If the Fed threshold changes

At the end of last week, there were rumours that the Fed may change its unemployment threshold from 6.5% to 6%, either at its 30-31 July meeting or, perhaps more likely, at its 17-18 September meeting. Such a move would confirm that the Fed funds rate is likely to remain in its current 0-0.25% range until 2015, which is in line with our baseline scenario. But while the change would be an acknowledgement that the US labour market has performed more strongly than expected, the change – if implemented – could still be a mistake as it may erode the value of forward guidance by moving the goalposts.

Tweaking the unemployment threshold

The US Federal Reserve (Fed)'s monetary policy committee, the Federal Open Market Committee, meets this week, with markets anxious to find out whether the result will be a more hawkish statement like the one that followed the previous meeting; or a more dovish statement as articulated by Chairman Bernanke after market reaction to the perceived hawkishness of the minutes. In addition, Friday sees the publication of the unemployment rate and non-farm payrolls. Payrolls is a highly volatile number, bound to be revised not once but twice. It is meaningless as a leading indicator of the economy (unemployment is lagging, not leading) but is increasingly important as a leading indicator of Fed behaviour.

Until now, we have been told that the Fed will keep its policy interest rate unchanged, at 0-0.25%, at least until the unemployment rate (currently 7.6%) has fallen to 6.5%. For this condition to hold, projected inflation 1-2 years ahead should not be more than 0.5 percentage points above the Fed's 2% longer-run goal (for the core PCE deflator which is currently just 1.1%); and longer-term inflation expectations should be well anchored. However, last Friday Jon Hilsenrath, often regarded as an unofficial mouthpiece for the Fed, wrote an article in the Wall Street Journal implying that the Fed may this month cut its unemployment rate threshold to 6%.

An acknowledgement of economic strength

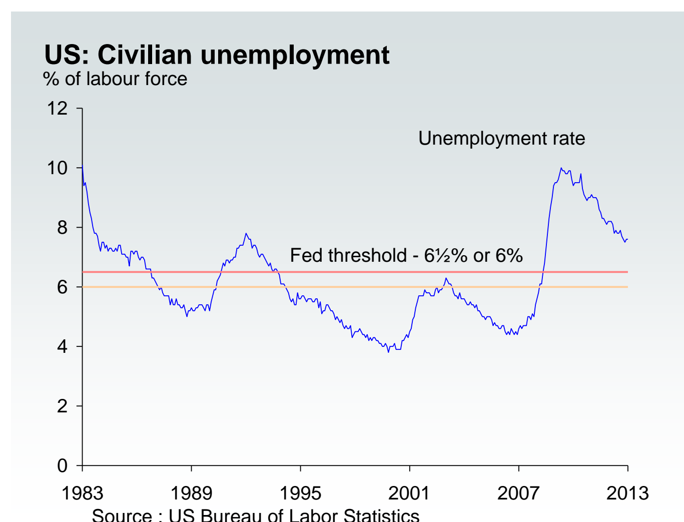
A change would be an acknowledgement that the US economy – or at least its labour market – somewhat surprisingly has done rather better than expected in recent months. In addition, according to the bureau of Labor Statistics, the US civilian labour force has grown (by 1.3%) over the period, meaning that labour force shrinkage (from April 2010 to July 2011) is at best only part of the explanation. Normally, the rate of unemployment would fall mainly as a consequence of above-trend growth. Yet since unemployment peaked in October 2009, quarterly GDP growth has averaged a seasonally adjusted annualised rate of 2.1%, at best at the lowest range of estimates of trend growth. This is below the Oxford Economics model current 2.5% estimate of US trend growth. Yet, the Fed now clearly believes that the unemployment rate can fall further without generating inflation, meaning that its estimate of trend growth should be higher than ours. Hence, whereas last December – when the thresholds were introduced – and as recently as last March, the Fed thought that 6.5% unemployment would only be reached by 2015, by June 2013 Fed economic projections assumed that this rate would be reached in 2014. This contrasts with our baseline scenario which expects the threshold to be reached only by Q3 2015.

A lower threshold does not affect QE tapering

It is important to note that a change in the threshold mainly relates to interest rate moves. It should not affect the issue of whether or not the Fed will start to taper its bond purchases. In fact, if anything, changing the threshold rather points to increased faith in the durability and strength of the current recovery, meaning a stronger case for tapering to begin sooner. Nevertheless, the news was immediately interpreted as good for both bonds and for stocks.

Each incremental fall in unemployment becomes more difficult

As noted above, US unemployment peaked at 10% in October 2009. Reducing that by 1.5 percentage points took 27 months, to December 2011. But the most recent 1.5 percentage point fall took only 24 months, from June 2011 to June 2013. That is rapid by past standards; in the mid-2000s boom, it took 33 months (from September 2003 to June 2005) to bring the unemployment rate down by 1.5 percentage points, although the starting point was a much lower 6.1%. Perhaps more relevant, the rate of unemployment has fallen by 2.4 percentage points from its late 2009 peak. In the two previous unemployment cycles, the rate took 43 months to fall 1.9 percentage points (from 6.3% in June 2003 to 4.4% in October 2006; and 33 months to fall 2.4 percentage points from July 1992 to February 1995. These were periods of very strong output growth – a quarterly annualised average of 5.6% from 1992 to 1995 and 6.2% from 2003 to 2006. True, the trend growth rate of the US economy is likely to be considerably lower now, meaning that slower growth may have a stronger impact on unemployment. On the other hand, at least part of the rapid fall in unemployment over the past four years is due to people leaving the labour force, people who may well return if stronger growth looks like creating increased demand for labour (as it should).



