STEIN BROTHERS
LONDON-STOCKHOLM

Phillips Curve vs fiscal stimulus? Ideally neither

- **The race to succeed Ben Bernanke is heating up**
- **The two main candidates have sharply different views – although both are probably in tune with the President**
- **Neither is the best choice**

Late last month President Obama attempted to calm speculation about who he would appoint to succeed Ben Bernanke as Chairman of the Board of Governors of the Federal Reserve. Mr Bernanke's term expires in January. The President had already made it clear that Dr Bernanke would not be reappointed. Just as appointing Supreme Court Justices is a way for a President to cement his judicial legacy, so appointing a Fed Chairman is now seen as a way to cement an economic legacy. However, the President's attempt to calm the waters – if that is indeed what it was – rather succeeded in agitating them instead. This was partly because of his outspoken defence of one of the candidates (Larry Summers) and partly because he threw another name into the hat (Don Kohn). The favourite to succeed Mr Bernanke was and remains Janet Yellen, previously President of the Federal Reserve Bank of San Francisco and currently a Fed Governor. But, judging by the odds offered by bookmakers, Mr Summers is eroding her lead. Both main candidates stand for policies that align closely to the President's, but in different ways. While the policies followed by either would obviously be shaped by circumstances, the following is an attempt to outline what we can at this stage expect from each of the two candidates.

Ms Yellen joined the Board of Governors in 2010. She is generally considered a dove and has never dissented from the majority. A key indicator to a Yellen Fed policy is the speech she gave on 11th February this year.[1] This speech came less than two months after the FOMC had announced its thresholds for action, including a 6½% unemployment rate. Ms Yellen, whose research in the past has centred on unemployment issues, made two points:

First, that the bulk of the rise in unemployment since the onset of the Great Recession has been cyclical, not structural. In other words, it can be reversed by stronger output growth, justifying a continued monetary policy stimulus.

Second, that reaching the Fed's unemployment threshold does not necessarily mean that any policy action would be forthcoming. Specifically, she said "It deserves emphasis that a 6-1/2 percent unemployment rate and inflation one to two years ahead that is 1/2 percentage point above the Committee's 2 percent objective are thresholds for possible action, not triggers that will necessarily prompt an immediate increase in the FOMC's target rate. In practical terms, it means that the Committee does not expect to raise the federal funds rate as long as unemployment remains above 6-1/2 percent and inflation one to two years ahead is projected to be less than 1/2 percentage point above its 2 percent

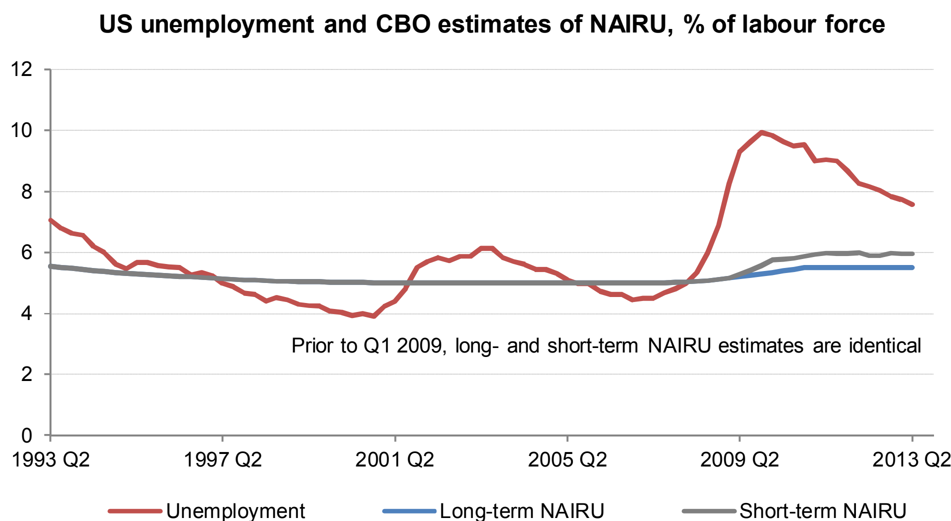
[1] *A Painfully Slow Recovery for America's Workers: Causes, Implications, and the Federal Reserve's Response*, at the 'A Trans-Atlantic Agenda for Shared Prosperity' conference sponsored by the AFL-CIO, Friedrich Ebert Stiftung and IMK macroeconomic Policy Institute.

Any persons or organisations taking decisions on the basis of facts and opinions in this comment do so at their own risk. Stein Brothers (UK) Ltd. accepts no liability whatsoever for the consequences of such decisions. Stein Brothers (UK) Ltd. does not give any form of investment advice and does not accept liability for any losses that arise from positions taken in securities or asset classes.

