Is it time to take away the punch bowl?

By Brian Fabbri
Visiting Senior Research Fellow, CAMRI & President, FABBRI Global Economics

A bittersweet celebration

No! However, the punch bowl needs to be removed gradually and firmly and with sufficiently warning, if the pace of withdrawal needs to be accelerated, so that it does not shock the financial system. The new and old Federal Reserve chairs have made their intentions perfectly clear embracing transparency as a key component of their approach to conducting monetary policy. Both Ms. Yellen and Mr. Powell have specifically stated that the Fed will raise their policy rate three times this year and sell assets from their portfolio of non-Treasury securities into the bond markets to reduce their balance sheet holdings. The punch bowl will be pushed further away by both actions and the present degree of monetary policy will have been tightened.

Fiscal policy will influence the decision

Economic conditions have changed in the months between the ascent of Mr. Powell to the chairmanship and the departure of Ms. Yellen. The most critical is the passage of two economically stimulative pieces of legislation: the 2017 tax rate reduction and the $1.5 trillion infrastructure bill. Economic pundits differ on the how much of a stimulant these measures will create for GDP in the short-term, but all agree it will boost GDP.

Real GDP growth (Q4/Q4) is picking up in US and EU

Of course there is also widespread economic consensus on the longer-term negative effects for the US economy that these revenue reductions and spending increases will have on future budget deficits. The Congressional Budget Office (CBO) has
estimated that as deficits mount they will reach unsustainable heights unless some new legislation reverses the present trend.

**An unexpected acceleration in real Growth**

Most recent public and private economic forecasts for real GDP growth per annum in 2018 and 2019 ranged between 2% to 3%. These expectations have been raised several basis points from forecasts made earlier in 2017. Many forecasts have been steadily revised upward as evidence of faster GDP growth in 2017 materialized. Real GDP growth in 2017 ended the year expanding by 2.5%, well in excess of most forecasts made at the beginning of 2017. Economists in early 2017 had been debating the merits of long run growth projections that would average between 1% and 2%. Consequently, they were pleasantly surprised by the late cycle acceleration in real growth throughout 2017.

**Soaring US Consumer Confidence**

(Conference Board)

**The Fed has been fooled too!**

A good example of this underestimation is seen in the Federal Reserve Board of Governors’ prognostications. Little more than one year ago in December 2016 the Governors were forecasting that real GDP would increase by 2% in 2018 and 1.9% in 2019. (Yes, they also under estimated real GDP growth for 2017). In their latest forecast (December 2017) the FOMC raised their predictions significantly believing that real GDP would grow by 2.5% in 2018 and 2.1% in 2019. This last forecast was made before Congress legislated the president’s tax cut proposal and his $1.5 billion infra structure.

**Signs of economic growth accelerating abound**

Two key signs of a strengthening in economic growth are: the soaring increase in consumer confidence, and the steepening of the Treasury yield curve. Both shifts have corresponded in the past to periods of accelerating economic growth.

**The risk of overheating is gaining sway**

In his latest Congressional testimony Chairman Powell has stated that his assessment of the economy has changed in the wake of the passage of more stimulative fiscal policy. More economic growth, even
incrementally more, will drive the unemployment rate further below its full employment estimate and risk increasing labor costs. While we do not know how much more growth he thinks the fiscal stimulus will add to near term GDP growth we can surmise that it will drive the unemployment rate deeper into full employment status. The FOMC had estimated that the unemployment rate would slip to 3.9% this year. It already has and now it should dip further.

Unemployment Rates are plunging

A flat relationship should steepen soon

While many economists presently agree that the traditionally defined tradeoff between the unemployment rate and wage gains is probably flatter today than historical estimates have argued, it, nevertheless, will spark some wage increases as the unemployment rate keeps dropping deeper into full employment territory. One factor that is keeping the wage/unemployment curve unusually flat at this late stage of the business cycle is the relatively low participation rate. However, as economic growth accelerates in the next few quarters it is expected that more middle aged men and women will be attracted back into the labor force as available workers become scarce.

This process has already begun as the participation rate jumped 0.3 percentage point in the latest month’s (February) employment report mostly due to middle age citizens stepping back into the labor market. Once participation increases it will weigh heavily upon wages and re-steepen the UR-wages curve again. Over the past year the hourly earnings rate increased 2.9% and should begin to rise quite soon..

US Participation Rate will increase as UR hits bottom

Overheating risks are rising

Moreover, additional economic growth over the next two years will lower the risk of watching the economy grow at a permanently inadequate growth rate, and raise the risk of overheating an already relatively hot economy. Lighting the path to somewhat faster economic growth is the recent steepening of the Treasury yield curve. After remaining relatively stable for
the past several years, 10-year Treasury yields increased significantly more than the Fed funds rate did in the past several months. A steeper curve foreshadows a speedup in economic growth.

**Adjustments to gradual are coming soon**

As these calculated risks to future growth shift, the need for a steady, gradual return to a normal policy rate level as stipulated in recent Federal Reserve guidance will have to be adjusted.

It isn’t the specter of soaring inflation on the horizon that is causing this expected adjustment in the pace of policy tightening, it is the clear responsibility of monetary policy officials to modify their stance when fiscal policy changes the economic setting.