Source : US Bureau of Labor Statistics

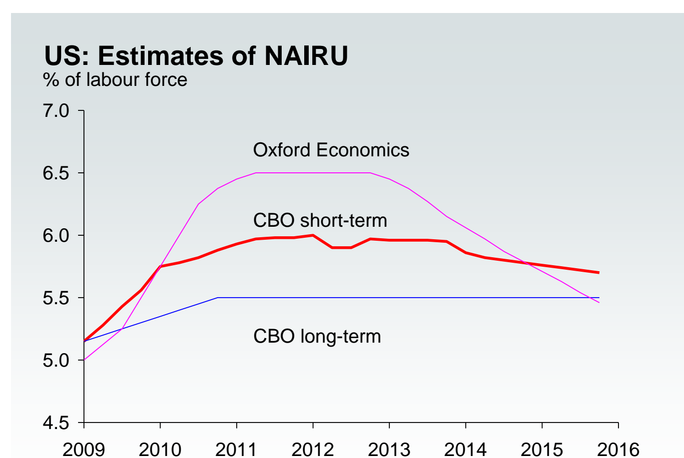
Any change remains conditional

There are a number of dangers with tweaking the threshold – if, indeed, this will be done. First, it erodes the value of forward guidance. The point about forward guidance is presumably that it gives markets the opportunity to plan ahead and rest assured that policy will remain unchanged unless and until the economic background changes. But, by moving the goalposts, some of that reassurance disappears. If after seven months the threshold can be changed because it is closer to being reached, what is there to stop it from being changed again? Hence, a question mark is raised over Fed credibility and over the whole strategy. Further, the impact of output growth on the labour market is also subject to the law of diminishing returns. It may take considerably longer to go from 6.5% to 6% unemployment than from 7.6% to 6.5%. But the process will be accompanied by above-trend growth. Although

inflation is currently not a problem, nor is likely to be for the next few years, it is nevertheless difficult to see the Fed standing idly by and leaving interest rates at a crisis level while the economy powers ahead. Moreover, current interest rate levels, however necessary they are, carry dangers as well as benefits. In that sense, any change in the Fed's threshold will therefore be as conditional as the current thresholds are – ie, only valid as long as nothing happens to change their validity.

Problems and risks with changing the threshold

But, what's wrong with bringing unemployment down further? Nothing – yet. The US trend unemployment rate (the non-accelerating inflation rate of unemployment, NAIRU) is likely to be in the 5-6% range, at least judging by its movements over the past 30 years. The Fed's latest estimate is in the 5.2-6% range whereas the Congressional Budget Office estimates between 5.5% (long-term NAIRU) and 6% (short-term NAIRU). In both cases, the number is lower than the current Oxford Economics estimate, which currently puts NAIRU at 6.4%. This is another way of saying that the Fed's perception of US trend growth is higher than our estimate of around 2%. It partly explains the Fed's view that there is no need to tighten monetary policy and that the unemployment threshold could safely be lowered (if this will indeed happen). Hence, a shift in the Fed threshold is an upside risk to our baseline scenario, which has output growing no more than 0.5 percentage points in excess of trend over the next few years, leaving the US output gap negative until the early 2020s.



Source : Oxford Economics/Haver Analytics, Federal Reserve Bank of St Louis

But there comes a time when attempting to bring the rate too far down would become inflationary. This could be a particular concern if the prevailing Fed policy changes towards a belief in the existence of the Phillips Curve, ie, a belief that it is possible to trade medium-term unemployment for higher inflation and that this is a good trade. Depending on who succeeds Ben Bernanke as Chairman of the Board of Governors, this is a distinct possibility.

Few benefits of tweaking the threshold

Nor would a change in the threshold necessarily be good for all asset prices. Yes, short-term, as we have seen, it would boost bonds. But bond prices will still for the time being remain dependent on the Fed's purchases or lack thereof, so changing the unemployment threshold should only produce a once-off effect. Of course, equities, which depend more on growth and profit prospects, should benefit if the Fed believes there is more growth to be had before there is any need for tightening.

The one thing that tweaking the unemployment threshold would probably do is ensure that there will be no increase in the Fed Funds rate until 2015. But no hike prior to 2015 is already the message from most Fed Governors and regional Presidents. It is therefore difficult to see a change in the unemployment threshold as anything else than a signal that the Fed would like unemployment to come down below 6.5%; but this point has already been made, leaving increasing confusion as the only result of a change.

Of course, there may ultimately be no change. And the Fed may also stand pat this week – especially given that the labour market data is published on 2 August – but prepare the ground for a changed threshold at its next meeting in mid-September.

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