



the tampa bay economy

DOES ULTRA-LOOSE MONETARY POLICY CREATE ECONOMIC AND FINANCIAL DISTORTIONS?

By Vivekanand Jayakumar, Ph.D.

Despite the fact that unemployment rates are low and that inflation rates are near target levels, the U.S. central bank decided to ease monetary policy in 2019. Some have expressed concern that the Federal Reserve (Fed) was responding to pressures emanating from Wall Street and from the Trump administration. Others have commended the Fed for undertaking pre-emptive insurance rate cuts, which they believe will prolong the current expansion and sustain an already hot labor market. While the natural tendency is to focus on short-term developments, it is worth examining recent Fed actions within the context of a broader debate surrounding the central bank's ultimate goals and objectives.

As indicated by Figure 1.1, the Fed was meeting its mandate at the beginning of the year (the 1978 Humphrey-Hawkins Act amended the Federal Reserve Act and set the following congressional mandate for the Fed: "promote effectively the goals of maximum employment, stable prices, and moderate long term interest rates" – the moniker 'dual mandate' is often used in

the media to highlight the emphasis placed on both employment and inflation). At this late stage of the expansion cycle, the various justifications for rate cuts appear somewhat unconvincing. As shown in Figure 1.2, after spending a decade or so in negative territory, the real (inflation-adjusted) policy interest rate has been in positive territory for just about a year. Additionally, the economy has been experiencing a positive output gap over the past two years. Recent speeches by Fed officials have provided a mishmash of rationales for the 2019 rate cuts. In a speech delivered on Sept 4, 2019, the New York Fed President John Williams offered a rationale for an insurance rate cut: "While there's not been a dramatic change seen in the overall numbers yet, the more detailed picture that emerged by summer of this year pointed to an outlook of slowing growth and inflation falling short of our goal. This in turn argued for a somewhat more accommodative monetary policy stance." Another rationale for Fed rate cuts was provided by San Francisco Fed President Mary Daly ("A New Balancing Act: Monetary Policy Tradeoffs in a Changing World," FRBSF Economic Letter, Federal Reserve Bank of San Francisco, Sept 3, 2019): "We found that, when the unemployment

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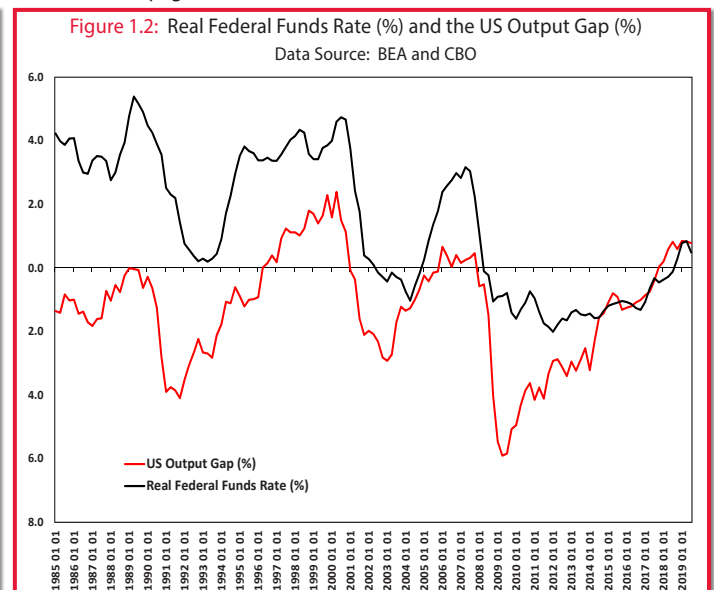
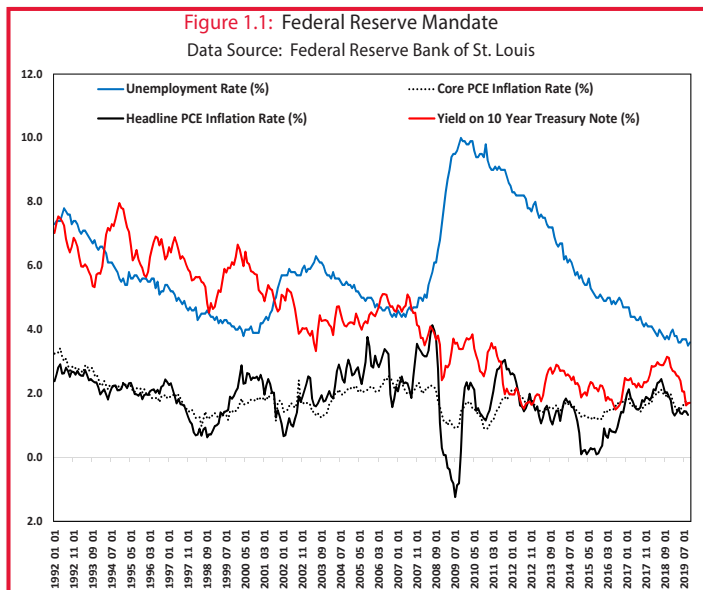


