Probing Powell’s Patience: Retrospect and Prospect

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The Risk of Mistaking Cyclical for Structural

The long-term decline in advanced economy trend growth, driven by demographics and productivity, isn’t over, despite wishful thinking to the contrary. But when that mistaken belief drives policy – in particular the timing of the big shift from quantitative easing to quantitative tightening on a global scale – monetary policy goes on a collision course with the economic cycle. If policy doesn’t change course, that raises the risk of a new recession (April 2018).
Components of U.S. CPI Inflation

- Core Goods CPI Growth (%)
- Core Services CPI Growth (%)
- CPI Food and Energy Growth (%)
Greenspan’s “Hunch”

“In mid-1996, the unemployment rate was below the natural rate … and many FOMC participants … were forecasting growth above the economy’s potential. Sentiment was building … to raise the federal funds rate to head off the risk of rising inflation. But Chairman Greenspan had a hunch that the United States was experiencing the wonders of a ‘new economy’ in which improved productivity growth would allow faster output growth and lower unemployment, without serious inflation risks. Greenspan argued that the FOMC should hold off on rate increases. …”

– Jerome H. Powell, Jackson Hole, WY, August 24, 2018
Greenspan’s Fortitude

“Over the next two years, thanks to his considerable fortitude, Greenspan prevailed. … Starting in 1996, the economy boomed and the unemployment rate fell, but, contrary to conventional wisdom at the time, inflation fell. … Greenspan was also right that the potential growth rate had shifted up … accommodat[ing] the very strong growth that actually materialized …”

– Jerome H. Powell, Jackson Hole, WY, August 24, 2018
Greenspan’s Patience

“Under Chairman Greenspan’s leadership, the Committee converged on a risk-management strategy that can be distilled into a simple request: Let’s wait one more meeting; if there are clearer signs of inflation, we will commence tightening. Meeting after meeting, the Committee held off on rate increases while believing that signs of rising inflation would soon appear. And meeting after meeting inflation gradually declined.”

– Jerome H. Powell, Jackson Hole, WY, August 24, 2018
U.S. Productivity Growth (%)
Greenspan’s Disbelief in the Phillips Curve

“[T]he experience of the past three decades has demonstrated that what appears to be a tradeoff between unemployment and inflation is quite ephemeral and misleading.”

– Alan Greenspan, Congressional testimony, February 22, 1994
When to Act

On principle, I prefer not to tighten monetary policy on the basis of strong output and employment growth or even a low unemployment rate. I know that we should not wait to see the "whites of inflation's eyes" before acting, but I do think we might well wait for some leading indicators of rising inflation before we act.

Inflation is Cyclical

Shaded areas represent U.S. inflation cycle downturns.
The Inflation Cycle is Not the Business Cycle

Gray-shaded areas represent U.S. business cycle recessions, and blue-shaded areas represent U.S. inflation cycle downturns.

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Inflation Downturn Signals and Rate Cuts


Shaded areas represent U.S. business cycle recessions.

Fed Funds Rate (%)

Cut

Signal

Fed Lag

2015-Present

Shaded areas represent U.S. business cycle recessions.
Indicators of U.S. Growth (%)
In Conclusion

- If our leading indexes turn back down, there may be a recession later this year.

- If they enter a fresh cyclical upturn, along with the FIG, the Fed will find it hard to hold off on further rate hikes.

- In both scenarios, the inability to execute preemptive rate hike and rate cut cycles is a key danger.
Thank you.

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