Registered office: 45 Chesilton Road, London SW6 5AA. Registered in the United Kingdom, registration number 08186233.

objective. When one of these thresholds is crossed, action is possible but not assured." The clear implication is that monetary policy should remain loose and aim at driving unemployment down further.

Unemployment in the five years before the onset of the Great Recession (September 2007) averaged 5.2%. This also happens to be the lower bound of the Fed's current 5.2-6% estimate of US full employment (strictly speaking, the non-accelerating inflation rate of unemployment, NAIRU).



Since the Fed currently worries about inflation being too low, there would seem to be every reason to continue to pursue lower unemployment. Up to a point this is true. But both unemployment and inflation operate with sometimes substantial lags. It might be more prudent to ensure that the economy is on a sustained recovery path and then gradually normalise interest rates, rather than keep going at full throttle until unemployment is at or below NAIRU, when inflation actually could be an issue and require a more rapid tightening. It is difficult to shake off the view that Ms Yellen not only believes in the Phillips Curve – ie, the idea that you can trade lower unemployment for higher inflation, a view disproved by Milton Friedman in the 1960s – but also that this is a good trade.

If Ms Yellen believes that monetary policy can have a substantial impact on unemployment, Mr Summers, a former Secretary of the Treasury, seems to feel that, at least in the recent and current circumstances, it has no effect. This fits in with the prevailing views of monetary policy prior to the Great Recession, which held that central banks have one target – inflation – and one instrument – a policy interest rate. However, one of the lessons of the Great Recession (perfectly familiar to anyone who studied economics before 1980) is that there are other instruments than the policy interest rate. Quantitative easing (QE) can be used to accelerate the growth in money supply and to boost banks' balance sheets. It is more difficult to boost credit growth (not least in the wake of an excess debt-induced crisis), but it is clear that the zero-bound does not necessarily inhibit central banks from further action.

Stein Brothers (UK) Ltd.
Telephone: +44 (0)7768 094 340
Email: gabriel.stein@steinbrothers.co.uk

Any persons or organisations taking decisions on the basis of facts and opinions in this comment do so at their own risk. Stein Brothers (UK) Ltd. accepts no liability whatsoever for the consequences of such decisions. Stein Brothers (UK) Ltd. does not give any form of investment advice and does not accept liability for any losses that arise from positions taken in securities or asset classes.

Registered office: 45 Chesilton Road, London SW6 5AA. Registered in the United Kingdom, registration number 08186233.

However, Mr Summers dismisses QE as having little impact. While he also believes it does little harm, a Summers Fed would be much more likely than a Yellen Fed to withdraw the stimulus sooner. Leaving aside the incongruousness of having a central bank head in charge of monetary policy who does not believe monetary policy works, this raises the question of what he does believe in. The answer is fiscal policy. Yes, of course, says Mr Summers, it is necessary reduce federal debt and prospective deficits. But it is important not to obsess about them. Repressing deficits can be just as bad as repressing inflation.[2]

So whereas a Yellen Fed would remain activist, a Summers Fed is more likely to be quietist. But if monetary policy takes a back seat, that leaves fiscal policy as the main component of economic policy. The euro area experience of the last few years shows that 'obsessing with deficits' has its drawbacks. But the excessive deficits were at least in some cases the cause of the problem. The line between not obsessing and ignoring is not quite as clear as Mr Summers seems to imply.

Both candidates stand for policies that would appeal to President Obama. Ms Yellen seems to believe that you can push unemployment down even at the risk of igniting inflation, a clear attraction for a President from the left of the (US) political spectrum. Mr Summers gives primacy to fiscal policy and would apparently support larger public sector deficits for longer, a view that should resonate with a President who believes in Big Government.

From an investment perspective, neither candidate seems particularly attractive. Both would ultimately be bad for bonds – although Ms Yellen would in the short term be better for bonds (more purchases) and, again in the short term, for equities (lower interest rates). Long-term, a policy leading to high inflation would be bad for both. Maybe it would be best if President Obama turned to his (apparently) third choice, Don Kohn. Mr Kohn has the advantage of not being a respected central banker who is not an academic economist.

Gabriel Stein 2013-08-05
gabriel.stein@steinbrothers.co.uk

[2] See, eg, Mr Summer's *Financial Times* blogs, *End the damaging obsession with deficit,* 21 January 2013, and *US must do more than focus on deficit*, 10 February 2013.

Stein Brothers (UK) Ltd.
Telephone: +44 (0)7768 094 340
Email: gabriel.stein@steinbrothers.co.uk

Any persons or organisations taking decisions on the basis of facts and opinions in this comment do so at their own risk. Stein Brothers (UK) Ltd. accepts no liability whatsoever for the consequences of such decisions. Stein Brothers (UK) Ltd. does not give any form of investment advice and does not accept liability for any losses that arise from positions taken in securities or asset classes.

Registered office: 45 Chesilton Road, London SW6 5AA. Registered in the United Kingdom, registration number 08186233.