Figure 1.3: Federal Reserve Policy Interest Rate - Federal Funds Rate Target (%)
Data Source: Federal Reserve Bank of St. Louis

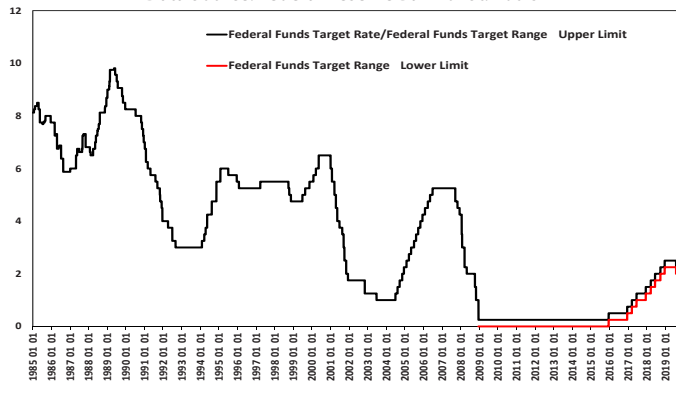
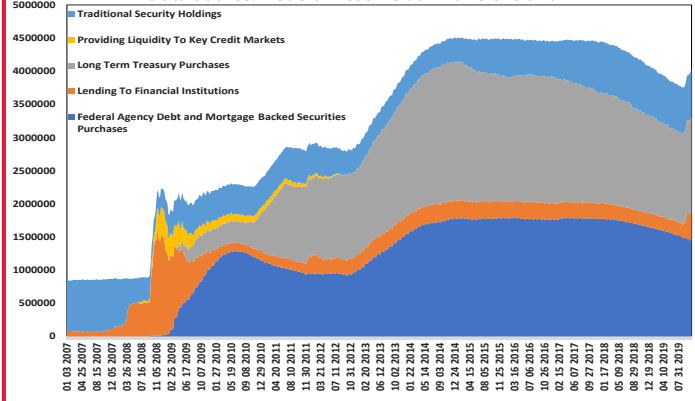


Figure 1.4: Federal Reserve Assets (\$ Millions)
Data Source: Federal Reserve Bank of Cleveland



Does Ultra-Loose Monetary Policy Create Economic and Financial Distortions?

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rate drops below what is thought to be its long-run sustainable level, the benefits to marginalized groups increase. Said simply, the gains to running a hot economy disproportionately flow to groups that are historically less advantaged." A further rationale for Fed's accommodative monetary policy stance was provided by Minneapolis Fed President Neel Kashkari in a May 16, 2019 speech: "With policy having delivered headline inflation 0.5 percentage point below target over the prior five years, I interpret the symmetry of our target to mean that we should have been equally willing to tolerate inflation of 2.5 percent for the following five years. The symmetric target is not a make-up strategy that calls for intentionally delivering high inflation, but, in my view, its tolerance of some above-target inflation reduced the need to preemptively raise rates to prevent inflation from climbing above 2 percent."

Some outside observers are worried about the effects of external pressure on monetary policymakers. Harvard University economist Robert Barro ("Is Politics Getting to the Fed?", Project Syndicate op-ed, July 23, 2019) recently observed: "The desire to restore normalcy should still be putting upward pressure on rates, just as it did during the period of rate increases between December 2016 and December 2018. Indeed, it was Bernanke's earlier failure to initiate the normalization process that made things more difficult than necessary for Yellen and Powell. My view is that the shift in 2019 away from normalization is primarily due to the intense opposition to further rate increases last December, when the loudest objections came, notably, from stock-market analysts and the Trump administration."

