Janet Yellen’s Swan Song

Written by Diane Swonk

The Federal Open Market Committee (FOMC) raised rates for a third time this year, the fifth of Chair Janet Yellen’s tenure, to a target range of 1.25% to 1.5%; that’s up .25%. The statement again flagged the lagging performance of inflation despite stronger economic conditions. Presidents Neel Kashkari at the Minneapolis Fed and Charlie Evans of Chicago dissented on the decision to raise rates. They, along with a growing minority within the Federal Reserve System, have become more concerned about the persistence of tepid inflation. The core PCE deflator, a more accurate measure of future inflation than the overall PCE, has been below the Fed’s 2% target since March 2012. This is at the same time that wage gains remain stagnant.

The FOMC upgraded its forecast for 2018 from 2.1% in September to 2.5% today. That is similar to our own forecast and is more reflective of stronger growth abroad and the return of business investment than any major shift in fiscal policy. Most estimates of the tax cut legislation, which is still being written, suggest a very small near-term boost to growth because of the focus on wealthy households and corporations and the timing so late in the economic cycle. Tax cuts have a larger effect when the economy is faltering than when it is well into an expansion as it is now. Indeed, the wealth effects tied to expected tax cuts are likely greater than the direct effects of the tax cuts in terms of recent market gains. Again, those effects are concentrated in the highest income households. It will be a good holiday season for luxury retailers. Longer term effects of the tax cuts actually turn negative because of the upward pressure that they will have on deficits, the debt and interest rates.

The FOMC also lowered its estimate of unemployment for 2018. The unemployment rate is now expected to slip below 4%. Estimates of inflation, however, remained unchanged. The persistence of stagnant wages and low inflation is occurring in Germany and Japan as well, raising concerns that something more systemic may be going on with inflation.

The Fed’s forecast for rate hikes in 2018 held at three. That seems reasonable given the persistence of low inflation. The challenge for current Governor Jerome

Powell, who is slated to replace Chair Yellen at the helm of the Fed, will be whether to worry more about inflation that is too low or asset prices that are too high. Governor Powell is not an economist but he is better versed than many of his colleagues in the workings of financial markets, which suggests that concerns about asset bubbles and financial market stability will intensify under his leadership.

Chair Yellen will leave on a high note, having steered the economy through the financial crisis beyond to the other side of crisis-era policies. She was able to reduce the size of the Fed's bloated balance sheet without roiling financial markets. She still has one meeting before her tenure is over. She will be remembered for her unique ability to see beyond the numbers to the people they represent. She went out of her way to shift the Federal Reserve's focus from simple summary indicators such as the unemployment rate to its components: labor force participation, the number of workers still forced to accept part-time instead of full-time work, and those who appear to have been permanently marginalized by the crisis. She saw both the progress made and the scars remaining from the crisis. In her own words, Yellen said that there's "less to lose sleep about than for quite some time." Thank you, Chair Yellen.

Bottom Line: Chair Yellen is leaving on a high note. Chair Powell will inherit an economy with solid growth. His greatest challenges will be to bridge the gap between those most concerned about inflation and asset price bubbles and, most likely, to navigate policy through the next recession. The concern is that tax cuts as opposed to tax reform (which could have been revenue neutral) will make managing the next recession even more challenging for the Federal Reserve, as that will likely undermine the ability to cut taxes and increase spending when we need it most.