Watching the Fed Watch Covid-19

By Tim Duy *Thu, Nov 19, 2020*

The Fed's tea leaves are perplexing our guest columnist, an economist at the University of Oregon. Whether we see 'quantitative easing' may depend on how bad the pandemic resurges and how financial markets react, he writes.

The Fed has positioned itself in such a way that its next move seems obvious and that it will ease policy further by some means sooner than later—with sooner being the December FOMC meeting. Expectations are moving in the direction of the Fed shifting asset purchases toward the longer end of the curve. Not to be outdone, some shops are expecting the Fed to increase the pace of asset purchases.

I have some nagging doubts about this narrative. Here I am going to outline those doubts and hopefully provide some context. Six facts are central elements to the growing narrative:

1. As in the last cycle, the Fed forecasts that inflation will remain below target for a protracted period of time. So the Fed should take further action to support the economy and accelerate the return to target. They haven't yet, but presumably could.
2. Fed officials have expressed concerns about the dual downside risks of a Covid-19 surge and insufficient fiscal support. Both of those events look more like reality than risks.
3. The Fed has also expressed concerns about inequalities and permanent job loss arising from the pandemic recession. Federal Reserve Chair Jerome Powell reiterated these points. There seems to be no point in complaining about such issues yet still hold policy steady.
4. The Fed believes their tools remain effective. On Monday Federal Reserve Vice Chair Richard Clarida pointed to interest rate sectors of the economy as evidence that monetary policy was just as effective in this cycle as in past cycles.
5. Federal Reserve Governor Lael Brainard said in October that "in the months ahead, we will have the opportunity to deliberate and to clarify how the asset purchase program could best work in combination with forward guidance to support achievement of maximum employment and 2% average inflation."
6. With interest rates at zero and the Fed dismissive of yield curve control, the primary tool available to the Fed is the asset purchase program. The Fed discussed possible extensions of the asset purchase program at the November FOMC meeting.

The path from those acts to some type of action at the December meeting seems straightforward. So what’s eating at me?

First, I don’t know entirely how to interpret Powell’s dovishness. I think he is rightly concerned that showing optimism will lead market participants to erroneously conclude that the Fed is closer than expected to hiking rates. He is genuinely committed to sustained accommodative monetary policy. Even if the US recovery remains intact this winter, the economy will still be in a hole with high unemployment. I don’t think he wants to blunder into a “taper tantrum” and slow progress toward the Fed’s goal.

That said, if Powell is concerned about inequality or long-term labor market damage, why hasn’t he pushed his colleagues into expanding the pace of asset purchases? The situation now is no different from two or three months ago. I can only conclude that he views monetary policy as a poor substitute for fiscal policy at this point.

When Powell says the Fed has reviewed the asset purchase program and concluded that it is providing the appropriate amount of accommodation, he may be saying that increasing it will neither accelerate the recovery nor deal with the structural issues that concern the Fed. Why then would they do something in December that they have already concluded won’t help?

While Powell may be suppressing optimism, Clarida let the optimism fly as he revealed that the good news on the vaccine gave him

“…more conviction in my baseline for next year and more conviction that the recovery from the pandemic shock in the US can be potentially more rapid, potentially much more rapid, than it was from the Global Financial Crisis…there is an enormous quantity of pent-up saving….so you [if] combine the good news on the vaccine with north of a trillion dollars of accumulated saving, then there is a very, very attractive right tail to this distribution.”

Could Powell see more upside risk than he is willing to admit?

Second, the Fed has not identified how the asset purchase program interacts with the Fed’s new strategy. The path of the asset purchase program and its relation to economic outcomes has not been tied down as the path of interest rates has. Powell said this at the November press conference:

EDWARD LAWRENCE. What would cause the Federal Reserve to shift more of its asset purchases towards the long-term securities and Treasuries and change the amount of spending there also? And, if there's no fiscal stimulus package, would that trigger buying of more long-term assets or change the asset purchases?

CHAIR POWELL. We understand that there are a number of parameters that we have where we can shift the composition, the duration, the size, the life cycle of the program. All of those things are available to us as ways to deliver more accommodation… Right now, we like the amount of accommodation the program is delivering. It will just depend on the facts and circumstances.

What "facts and circumstances" were discussed? We don't know. We can only assume that the "facts and circumstances" include addressing the negative impacts of a Covid-19 surge, but we don't know that. Again, it appears the Fed has concluded that changing the asset purchase program would not accelerate the recovery. So why would they believe it could offset fresh pandemic weakness?

One obvious set of "facts and circumstances" would prompt the Fed to alter the asset purchase program: A financial disruption. And that brings me to my third concern. A financial hiccup would get the Fed's attention and provoke a response. As of yet, however, there has been no financial disruption, despite the surge of cases across the nation.

The financial situation appears very different from this past spring. Then the markets quickly discounted the implications for the economy and stocks crashed while credits markets nearly froze. This time no such thing has occurred. Why? First, this will be "lockdown light." It will have less significant economic impacts. Second, selling off is foolish because we know there will be a rebound on the other side. Third, market participants are looking through the short-term problems to the long-term solutions.

Whatever the reason, financial markets are not tightening. To be sure, longer term interest rates are edging higher, but that increase could be consistent with improving economic conditions, so it is not readily obvious the Fed would need to push back. This from Clarida was illuminating:

We are buying a lot of Treasuries, we're buying $80 billion a month, that comparable to the path of QE2 and it's roughly the duration pull…with long-term yield at historically low levels and below both current and projected inflation, financial conditions are accommodative…not concerned about the rise in Treasury yields and it is still in an accommodative range.

Those were not the words of someone interested in expanding asset purchases or changing the duration of the program to sit on the long end of the curve.

Bottom line: I don’t know that the Fed’s behavior with regard to the asset purchase program to date argues for changing the composition of purchases in response to feared renewed pandemic weakness.

If the Fed believed alterations to the program would affect economic outcomes in the current environment, they should already have changed the program. That outcome, though, seems more likely than expanding the pace of asset purchases.

Another possibility is that the Fed decides to clarify the length of the program to make is consistent with guidance on the interest rate. This seems like an easier call than other options.

The most likely reason to alter the asset purchase program would be to offset a tightening in financial markets. As of yet that doesn’t seem necessary. The upcoming minutes of the November FOMC meeting might reveal new information and the Fed’s discussion of the asset purchase program.