To fully appreciate the controversies surrounding recent Fed actions, it is necessary to take a step back and review the

post-crisis actions of the US central bank. Following the collapse of Lehman Brothers in September 2008, the Fed undertook

"A less self-serving and more accurate analysis of the factors that are putting persistent downward pressure on prices would highlight the role of structural forces (globalization, technological changes, and decline in the bargaining power of labor vis-à-vis capital). In fact, an argument can be made that as central bankers keep trying to raise inflation rates when the natural tendency is towards disinflation, they risk creating economic and financial distortions"

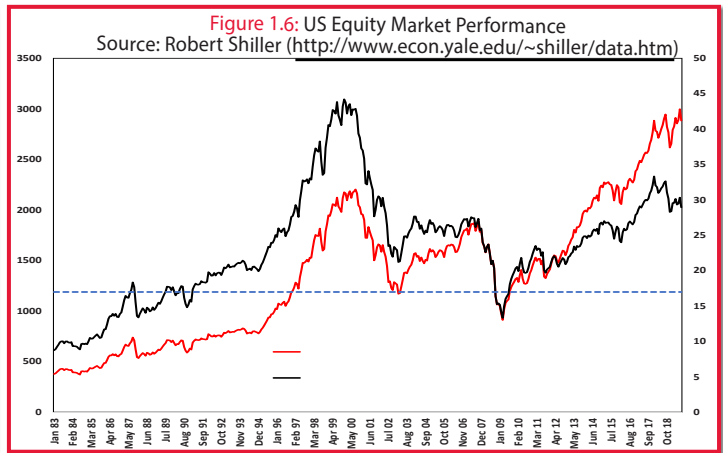
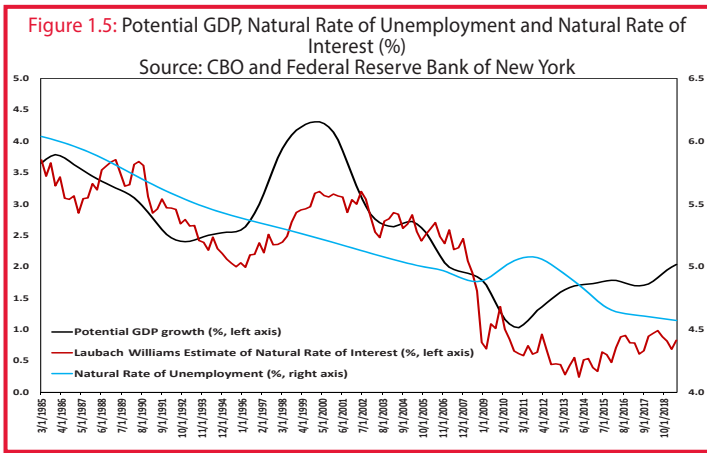
several bold steps: it maintained the target range for the Federal Funds Rate (the U.S. central bank's primary policy rate) in the 0%-0.25% range between December 2008 and December 2015; and, it dramatically expanded its balance sheet from around \$900 billion before the onset of the Great Recession to around \$4.5 trillion in October 2014. The balance sheet expansion resulted from the Fed's three large-scale asset purchase programs (LSAPs), which were referred to as Quantitative Easing (QE) in the media. Additionally, the Fed used forward guidance during the crisis aftermath to signal to financial markets that rates were likely to remain near zero for an extended period.

With improvements in labor market conditions and with rising expectations of a return of inflation to the 2% target level, the Fed embarked on a gradual and cautious monetary policy normalization program. The initial step toward returning the Federal Funds Rate to a more neutral level began with an increase in the target range from 0%-0.25% to 0.25%-0.5% in December 2015. The next quarter point

increase was delayed until December 2016. This was followed by three increases in 2017, and four increases in 2018. As part of its monetary policy normalization program, the Fed also decided in September 2017 to begin reducing the size of the balance sheet. The balance sheet normalization program was first implemented in October 2017. The unwinding (essentially, a balance sheet runoff) involved the Fed not replacing maturing assets (specifically, long-dated US Treasury securities and mortgage-backed securities) on its balance sheet. This was done in a gradual manner by capping the monthly amounts of securities that matured and were not replaced (amounts in excess of the cap continued to be reinvested). This process came to be known as Quantitative Tightening (QT) in the media.

The Fed's brief dalliance with monetary policy normalization ended rather abruptly when it made a quick U-turn and undertook three rate cuts over the course of 2019. A sharp sell-off in U.S. equity markets at the end of 2018, growing policy uncertainty associated with the U.S.-China trade war, and an emerging slowdown in the global economy were primary factors behind the Fed's dovish turn. Notably, the first post-crisis rate hike cycle ended in December 2018 with the policy rate target peaking at 2.25%-2.5% (see Figure 1.3). Furthermore, the Fed ended its QT program earlier than previously expected – the Fed announced an end to its balance sheet unwind in July 2019. Recently, a sudden cash crunch in the repo market has forced the Fed to re-inject liquidity and once more expand its balance sheet as it tries to provide a backstop to the overnight funding market (see Figure 1.4).

