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Crosswinds, Muted Inflation Leave Clarida "Patient"

Board Vice Chair Clarida's wide-ranging speech yesterday evening was very dovish. He emphasized that "we can afford to be patient," the same language that Powell has been using. But he didn't sound nearly as optimistic as Powell, expressing much greater concern about slowing global growth in particular. His concern was overwhelmingly about downside risks, with risk-management concerns calling for at least a delay in further rate hikes. Indeed, he didn't make much of a case for raising rates at all, and some of his remarks will likely stoke speculation about the prospect of an easing. With regard to upside risks, his main point was that there is little reason to worry about too-high inflation. Many of themes of his speech were ones he has developed in recent speeches and interviews. But he stated them more forcefully here and suggested they have a greater relevance to current policy given recent developments in the U.S. data, foreign data, and financial markets.

Clarida began by discussing initial conditions, which he described as "favorable." In particular, real GDP growth was strong in 2018, and "ongoing momentum heading into this year indicates that that above-trend growth is likely to continue in 2019." The labor market is "healthy," with the unemployment rate low and job gains "continuing to outpace the increases needed over the longer run to provide employment for new entrants to the labor force." He also noted that wage growth is "picking up." Now, "Aggregate wage gains are broadly in line with productivity growth and our 2 percent inflation objective, and they are consistent with a labor market that is operating in the vicinity of full employment."

This all sounds quite positive. But for each of these positive points about growth and the labor market he gave a reason, or several, why it does not necessarily point to overheating. Sure, growth has been strong, but "Strong growth supported by supply-side gains in hours worked and productivity is not inflationary, as the experience of 2018 confirms." The unemployment rate is very low, but, "That said, the participants' median estimate of u* has been falling for several years as strong employment gains have not triggered a worrying rise in price inflation." Job gains have been strong, but "participation in the job market may still have some further room to rise." Wages are picking up, but "They are not, at present, a source of upward, cost-push pressure on price inflation."

As for the inflation picture, Clarida noted that, "notwithstanding strong economic growth and a low unemployment rate, inflation has surprised to the downside recently, and it is not yet clear that inflation has moved back to 2 percent on a sustainable basis." There appears to be at least as much concern among participants about too-low inflation as there is about too-high inflation. He clearly wanted to make the inflation outlook a more prominent part of the monetary policy discussion: "I will closely monitor the incoming data on inflation expectations as well as actual inflation, among the broad range of real and financial indicators that I consult. To me, it is important that any future policy decisions we may consider in 2019 be consistent with *both* pillars of our dual mandate" (italics his emphasis). Clarida focuses a great deal on inflation expectations in his decisions about monetary policy. As for longer-term inflation expectations, though he expressed some concern about possible softness, as he has before, he didn't express any alarm about the most recent decline in TIPS-based breakeven inflation rates. While "straight readings" of the TIPS data may suggest expectations have "drifted downward," adjusting for term premiums and liquidity suggests they "remain near 2 percent."

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He went on to say that the data on labor supply and productivity will also be important because of their implications for inflation. He thinks that stronger labor supply and productivity growth in 2018 could be sustained, boosting aggregate supply, which "would need to be factored into the inflation outlook and thus the appropriate settings for monetary policy." In general, he is skeptical of the risks of too-high inflation: "Were models to predict a surge in inflation, a decision for preemptive hikes before the surge is evident in actual data would need to be balanced against the cost of the model being wrong. Speaking for myself, I believe we can afford to be patient."

Clarida's discussion of initial conditions was already relatively dovish, and his discussion of "crosswinds to the U.S. economy" took it up a notch. He said that "growth and growth prospects in other economies around the world have moderated somewhat in recent months, and overall financial conditions have tightened materially." During the Q&A following his speech he commented that "what we need to be really focusing on is what those adjustments mean for our outlook for the economy, if adjustments in financial valuations are sustained, over time." He elaborated, "We also will need to factor in whether or not financial markets are forward-looking, and what's the signal about the future economy." Monetary policy affects the economy with a lag, suggesting "it would not be prudent everywhere and always to wait to see a slowdown in the U.S. before reacting."

I mentioned above that some of his remarks will stoke speculation about the potential for easing. In particular, in his prepared remarks he said, "If these crosswinds are sustained, appropriate forward-looking monetary policy should respond to keep the economy as close as possible to our dual-mandate objectives of maximum employment and price stability. I will closely monitor the incoming data on these global economic and financial developments as, at each future FOMC meeting, I consider what adjustment to our monetary policy stance is warranted to achieve and sustain our dual-mandate objectives."

Of course, it's not a new idea that monetary policy responds to a worsening outlook with more accommodative policy than otherwise. But in recent years, given the large amount of accommodation, this has meant removing accommodation more slowly than otherwise but still continuing to tighten, not easing outright. In talking about adjusting monetary policy in response to these "crosswinds," he didn't make this point. He didn't specify that he was talking about pausing rate hikes for a time or hiking less than would otherwise be appropriate. His comment about considering "what adjustment to our monetary policy stance is warranted" was ambiguous about the likely direction of future adjustments. And overall in his speech he did not make much of a case for the need to raise rates at all. Notably absent was any reference to further rate hikes being his base case, even though it clearly is for the FOMC as a whole, with the FOMC even deciding to retain a reference in the December statement ("some further gradual increases"). He described the upper limit of the fed funds target range as "equal" to the lower end of participants' range of estimates of its longer-run level, and noted that, "Over the past seven years, FOMC participants have continually revised down their estimates of long-run u* and r* as the unemployment rate fell and historically low policy rates did not trigger a surge in inflation and inflation expectations above target. This process of learning about u* and r* as new data arrive continues."

Later lines from Clarida's speech were similarly ambiguous with respect to the likely direction of policy changes: "With inflation muted, I believe that the Committee can afford to be patient as we see how the data evolve in 2019 and as we assess what monetary policy stance is warranted to sustain strong growth and our dual-mandate objectives." His comment that policy should seek to "sustain strong growth" is striking. Sure, Powell has described the growth outlook as "strong" as well. But Powell, like other FOMC participants, also emphasizes that growth is expected to moderate substantially in 2019 and that the 2018 pace should not be expected to be sustained.

Besides the economic outlook, he also commented on a couple other areas related to monetary policy, balance sheet policy and the Fed's review of its strategy, tools, and communication. He didn't say much about the balance sheet except to describe what the FOMC is considering as it assesses its operating framework. His primary goal appeared to be to reassure the market that, "If we find that the ongoing program of balance

sheet normalization or any other aspect of normalization no longer promotes the achievement of our dual-mandate goals, we will not hesitate to make changes." On the Fed's policy review, he said "We anticipate making our findings public after the FOMC concludes this review sometime in 2020," but he didn't provide any hints as to his personal views.

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