Publication: The Business Times, pg 19
Date: 17 June 2020
Headline: FOMC playbook: the only new game in town?

FOMC playbook: the only new game in town?

By Thomas Lam

IN LIGHT of the Covid-19 pandemic, the Federal Open Market Committee (FOMC), while taking more aggressive actions, seems to have stuck more or less to the standard playbook of responding to "unusual and exigent circumstances".

This essentially calls for slashing conventional policy rates to their effective lower bound, accompanied by forward guidance, embarking on asset purchases, rolling out emergency liquidity facilities and experimenting with lending programmes. But policymakers, with the required US Treasury backstop, have also introduced more creative programmes to encourage credit extension and reached into different market segments. Consequently, some believe that the Fed has overstretched in the current environment by seemingly protecting against credit and default risks. Nonetheless, Fed chair Jerome Powell has repeatedly underscored that the Fed is merely harnessing its "lending powers and not spending powers". Hence, the more novel "Corporate Credit Facilities", "Main Street" lending programmes and liquidity facility to support municipal debt, all of which backstopped by the Treasury, are intended to lend – as Mr Powell alluded to – "forcefully, proactively and aggressively" in the current backdrop.

The asset-side of the Fed balance sheet (as of early June) has ballooned by more than US$2.8 trillion, mainly as a result of the announced measures, totalling above US$7 trillion and growing, exceeding the prior peak of around US$4.5 trillion. Cumulatively, both asset purchases (more than 77 per cent of the rise) and central bank liquidity swaps (greater than 16 per cent) account for the bulk of the increase so far. Lately, however, the daily pace of expansion in the balance sheet (for the full range of tools) has slowed to around US$5 billion from the earlier run-rate of roughly US$20 billion. Basically, as market functioning improves, purchases scale down.

Similarly, the initial strains in dollar funding markets globally appear to have eased. Thus, the slower rate of balance sheet expansion partly reflects better (or less abnormal) market liquidity conditions. Overall, we think the objective of ensuring more normal market functioning can be viewed as the first phase of the "new" or unconventional monetary policy thrust.

The recent Fed communication suggests that the main policy strategy is to broadly emphasise forward guidance and balance sheet policies, with a general aversion toward pursuing negative rates for now. Hence, the second phase of the new policy shove, we surmise, will focus on strengthening or reinforcing the forward guidance and calibrating the balance sheet. Generally, we think the preference is to adopt an outcome-based forward guidance (linked to achieving an average level of inflation and perhaps activity) rather than a date-based guidance. We also suspect that the FOMC is exploring some variation of interest rate cap or yield curve control to further reinforce the existing guidance. One likely risk to rate capping, however, is determining how to appropriately exit without necessarily disrupting markets.

The apparent dichotomy between the macro economy and financial conditions, particularly given the swifter-than-expected recovery in equity prices, might arguably complicate the Fed's policy intentions. Likewise, the markets' foggy perception of conditional versus unconditional policy commitments from the FOMC in the current backdrop is another hurdle (that is, how should policymakers communicate and conduct policy without exacerbating the markets' tendencies toward overshooting and one-sided bets?). Our base case, however, is still for the FOMC to maintain an exceptionally accommodative stance for some time and preserve the option of growing its balance sheet if needed. But new or unconventional monetary policy should not be the only new game in town.

Therefore, notwithstanding the acrimonious divide within Congress, it is encouraging to witness a timely bipartisan push in favour of the forceful fiscal thrust recently. Supportive fiscal policy, in the face of an unparalleled economic shock amid a global pandemic, is paramount.

MOST LIKELY OUTCOME

But the political appetite for additional fiscal stimulus appears to be waning as politicians gear up for the November elections. At this time, we think the most likely outcome might be a split government. Hence, the propensity for additional post-election large-scale fiscal stimulus, all else equal, might be reasonably low as Democrats and Republicans clash over budget priorities.

According to the Congressional Budget Office's preliminary estimates (under "current law"), the US fiscal deficit (as a percentage of GDP) could potentially jump to around 18 per cent this fiscal year before declining to roughly 10 per cent in 2021, while the debt-to-GDP ratio is expected to sustain beyond 100 per cent going forward (our calculations imply a larger deficit and debt). Indeed, the fiscal arithmetic, either in the near or distant future, is increasingly challenging.

First, the US is headed for several fiscal cliffs in the near future (initially during the summer months, then into next year as the deficit narrows), which could prospectively cause a notable drag on the economy. Second, the path of the fiscal debt ratio, presumably in the distant future (given the dynamics of the debt-to-GDP ratio of more than 100 per cent and rising), can eventually spark greater concerns surrounding the available fiscal space and appropriate borrowing costs. While the late Herbert Stein did remind us that "if something cannot go on forever, it will stop", he also quipped that "economists are very good at saying that something cannot go on forever, but not so good at saying when it will stop".

At this juncture, the US economic outlook is still decidedly hazy or, as Fed vice chair Richard Clarida puts it, subject to an "unusually wide range of scenarios" going forward. We continue to conjecture, however, that intricate and prolonged demand-and-supply-related adjustments – with simultaneous cyclical and structural changes – amid the ongoing pandemic could be consistent with a subdued economic recovery in the US. Besides, the literature suggests that deeper recessions in advanced countries, analogous to the current US episode, are likely to have protracted scars on the economy's trend.

With the emerging hesitancy on fiscal policy, the onus will inevitably be on the Fed. But history suggests that the lopsided reliance on monetary policy is typically accompanied by increasing financial stability concerns, growing risk of market distortions and intensifying political pressure. Hence, we should keep our fingers crossed for monetary policy, progressively the only new game in town.

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