To evaluate the appropriateness of Fed's actions, it is necessary to understand the impact of monetary policy on the real side and the financial side of the economy. Since the early 1990s (see Figure 1.1), inflation rates have been low and relatively stable regardless of the monetary policy stance. Many central



bankers have naturally taken credit for this development by arguing that inflation has become "well-anchored" primarily due to the credibility that the Fed has supposedly established since the early 1980s. A problem with this hypothesis is that worldwide inflation, and not just U.S. inflation, has been on a downward trajectory for much of the past two decades. Another reason for downplaying the significance of the central bank credibility argument is the straightforward observation that, over the past decade, higher inflation has failed to materialize despite the Herculean efforts (that included a combined increase in the central bank balance sheets of over \$11.5 trillion dollars, and the implementation of zero or even negative interest rates) of the Bank of England (BOE), European Central Bank (ECB), Bank of Japan (BOJ) and the Fed to push up average price levels.

A less self-serving and more accurate analysis of the factors that are putting persistent downward pressure on prices would highlight the role of structural forces (globalization, technological changes, and decline in the bargaining power of labor vis-à-vis capital). In fact, an argument can be made that as central bankers keep trying to raise inflation rates when the natural tendency is towards disinflation, they risk creating economic and financial distortions. There is some evidence (see for instance, Michael D. Bordo & John Landon-Lane, 2013. "Does expansionary monetary policy cause asset price booms? Some historical and empirical evidence", NBER Working Paper no. 19585) that, despite claims to the contrary by central bankers, ultra-loose monetary policy appears to encourage the formation of asset bubbles and leads to misallocation of resources.

A fundamental challenge that exists for macroeconomists (and monetary economists) is that three of the most important benchmarks for evaluating short-term economic conditions can never be directly observed. To evaluate whether an economy is overheating or

not requires an economist to compare actual GDP to potential GDP and/or compare actual unemployment rate to the natural rate of unemployment (or the related non-accelerating inflation rate of unemployment [NAIRU]). Neither potential GDP nor the natural rate of unemployment can be directly measured. They are theoretically defined concepts which are empirically estimated using economic models. They suffer from a basic weakness – they are not constants, that is, when structural forces affect the economy, potential GDP and natural rate of unemployment will change. During periods of major structural change (like the past two decades), there is naturally considerable debate about the appropriate assumptions made in estimating potential GDP or natural rate of unemployment. Furthermore, a third critical benchmark that is crucial for monetary policymaking is also unobservable. The equilibrium real interest rate or the natural rate "is defined to be the real fed funds rate consistent with real GDP equaling its potential level (potential GDP) in the absence of transitory shocks to demand. Potential GDP, in turn, is defined to be the level of output consistent with stable price inflation, absent transitory shocks to supply. Thus, the natural rate of interest is the real fed funds rate consistent with stable inflation absent shocks to demand and supply" (John C. Williams, 2003. "The natural rate of interest," FRBSF Economic Letter, Federal Reserve Bank of San Francisco). As shown in Figure 1.5, estimates for US potential GDP, natural rate of unemployment and natural rate of interest have all varied substantially in recent decades.

Given the inherent uncertainty and technical difficulties associated with deciphering short-term macroeconomic conditions, it may help central bankers to examine a broader set of economic conditions when evaluating the appropriateness of their policy stance.

Instead of just obsessing over whether inflation rates are above or below an arbitrarily chosen 2% target or attempting to gauge whether the unemployment rate is above or below an estimated natural rate, it may help monetary policymakers to consider a wider set of economic and financial market variables. For instance, excessive credit growth, frothy asset markets, overvaluation in currency markets, and gratuitous risk-taking by investors or corporations may indicate the presence of serious economic/financial distortions that may pose a future risk to the economy. Recently, inflation has been quiescent even though the unemployment rate has been at or below 4% since March 2018. Yet, key asset markets appear exuberant – as shown in Figure 1.6, U.S. stock market appears rather expensive by historical standards. High risk exposure in the corporate debt market is a growing cause for concern. Surge in high-yield corporate bond issuance and the dramatic growth in collateralized loan obligations (CLOs) could pose problems if there is an economic downturn in 2020-21. As noted in a recent article: "The heart of the problem is the very same phenomenon that fueled the growth in the market in the first place: those ultralow rates. A CLO begins with what Wall Street calls a leveraged loan— basically, a loan that piles more debt on a company's balance sheet than most traditional lenders would tolerate. A few hundred of the loans can be packaged together into a CLO. ...What makes it all work is investors hungry for yield in a world where interest rates have been at historic lows for 10 years and trillions of dollars of debt with negative yields. Now, the same low rates that have fueled the market are creating problems for it. The reach for yield has allowed private equity barons to load debt on the companies they acquire to boost returns on their buyouts. Corporate borrowers have loaded up on debt too" ("Trouble Brews for American Companies That Gorged on Cheap Credit" by Lisa Lee,

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TAMPA BAY FORECAST: REFLECTIONS OF A 3-2-1 ECONOMY?

