Fed's Clarida Reinforces The Base Case No-Cut Scenario While Monitoring Risks

- The Fed's base case remains positive against easing bets;
- The alternative scenario of downside risk speaks to what markets are already monitoring;
- There is still an upside narrative worth telling.

Federal Reserve Vice Chair Clarida's speech (here) carried no real surprises but it's worth briefly reinforcing where the top of the house at the Fed stands on the current and future stance of monetary policy.

Clarida explains that **the Fed's base case** remains that "the U.S. economy is in a very good place," and "the federal funds rate is now in the range of estimates of its longer-run neutral level" while "the current stance of policy remains appropriate" and that "some of the softness in recent inflation data will prove to be transitory." **This base case view leans against market pricing for rate cuts without slamming the door on them.**

The **alternative scenario** is expressed in the following quote:

> "However, if the incoming data were to show a persistent shortfall in inflation below our 2 percent objective or were it to indicate that global economic and financial developments present a material downside risk to our baseline outlook, then these are developments that the Committee would take into account in assessing the appropriate stance for monetary policy."

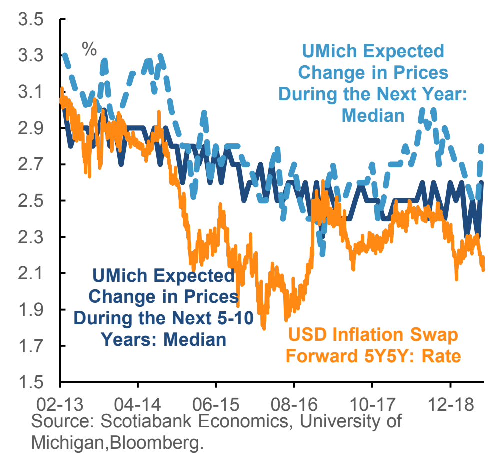
That should come as no surprise. For one thing, they keep saying something to that effect and for another the market is watching the same uncertainties. The Fed is in standby mode assessing risks and is more worried about downside risks than upside risks but not enough to make those downsides its base case scenario. One can't fault them for this policy bias given the shape in which we find the rest of the global policy framework beyond monetary policy considerations.

I do, however, think that **largely ignoring potential upside risks with nary a mention is unusual for a central bank.** For instance, what if inflation responds more positively to the lagged effects of the aggressive move into excess aggregate demand with not enough time having been given for expecting this to have occurred? What if growth exceeds expectations as it generally has for multiple quarters and the bond market's automatic stabilizers assist such upsides? What if factors weighing down inflation are truly transitory and we bounce higher than the Fed or consensus think? What if the broad dollar has a lessened effect on core inflation into 2020 given that the recent appreciation over the past month may or may not last and has only taken us back to levels late last year? The disinflationary effects of the sharper appreciation throughout 2018 should dissipate by year-end if the Fed's standard rules of thumb are adhered to. What if the Fed is underestimating wage Phillips curve influences with wage growth at about a ten year high amidst notable real wage gains? What if into a Presidential election year (or sooner, like the G20) a trade truce is called? **What if all of these things happened together?** That's a lot of 'ifs', but the polar opposite narrative of downside risks is also dependent upon a whole suite of 'ifs' all going

CONTACTS

Derek Holt, VP & Head of Capital Markets Economics
416.863.7707
Scotiabank Economics
derek.holt@scotiabank.com

Falling Inflation Expectations - But No Crisis Yet



Source: Scotiabank Economics, University of Michigan,Bloomberg.

wrong. Balanced monetary policy risk assessments can't ignore the upside tail even if one skews the assigned probabilities in one direction over the other.

The core of the speech explained the main considerations that have changed over time to merit re-evaluating the Fed's overall framework. None of these reasons are new insights but they're nicely pulled together here.

1. The fall in r*, or the real neutral rate of interest.
2. The fall in u*, or the natural rate of unemployment. Clarida expressed the view that "I believe the range of plausible estimates for u* may extend to 4 percent or even below." This reinforces his earlier remarks that the unemployment rate could push lower without igniting material inflation.
3. A flatter Phillips curve.

His quote on inflation expectations is a bit more interesting. It suggests that much further downside in such measures would cause some concern.

> "As I assess the totality of the evidence, I judge that, at present, indicators suggest that longer-term inflation expectations sit at the low end of a range that I consider consistent with our price-stability mandate".

I'm less sure of that though it partly depends upon exactly what measure may be best. The accompanying chart shows a few and it's not clear to me we're anywhere close to crisis mode. In fact, it remains feasible that falling inflation expectations from previously excessive levels is a policy success. Perhaps the market and consumers have more faith in the Fed hitting its inflation goals over time such that the years in which both sets of readings seriously overshoot actual inflation may be transitioning toward a newer reality.

In tying it all together, Clarida utilizes a Taylor rule approach. Obviously this is always dependent upon agreement toward the inputs, but **Clarida observes that the Fed's inputs arrive at a policy rate range of 2.25–2.5% which is where the policy rate presently sits.**

The bottom line is that overall Fed guidance is unchanged. They're close to their dual mandate goals, the economy is doing well, they view inflation (core) as temporarily weak, core PCE is expected to rise in terms of their central thinking (ie: no cuts, leaning against them) but if it doesn't and things skid in the ditch then they'll react. That should surprise absolutely no one.

That brings us right back to where we left off with the latest information to the inflation debate (recall here). We remain in for the long haul in terms of tracking core PCE developments over coming quarters, not just for a print or two or a handful.

On timing when to expect the Fed to weigh in on potential alterations to their framework, Clarida noted:

> "In addition, we are holding a System research conference next week at the Federal Reserve Bank of Chicago that will feature speakers and panelists from outside the Fed. Building on both the perspectives we hear and staff analysis, the FOMC will conduct its own assessment of its monetary policy framework, beginning around the middle of the year. **We will share our conclusions with the public in the first half of 2020."**

On what to expect, Clarida left the door wide open to tinkering or substantive changes to the framework but without further elaboration:

> "…my colleagues and I do not want to prejudge or predict our ultimate findings. What I can say is that any refinements or more-material changes to our framework that we might make will be aimed solely at enhancing our ability to achieve and sustain our dual-mandate objectives of maximum employment and stable prices."

There is likely a high bar to big changes to the framework. By way of other global central banks, the BoC's review of its policy framework every five years since it embraced inflation targeting in the early 1990s may be an appropriate reference. There have been tweaks to the operational parameters—such as three core inflation measures versus one, two output gap measures versus one and a new exchange rate term—but the broad 2% inflation targeting framework hasn't been meaningfully altered since the beginning.

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