's rate projections include no further rate cuts this year or next year. And, in fact, gradual increases starting in 2021. At the same time, projections based on financial market prices include one additional cut this year that is 25-basis points down from the current level. And an additional cut in 2020 taking it to 50-basis points below current levels. And so, this is an unanswered question. Why the Fed and the financial markets remain so far apart.

So, the implications for banks, I think, include a favorable outlook for the economy from the Fed. Chairman Powell was at pains to state that the Fed is in good shape. Inflation appears to be under control, so rate increases seem very unlikely in the near term. There is divided opinion within the FOMC about the proper direction of policy. And that would suggest, I think, that rate cuts also are unlikely without further evidence of economic weakness. So, we'll just have to wait and see on that.

So, what to expect? I think economic uncertainty and market volatility have actually calmed down a bit. They're remaining moderate. I think the rate outlook is unclear and economic data will determine the path of the funds rate. I think it's possible that the focus of financial markets during the next few weeks may shift away from rates and maybe toward conditions in money markets. Which the Fed is watching very closely. Because it appears now that there may be some unfinished business from the financial crisis. And that is, how will the money markets operate under this new regime with new regulations on liquidity and a very large Fed balance sheet. Thanks for listening and we'll see you next time.

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