By John R. Stinespring, Ph.D.

Many forecasters have been predicting a 3-2-1 economy: U.S. real GDP growth at 3% in 2018; 2% in 2019; and 1% in 2020. This forecast appears to have been borne out for both 2018 and 2019. Barring any abnormally large shocks to the economy—and shocks are expected given the current domestic and global environment—signs indicate the 1% forecast for 2020 is highly likely. In this update, we look for reflections of these conditions in our local economic indicators from the Tampa Bay metropolitan area (consisting of Hernando, Hillsborough, Pasco, and Pinellas counties combined). We argue various signs of the national growth slowdown appear in the local labor markets, housing markets, and measures of aggregate spending.

Let us first get a bird's eye view of both

the national and Tampa Bay economy (TBE) using the Federal Reserve's indices of aggregate economic activity, shown in Figure 2.1 (where values above zero indicate an expanding economy; those below, a contraction). Movements at the national level substantively affect the local level with a correlation of 0.76 (a value of 1.0 would imply they move in lockstep). Though the data are volatile, a pattern can be discerned of increasing growth until mid-2015 followed by a decline thereafter. The decline appears to have either plateaued or slowed. The most recent values—3.3 for the TBE and 1.9 for the US in October 2019—are below the 2016-2019 averages of 3.4 and 2.9, respectively.

The growth downshift appears in the local and US labor markets. Figure 2.2 shows that unemployment's historically-long decrease beginning in December 2009, plateaued between 3%-4% starting

in mid-2018. Both unemployment rates remain well below their pre-Great Recession historic averages of 5.5% for the US and 4.7% for the TBE. Figure 2.3 shows the growth in payrolls has declined for both the US and TBE. The fall is particularly pronounced in the TBE

“... a pattern can be discerned of increasing growth until mid-2015 followed by a decline thereafter.”

after the mid-2016 growth peak of 4%. The 3-2-1 impact may explain the decline from an average rate of 2.4 in 2018 to 2.0 in 2019. The most dramatic slowdown is in real wages (year-over-year) shown in Figure 2.4. While the US appeared to plateau near 1% over the 2018-2019

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Figure 2.1: Monthly Economic Activity Indices, US and Tampa Bay MSA
Feb 2010 - August 2019
Source: St. Louis Federal Reserve

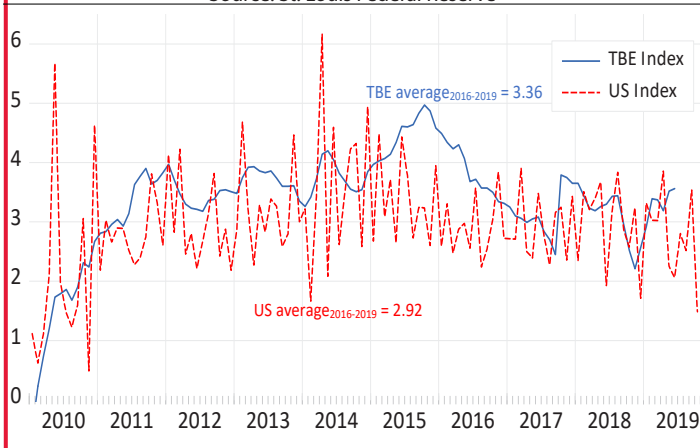


Figure 2.2 Unemployment Rate (%) for U.S. and Tampa Bay MSA,
Jan 2010 – Oct 2019
Source: U.S. Bureau of Labor Statistics (Seasonally-Adjusted)

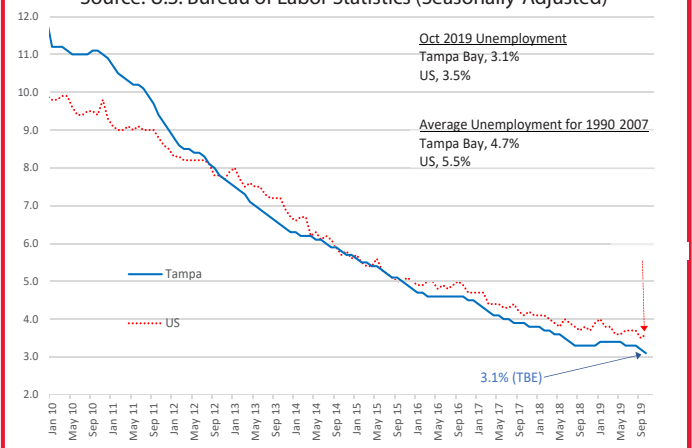


Figure 2.3: Percentage Change in Monthly Nonfarm Payrolls, 2010-2019
Source: Bureau of Labor Statistics Seasonally-Adjusted)