**Inflation is Benign**

In the past few years central banks began to insist they would target 2% in order to raise inflation rates from near zero up to that level. Somewhat later the central banks began to consider targeting inflation on a three-year average in order to permit more leeway in addressing inflation when it first exceeds the 2% threshold. That is probably
the informal policy guideline that guides policymakers at the present moment.

The latest risk is a tariff war

President Trump’s latest assault on international trade carries the risk of thoroughly upsetting the gradual return to a neutral monetary policy stance. Higher tariffs on imported steel and aluminum will automatically raise domestic prices for these items and all the multiple of items that they contribute to from beer cans to automobiles to everything in between.

While the economics profession had lengthy debate and disagreement over the merits of deflation and how slow developed economies were doomed to grow, there is one thing that all economists have traditionally agreed to: the pernicious economic effects from raising tariffs.

Impediments to free trade are lose-lose results for all

Already warnings of retaliation have echoed across the globe from Canada to China and nearly all corners of the global community. If President Trump follows through with his tariff proposal, he will surrender all the mutual benefits derived from the World Trade Organization agreements. Trade retaliation is not limited to raising tariffs and could also include disruptions to the flow of trade in specific industries, which will interfere with the global supply chain that so many American companies depend upon for their production. Consequently, beyond increasing domestic prices the imposition of trade impediments will ultimately stifle economic growth in the US and around the world. It is a lose-lose scenario.

The risk for central banks

The risk from higher tariffs for monetary policy makers is that, when they are raising official rates higher to counter the threat from the new fiscal stimulus measures, inflation will be accelerating due to multiple rounds of higher tariffs that will likely be globally imposed on international trade. The Fed and other developed economy central banks will react to higher inflation in the already heated economy by raising official rates higher than planned and sooner than presently projected. Now the punch bowl will be removed.

Conclusion: say goodbye to the punch bowl

Recent central bank guidance was informing us that they will remove the present degree of monetary accommodation very gradually. However, their pronouncements have preceded two important events that could potentially alter the near-term economic and inflation outlook: new fiscal stimulus, and the imposition of tariffs on steel and aluminum. Both of these new developments will alter the Federal open Market Committee’s (FOMC’s) economic outlook and both are likely to add to inflation in the near term. Consequently, the FOMC should announce quite soon that they will begin to
withdraw monetary stimulus at a faster pace than they previously disclosed.

Because the FOMC is perceived to be the leader in setting the tone of monetary policy direction for the developed economies, their anticipated announcement for a somewhat faster removal of the present stimulus is likely to be followed with a short lag by the European Monetary Authority and the Bank of Japan.

The present ‘skeleton in the closet’ is the unknown extent to the degree of trade protectionism that President Trump’s call for tariffs sets off. If trade is impeded by successive rounds of ‘tit for tat’ higher trade tariffs and quotas by trading counterparties during or after the punch bowl has been removed, then the risk to economic growth will quickly reverse and it will soon launch a global recession.

For more information, please contact camri@nus.edu.sg
### KEY INDICATORS TABLE (AS OF 28 FEBRUARY 2018)

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**Source:** Bloomberg

### APPENDIX

**GLOSSARY OF KEY TERMS (Source: Bloomberg, with tickers in parenthesis. In US$ where applicable)**

- **S&P500**: capitalization-weighted index of the prices of 500 US large-cap stocks (SPX)
- **FTSE**: capitalization-weighted index of the prices of the 100 largest LSE-listed stocks (UKX)
- **NIKKEI**: capitalization-weighted index of the largest 225 stocks of the Tokyo Stock Exchange (NKY)
- **HANG SENG**: capitalization-weighted index of companies from the Hong Kong Stock Exchange (HSI)
- **STI**: cap-weighted index of the top 30 companies listed on the Singapore Exchange (FSSTI)
- **EUR**: USD/EUR exchange rate: 1 EUR = xx USD (EUR)
- **YEN**: YEN/USD exchange rate: 1 USD = xx YEN (JPY)
- **CMCI**: Constant Maturity Commodity Index (CMCIP)
- **Oil**: West Texas Intermediate prices, $ per barrel (CLK1)
- **3MO LIBOR**: interbank lending rate for 3-month US dollar loans (US0003M)
- **10YR UST**: 10-year US Treasury yield (IYC8 – Sovereigns)
- **10YR BUND**: 10-year German government bond yield (IYC8 – Sovereigns)
- **10YR SPG**: 10-year Spanish government bond yield, proxy for EU funding problems (IYC8 – Sovereigns)
- **10YR SGS**: 10-year Singapore government bond yield (IYC8 – Sovereigns)
- **US ISM**: US business survey of more than 300 manufacturing firms by the Institute of Supply Management that monitors employment, production inventories, new orders, etc. (NAPMPMI)
- **EU PMI**: Purchasing Managers’ index for the 17 country EU region (PMITMEZ)
- **JP TANKAN**: Bank of Japan business survey on the outlook of Japanese capital expenditures, employment and the overall economy, quarterly index (JNTGALLI)
- **CHINA IP**: China’s Industrial Production index, with 1-month lag (CHVAI0Y)
- **LC**: Local Currency

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