Fed Frets Over Fiscal Cliff

By Tim Duy *Thu, Jul 30, 2020*

'The Fed intends to maintain accommodative financial conditions for years,' writes our guest columnist, an economist at the University of Oregon.

The Federal Reserve reiterated its intention to “act as appropriate to support the economy” at the conclusion of this week’s policy meeting while worrying that resurgence of the virus threatens to derail the recovery.

Federal Reserve Chair Jerome Powell emphasized the importance of fiscal policy in supporting the recovery, a not-thinly veiled hint that Congress (or, more specifically, Senate Republicans) need to get their act together.

No new policy measures were announced although Powell did hint that the policy review would be complete by September. Overall, a dovish message. The Fed intends to maintain accommodative financial conditions for years.

The FOMC statement was little changed from June, with the most notable addition being:

“The path of the economy will depend significantly on the course of the virus.”

This is not exactly news for most of us, but the Fed felt it important to emphasize that there is no tradeoff between the economy and public health. Until the virus comes under control, the economy can’t full recovery. The Fed is especially concerned that a resurgent virus already worsens the outlook. From Powell’s opening statement:

“Indeed, we have seen some signs in recent weeks that the increase in virus cases and the renewed measures to control it are starting to weigh on economic activity.”

Powell reviewed the Fed’s actions to support the economy and highlighted the importance of fiscal policy in minimizing the extent to the recession:

“Elected officials have the power to tax and spend and to make decisions about where we, as a society, should direct our collective resources. The fiscal policy actions that have been taken thus far have made a critical difference to families, businesses, and communities across the country. Even so, the current economic downturn is the most severe in our lifetimes. It will take a while to get back to the levels of economic activity and employment that prevailed at the beginning of this year, and it will take continued support from both monetary and fiscal policy to achieve that."

Powell commented heavily on fiscal policy, including praising the steps taken to date while making clear that the job is not done. It is hard to interpret Powell's position as anything less than a rebuke to Senate Republicans who have positioned the U.S. economy to fall over a fiscal cliff despite months of warning.

Powell could not be happy that he has to be the adult in the room; the Fed would prefer to stay out of fiscal policy. My suspicion is that he doesn't think staying quiet is an option. Why? Because buried under Powell's plead for more fiscal support was the implication that the Fed would be unable to compensate for a fiscal retreat.

To be sure, in response to a reporter's question Powell said the Fed has more tools available. Those tools, however, would not be sufficient to compensate for the fiscal cliff that lies ahead.

Powell said that meeting participants discussed the policy and strategy review and that they will "wrap up our deliberations in the near future." That to me sounds like September. He did not give any hints as to the outcome of that process. He played his cards a little closer to his vest than I anticipated. We will need to wait until the Fed releases the meeting minutes to learn more about the discussion.

The overall message was dovish: Powell indicated that disinflationary pressures were likely to dominate for the foreseeable future, that the recovery would not happen quickly and hence unemployment would remain persistently high, and that people really need to stop asking him when they will consider raising rates. That question is so far from his mind that he can't even begin to answer it.

Bottom Line: The Fed remains committed to accommodative policy. I expect that the Fed will conclude its policy review by September and then they will be free to take additional action. The three most obvious future actions are enhanced forward guidance, shifting asset purchases to the long-end of the yield curve, and yield curve control at the short end. Those would most likely occur prior to an expansion in the pace of asset purchases.