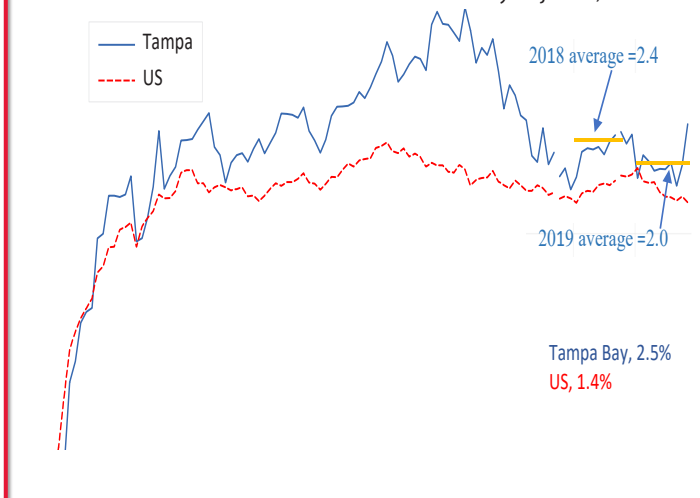
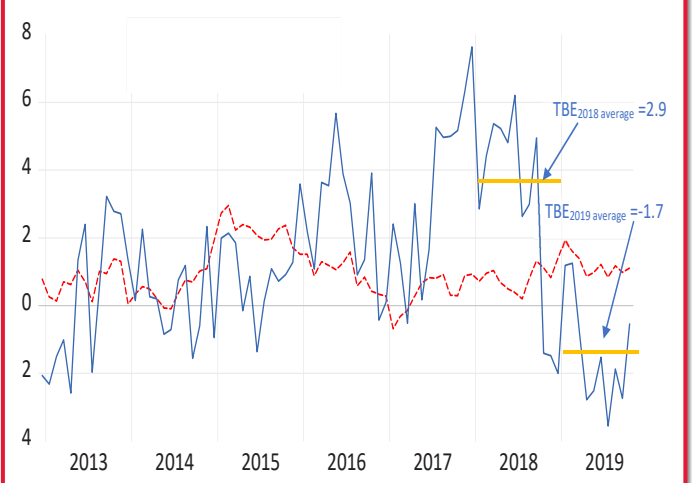


Figure 2.4: Percentage Change (Y-Y) in Monthly Real Wages (SA):
June 2009 - Sept 2018
Source: St. Louis Federal Reserve and author's calculations



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period, the TBE decline from an average of 2.9% in 2018 to negative 1.7% for 2019 (up through October).

The impact from a 3-2-1 slowdown is reflected in markets beyond labor, which is a lagging indicator of the economy. Consider aggregate demand within our local economy, herein proxied by gross sales shown in Figure 2.5. Gross sales serves as a coincident indicator showing the economy's current position in the business cycle. It trends up with local expansions amid seasonal spikes in December, March, June and September. A 3-2-1 impact on the TBE may explain the declining trend in gross sales portrayed by the progressively flatter trend lines (in yellow). The slopes of these lines represent monthly increases in sales that are forecasted up through 2017, 2018 and 2019. Results show the monthly increase in sales trends down from \$39 million through 2017, to \$38.7 million through

2018, and down to \$38.2 million through September 2019 (our most recent observation). The model provides a close fit between predicted (dotted line) and actual sales over the period. Moreover, our forecast of \$15 billion for December 2019 is below the previous December's sales number.

Signs of a deceleration in growth are more subtle in the housing market. This market is particularly important as it serves as a leading indicator to predict the future direction of the economy. Sustained increases in housing construction foretell economic expansions and sustained declines presage recessions. First consider the supply side of our local economy's housing market as shown in building permits for new single-family residential construction shown in Figure 2.6. Though the trend is upward, a statistical analysis reveals a break in mid-2017 after which the growth rate slows modestly. Though volatile, the data follow a clear upward trend with seasonal spikes, which our forecast (dotted line) predicts with 90% accuracy. The deceleration is seen from

the slowing increase in permits. Using January to October figures we see that the monthly average increased by 124 from 2017 to 2018 (1,094 compared to 1,218), but only 48 between 2018 and 2019 (1,218 compared to 1,266). These figures are well below the 2005 January to October monthly average of 2,340.

