A 'surprise' on forward guidance?

Dr Robert Gay | Fenwick Advisers | 12 September 2014

Speculation is building that the Fed will surprise financial markets with a new framework for forward guidance, perhaps as soon as the Federal Open Market Committee (FOMC) meeting on 16/17 September.

Minutes from the previous meeting include a discussion of how the Fed might expand on its assessment of other dimensions of labor market utilisation, rather than relying primarily on the unemployment rate. Chair Yellen has long emphasised the complex nature of today's unemployment picture. The issue of how to convey the FOMC's views on that complexity clearly is coming to a head. As the minutes concluded: "Many members noted, however, that the characterisation of labor market underutilisation might have to change before long, particularly if progress in the labor market continued to be faster than anticipated."

I spent some time recently at the Fed, visiting my former colleague, Bill Wascher, who now is Deputy Director of the Division of Research and Statistics. Recall that Wascher co-authored the paper on the output gap last autumn which, in my opinion, signaled that the Fed was running out of time to begin tapering its asset purchases. Now he has co-authored another paper on labor force participation that can be found prominently on the Fed website. Again, this research paper is no coincidence since the issue of why labor force participation has stayed depressed during this recovery is critical to the Fed's view of how much slack still remains. Roughly four million prime age men and a comparable number of young persons have remained on the sidelines, presumably because of insufficient job opportunities to warrant job search. The question, of course, is whether or not more monetary stimulus would help to generate more jobs, or whether these workers face bigger problems in that their skills do not match those that new jobs require - that is, that the remaining slack represents a 'structural' mismatch of skills and job requirements that cannot be remedied with monetary policy alone.

Bill and I reminisced that while the issues were quite similar to those faced during the Volcker years when he and I wrote similar papers, the answers seemed to be quite different. Namely, many discouraged workers during the early 1980s were adult women who were choosing careers and would reenter the labor market as opportunities arose. By contrast, many adult men were hit by plant closures and consolidation in the face of foreign competition and their road to re-employment often would require new skills. However, the US labor force has aged significantly since then and the magnitude of lost manufacturing jobs is much greater today. Manufacturing has lost about seven million jobs since 2000, four million of those since the onset of the Great Recession in 2008 - roughly four times as many as were lost during the

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1980s. In short, it appears that more of today's unemployment can be characterised as the stubborn structural type that monetary stimulus alone cannot resolve.

If so, then it is worth thinking more carefully about what the Fed can expect to achieve with its 'forward guidance'. Financial markets seem to be fixated on the timing of the first rate hike because that date will mark the official end of many carry trade opportunities. Indeed, the recent selloff in high yielding EM currencies seems to reflect an early exit in anticipation of some new guidance from the Fed. Likewise, the US dollar's recent strength against most major currencies belies a similar sentiment – that the Fed will signal an early rise in the fed funds rate because labor market conditions, however defined, are improving more quickly than the FOMC's members had anticipated. While this reaction makes sense to traders, it is reminiscent of the spike in long rates during May 2013 when markets sensed that the Fed was preparing to taper its purchases of US Treasuries. The sudden rush to the exit caused a downward spike in bond prices that has been reversed as the Fed's withdrawal from its large scale asset purchase program has proved to be gradual and predictable.

The Fed now faces a similar challenge in signaling the eventual normalisation of short term interest rates. Zero is not the correct policy rate at full employment, especially if inflation is anywhere close to the Fed's target of 2%. The Fed wants to give advance notice on 1) the timing of the first rate hike; 2) the likely progression of the policy rate toward neutral level that would no longer be stimulative; and, 3) some indication of what the neutral rate will be sometime in the future. In short, there are three dimensions to forward guidance, but only one indicator of when the Fed should reach the 'new normal' – namely, by the time the economy reaches full employment. If the other policy target of 2% inflation is breached significantly, we would know of course that price pressures are at hand. But, unfortunately, that also would mean that the Fed is remiss in not normalising policy sooner, which is an outcome that the Fed would like to avoid.

In that context, it is worth contemplating the implications of structural unemployment, if in fact that is a big part of the current disaffection towards searching for jobs. Remedies might include retraining or relocating or even redesigning our cities and work arrangements. None of these initiatives sound either quick or easy, in which case any resolution of US unemployment problems will take a long time. To make matters worse, the prospect of secular stagnation – the notion that a combination of an aging global workforce (a potential demand shock) and the hollowing out of western manufacturing by the rise of Asian manufacturing (a supply shock) plus the income inequalities that globalisation has engendered together are conspiring to lower potential growth almost everywhere – makes for a grim outlook for global growth in general and poor possibilities for job creation, in particular. For the Fed, those trends would portend a lower neutral rate rather than an early first rate hike or a faster path to back to normal. Put in other words that the Fed now uses, heightened uncertainty about the future translates into a lower neutral rate – or at least a great deal of caution in raising rates beyond about 2-1/2% without compelling evidence that tight domestic utilisation rates are the cause of inflation overshooting its target.

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Whether or not the Fed comes up with new guidelines for forward guidance at the FOMC meeting, it inevitably will be faced with an ongoing challenge as to how to balance their desire to be transparent on future policy and the practical need to keep their options open.

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