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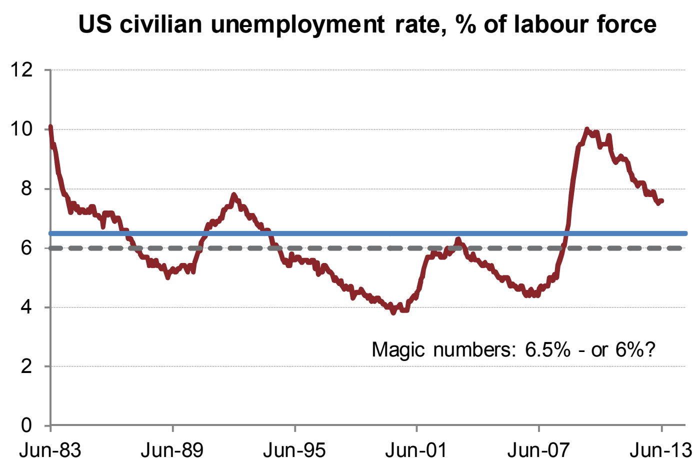
If the Fed threshold changes

- **The FOMC may change the 6½% unemployment threshold to 6% at this week's meeting**
- **This should not affect the QE tapering decision – but could possibly bring it forward**
- **The rationale behind a change is weak and carries risks**

The Federal Open Market Committee (and the Bank of England Monetary Policy Committee and the European Central Bank Governing Council) meets this week, with everyone presumably anxious to find out whether the result will be a more hawkish statement along the lines from the previous meeting; or a more dovish stamen as articulated by Chairman Bernanke following a turbulent market reaction to the perceived hawkishness. Meanwhile, on Friday we have non-farm payrolls – a highly volatile number, bound to be revised not once but twice, which is meaningless as a leading indicator of the economy (unemployment is lagging, not leading) but very important as a leading indicator of Fed behaviour.

Until now, we have been told that the Fed will keep its policy interest rate unchanged in the 0-¼% range, at least until unemployment has fallen to 6½%, assuming projected inflation 1-2 years ahead was not more than ½ percentage point above the Fed's 2% longer-run goal (for the underlying PCE deflator); and longer-term inflation expectations remained well anchored. However, last Friday Jon Hilsenrath, often regarded as an unofficial mouthpiece of the Fed, wrote an article in the *Wall Street Journal* implying that the Fed may this month tweak its threshold to 6% unemployment.

This is in many ways an acknowledgement that the US economy – or at least its labour market – has done rather better than expected in recent months. (Although readers of these Comments know that I have been bullish on the US economy since at least last autumn.) Whereas the Fed last December – when the thresholds were introduced – thought that 6½% unemployment would only be reached by 2015, the prevailing view now seems to be that it is likely to be reached by H1 2014.



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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, since changing the threshold shows increased faith in the durability and strength of the current recovery, that the case for tapering to begin sooner rather than later is strengthened. Nevertheless, the news was immediately interpreted as good for both bonds as well as stocks.

US unemployment peaked at 10% in October 2009. Reducing that by 1½ percentage points took 27 months, to December 2011. But the most recent 1½ 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 1½ 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 growth rate 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 can still be above-trend and so 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).

There are a number of dangers with tweaking the threshold – if, indeed, this is what will happen. 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, output growth 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%. This will be accompanied by above-trend growth. Although inflation is currently not a problem, nor 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, as has been discussed in previous Comments (eg, *Are ultra-low interest rates the new normal?* 19th December 2012), current interest rate levels, however necessary they were, carry dangers as well as benefits. Finally, any change in the Fed's threshold will be as conditional as the current thresholds are – ie, only valid as long as nothing happens to change their validity.

But, what's wrong with bringing unemployment down further? Nothing – yet. The US trend unemployment rate (NAIRU) is likely to be in the 5-6% range (the Fed estimates 5.2-6%), at least judging by its movements over the past 30 years. Hence, there is still plenty of excess capacity in the economy. But

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there comes a time when attempting to bring the rate too far down would become inflationary. This could become a particular concern if the prevailing Fed policy changes towards a belief in the existence of the Phillips Curve, ie, 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 and worrying possibility.

Nor would a change in the threshold necessarily be good for 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. Equities, meanwhile, should depend more on growth and profit prospects. If the Fed believes there is more growth to be had before there is any need for tightening, that is clearly good news for profits.

The one thing that tweaking the unemployment threshold would do, would presumably be to ensure that there will be no increase in the Fed Funds rate until 2015. But, although my view is that one increase in the second half of 2014 would be appropriate as a signal that interest rates will normalise, 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 6½%; 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. We will know later this week.

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