The deceleration in the growth of housing supply since mid-2017 has been reflected in slowing home prices. In fact, price increases in all price ranges have moderated significantly. Figure 2.7 shows the Case-Shiller Home Price Index for low-, middle- and high-tier home prices in the region August 2001 (note each index = 100 in year 2000). Price appreciation within the low-tier homes fell from 14% in 2017 to 11% in 2018. Price appreciation within the mid-tier homes fell from 7% in 2017 to 5% in 2018. Price appreciation within the high-tier homes fell from 4% in 2017 to 3.5% in 2018. From January to September 2019 price appreciation for all three tiers has been significantly below what it was for the same period in 2018. As is evident from Figure 2.7, all tiers are near or above their 2006 peak prices.

The 3-2-1 U.S. economy seems to be reflected in moderating growth in the Tampa Bay economy. Though a forecast of 1% average real GDP growth rate in 2020 is a forecast of continued expansion, economies are particularly fragile at such low rates. Economies growing at low rates may easily fall into recession when large negative shocks arise. Our local economy outperforms that of the US on many metrics and, as such, may prove more robust to the negative shocks which will inevitably come.



Write to Professor Stinespring at jstinespring@ut.edu.

Figure 2.5: Gross Sales in Tampa Bay, June 2009– December 2019
Source: Florida Department of Revenue and author's calculations

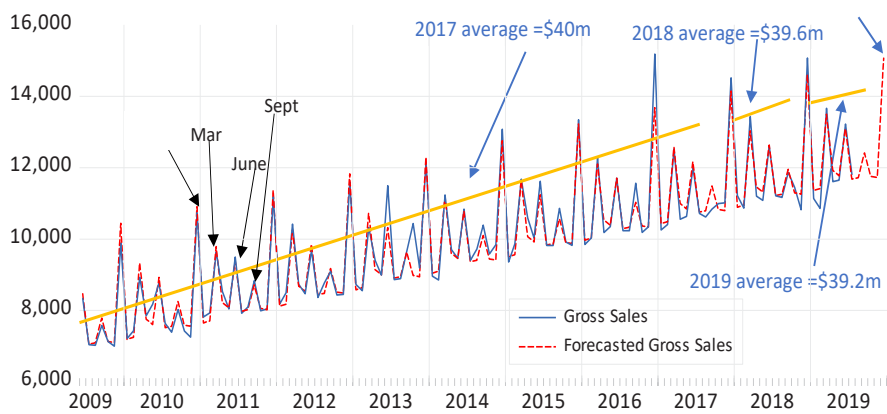


Figure 2.6: New Residential Building Permits in Tampa Bay: 2009 – 2019
Source: U.S. Department of Housing and Urban Development and author's calculations

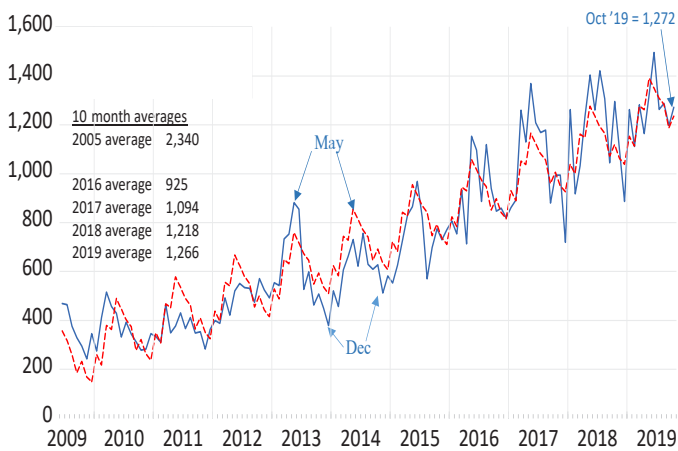
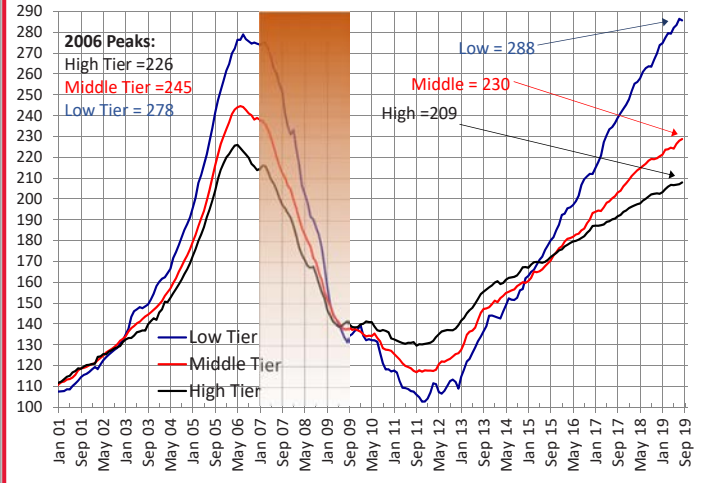


