The Fed’s waning magic in the age of Yellen

By Edward Luce

With a forecast year of take-off in danger of faltering, the central bank has run out of ammunition.

Every chairman of the US Federal Reserve seems to get hit by a crisis in their first year. For Paul Volcker in 1979 it was raging inflation. For Alan Greenspan it was the 1987 “Black Monday” meltdown. And for Ben Bernanke in 2006 it was the bursting of the US housing bubble. Whatever might blindside Janet Yellen, she starts off with a problem that affected none of her predecessors: the Fed has run out of ammunition. Moreover the one remaining weapon the Fed thinks it has – the hocus-pocus of “forward guidance” – is a gun that fires blanks.

Given how much emphasis Ms Yellen puts on forward guidance, her first conundrum is plain. A widely forecast year of US take-off is once again in danger of faltering before it happens. US job creation since November has averaged 116,000 a month – well below escape velocity. Manufacturing growth has stalled. And export growth is slowing sharply. Some of this might be seasonal. Last month’s chilling “polar vortex” was hardly
a good time for America’s jobseekers to pound the streets. But it is inconsistent with the strong rebound that was expected in 2014.

Should the poor numbers persist, Ms Yellen’s first option – to press pause on the Fed’s two-month-old tapering – would be hard to take even if she wanted to. At his final meeting in January, Mr Bernanke wound down quantitative easing by another $10bn to $65bn a month. Ms Yellen, who delivers her first congressional testimony on Tuesday, was right behind him. Last year the Fed confused everybody – and shook the markets – by hinting that tapering was imminent then changing its mind before finally going ahead in December. Another shift would look careless. Besides, Ms Yellen has made it plain that the costs of QE3, in terms of equity market froth, were starting to exceed its benefits. Expect her to continue with the taper.

Second, the Fed’s chief weapon, lowering interest rates, was used up a long time ago. The US is now in its sixth year of zero interest rates. Some, including Lawrence Summers, who was Barack Obama’s controversial first choice to replace Mr Bernanke, believe America’s equilibrium interest rate is minus several percentage points. His argument set off a fierce debate about “secular stagnation”. But even if he is right, and even if Ms Yellen shared his diagnosis, it is extremely doubtful she could persuade the Fed’s board to engineer higher inflation to bring about deeply negative real rates of interest. Moreover, the resulting uproar in Congress would pose a threat to the central bank’s independence: it would be a gift to the “End the Fed” gold bugs. This option, too, can therefore be ruled out.

Which leaves forward guidance. Its great advantage is that words are cheap – all the Fed has to do is fiddle with its language and the market’s expectations will supposedly comply. Its great disadvantage is that the markets often see through the Fed’s kabuki. Some of the best economists in the business have built cast-iron models to justify forward guidance. But monetary economists can often be too clever by half. As Liaquat Ahamed, the historian of central banking, quipped in an exit interview with Mr Bernanke last month, guidance tends to work in theory but not in practice.

Ms Yellen’s quandary is captured in the increasingly confusing US jobless numbers. Under the Fed’s existing guidance, which was communicated in early 2012, it pledged to keep interest rates at zero until unemployment fell below 6.5 per cent or inflation exceeded 2.5 per cent. Last month US unemployment dropped to 6.6 per cent – a month or two away from dipping below its threshold. Inflation is nowhere to be seen. No one believes the drop in jobless numbers reflects US overheating. Most of the fall is a result of people abandoning the search for work rather than robust job creation. The
same problem faces Mark Carney, the Bank of England governor, who promised to keep interest rates low until UK unemployment fell below 7 per cent. It recently fell to 7.1 per cent. Again, he is unlikely to raise rates when joblessness dips below that level. Neither guidance has credibility with the markets, which makes them useless.

Would any language work? Since forward guidance is basically a confidence trick, the answer is probably no. The moment one trick fails, the magician loses credibility. Ms Yellen must now find new criteria that markets will believe. Maybe she could choose the labour force participation rate – the share of adults who are working – which is a better measure of job market health because it includes those who are discouraged or have stopped seeking work altogether. Or perhaps she will come up with more novel indicators. The more sophisticated they are, the better they would reflect the multiple-speed nature of the US recovery – yet the easier they would be to ignore. Should she go vague and risk being ignored by the markets; or be specific and risk having to rewrite the Fed’s language – as it is already about to do? It is an unenviable choice. Yet it is the only significant one Ms Yellen has.

Central bankers were the heroes of the 2008 crisis. Faced with another Great Depression they reached for their bazookas and fired them. It is Ms Yellen’s challenge to take over at a time of deep ambiguity. Not only are the threats over the horizon tough to anticipate, as they always are, but she faces them in the knowledge that the Fed’s armoury is bare.