Fed Taking More Cautious Approach

Joseph E. Gagnon says Federal Reserve officials are warming to the view that the risks of raising interest rates too soon are much larger than those of holding monetary policy steady for a while longer.

Pedro da Costa: Hi I'm Pedro da Costa, Editorial Fellow here at the Peterson Institute for International Economics. And I'm joined by Joseph Gagnon, Senior Fellow here at the Institute to talk about what I see is a recent shift in Fed policy towards a slightly more dovish take. We had an FOMC decision that seemed to kind of acknowledge and really focus on the recent weakness both on the domestic front and on global risks. And then we had testimony from Chair Yellen this week in Congress that didn't really push the envelope any further as far as where she sees policy. And she's certainly not willing to commit to any calendar dates. How do you interpret the Fed's last decision and where do you think they are in policy?

Joseph Gagnon: Well, I think there's two factors behind the decision. The one that's easy to point to is the May employment report which came out just a couple weeks ago was surprisingly weak. And although the headline unemployment rate did come down that actually was at odds with the whole rest of the report which is all a story about weakness and I think that may have rattled them.

But, on the other hand, they didn't really mark down their forecast all that much despite that data, which makes you wonder. Well, then, why are they putting off a tightening? And part of that might be, well, they're nervous about their forecast because of that data so who knows.

But I think the other piece is that they are increasingly worried that the risks are not symmetric that the risks if they do go and tighten too much pushing us back down into too low inflation are much, much greater, much, much more worrisome than the risk from the other side. And, I think, a lot of this is reflecting the fact that the headwinds that they see slowing the economy really the ones they can point to are gone. And yet, growth is still slow. So what's going on?

So I think they're revising down their estimate of what the natural rate is and what the equilibrium real interest rate is going forward. And they're looking at other countries and seeing problems. And they're saying, "We don't want to have some of the problems we see in Europe and Japan."

Pedro da Costa: So basically, in the aftermath of the crisis, you had Fed that very much believed that we'd get a strong bounce back and that we'd get kind of a full return to what used to be potential growth which was even closer to a 3 percent rate of growth. And now we see the Fed consistently overestimating growth at the start of the year and then having to revise down their forecasts and kind of. So is this kind of a capitulation after several years of regrowth they kind of start to look ahead and just think that maybe this is what we're stuck with?

Joseph Gagnon: I think that's right. I think we had seven going on eight years now in which they first thought there would be a relatively quick recovery. And then it didn't happen. And then they told themselves. Well, we see special reasons. The people's 401(K) plans took a hit. Housing prices took a hit. They have to repair their balance sheets. And then fiscal policy was a drag. And all of those who have dissipated and still growth were still not.

So I think that has led them to think, oh well, something else is going on, namely, the potential of the economy is weaker. And the interest rate that we need to set for normal—the new normal for interest rate is lower.

Pedro da Costa: See, I sense the tension there though in that view because if that were indeed the case then that would lead them to be more worried about inflation pressures even from sort of what we consider moderate job growth. And yet, we see no sign of inflation. We see inflation that consistently has undershot the Fed's target. If anything, inflation expectations have continued to trend lower in a worrisome way for some. And so isn't this the moment that gives them the leeway to try something new to keep sort of pedal to the metal until they see employment growth that is satisfying?

Joseph Gagnon: Well, I think, they're inching that way and that's what we see. I think it's awkward for them to communicate because they say they're data dependent and they can point to the unemployment data, I suppose, lately.

But really what's going on in this case is the decision is not dependent on the latest economic data, but rather their own thinking of how to interpret several years of data. So their model of economy is sort of shifting or at least the parameters in that model are shifting. And how do you explain that to markets?

That is tough, but I think that's what they're doing. I think they're edging in that way as you say. I think they would just much rather have an overheating economy and rising inflation after all because they know how to deal with that than the opposite. Because when they look around the world and see countries that have the opposite problem, they think, "Geez, it's much harder to deal with that."

Pedro da Costa: Yeah. So what does that mean for the rate outlook because, again, I feel like the Fed trapped itself in a way that was unnecessary? Because after the December rate hike, they said they were data dependent. The market seemed to take them at their word. And so, the market was shifting with the data. But then certain Fed officials came out and committed themselves to a certain number of rate hikes in the year. And that set a whole new set of communication challenges that they then had to backtrack from. Do you think that was a policy mistake? And do you think they're not going to just kind of be more open-ended about it?

Joseph Gagnon: Well, it's hard to call it a mistake if you're changing your mind. I mean is that a mistake because you changed your mind? I don't know. I would prefer not to call it a mistake. I would just say they are changing their mind. It's a process that takes time. It makes it hard to communicate. Because when you're changing your mind, what do you say?

Pedro da Costa: You're trying to be transparent at the same time if that's what—

Joseph Gagnon: Yeah. I think what they said last year reflected where they were last year. And even though there isn't a lot of data in the meantime to change their mind, it's really more their reassessment of several years of data. And so you can't point to any one recent data point. But, yeah, how do you talk about that? It's very hard to communicate that.

Pedro da Costa: And so given the current scenario, where do you see their next move coming? Do you think July is still a possibility if there's no Brexit and everything is resolved? And do you think July is still a possibility or do you think September is more likely, gives them more time to think about it?

Joseph Gagnon: Well, yeah, I think July is (a) if there's no Briggs, (b) if the June unemployment report is very strong maybe July could happen. But it seems unlikely. I mean it would probably take some surprising upward development that is hard -- that's really unlikely. So more in September possible; even September would require some good news.

Pedro da Costa: Yeah. We'll leave it there. Thanks so much.

Joseph Gagnon: Okay. Sure.

Pedro da Costa: I appreciate it.