Figure 2.7: Case-Shiller HPI for the Tampa-MSA (SA) Aug 2001–Sept 2019
(Index = 100 in Year 2000)
Source: St. Louis Federal Reserve



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Sally Bakewell, and Katherine Doherty, Bloomberg Businessweek, Oct 28, 2019 issue). Clearly, the calm in the real economy is masking potential signs of overheating in the financial economy.

Meanwhile, Fed Chairman Powell has downplayed the risk of economic and financial distortions. In an August 23, 2019 speech, he noted: "We have not seen unsustainable borrowing, financial booms, or other excesses of the sort that occurred at times during the Great Moderation, and I continue to judge overall financial stability risks to be moderate." It is worth noting that U.S. household net worth (as a percent of disposable income) is once more nearing all-time highs, fueled this time around by record high stock prices. As shown in Figure 1.7, the previous two spikes in the ratio of household net worth to disposable income ended unceremoniously, with the bursting of asset bubbles (the dot-com bubble burst in 2001 and the housing bubble burst in 2007).

While the Fed's traditional focus on targeting a 2% inflation rate and achieving full employment may have been appropriate for the 20th century, it appears to be an increasingly outmoded framework for conducting monetary policy in the present day. The Fed has recently started a "listening tour" as part of a program to review its monetary policy strategy. If it is willing to listen, it may want to reconsider its goals and objectives. Greater emphasis on financial stability and a shift away from the dogmatic insistence on achieving a 2% inflation target may serve the U.S. economy well in the future. Furthermore, dispelling the widespread belief among market participants that there exists

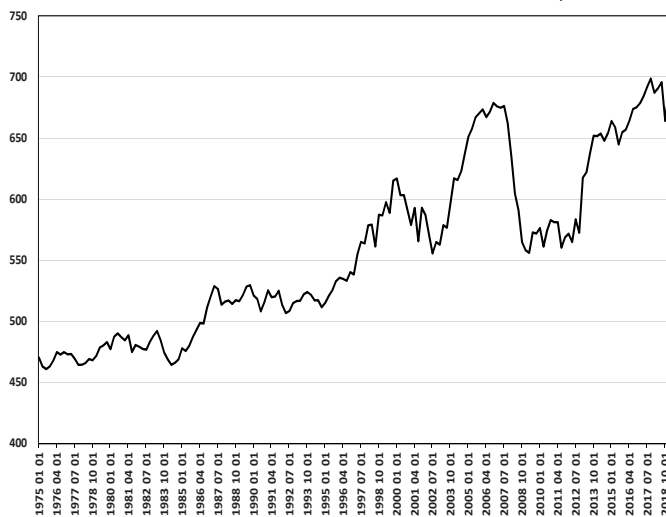
a "Greenspan put" would go a long way towards improving investor discipline and may even reduce the frequency of asset bubbles. A practice that began during former Fed chair Alan Greenspan's term, the Greenspan put refers to the notion that the Fed undertakes asymmetric actions to support stock markets by pursuing aggressive monetary easing in response to market corrections while showing a willingness to tolerate or even support frothy market conditions. The Fed and other central banks may want to heed the following suggestion made by the current head of the Monetary and Economic Department of the Bank for International Settlements (BIS): "I shall suggest that we need to make adjustments to current monetary policy frameworks in order to have monetary policy play a more active role in preventing systemic financial instability and, hence, in containing its huge macroeconomic costs. This would call for a more symmetrical policy during financial booms and busts—financial cycles. It would mean leaning more deliberately against financial booms and easing less aggressively and, above all, persistently during financial busts" (Claudio Borio, 2016. "Revisiting Three Intellectual Pillars of Monetary Policy," Cato Journal, Cato Institute, vol. 36(2), pages 213-238).



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Figure 1.7: US Household Net Worth (% of Disposable Income)

Data Source: Board of Governors of the Federal Reserve System



Adam Smith Breakfast: An Annual Tampa Bay Economy Update

Thursday, April 16, 2020

7:30 - 9:30 am

University of Tampa

Vaughn Center Crescent Room

Featuring: Associate Professors of Economics, John Stinespring, Ph.D. and Vivekanand Jayakumar, Ph.D.

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