Key messages from Janet Yellen's Jackson Hole remarks
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In opening remarks at the Jackson Hole Symposium Chair Yellen broke little new ground on the event's theme, designing resilient monetary policy frameworks for the future, and suggested a Committee that is generally satisfied with its strategy for normalization, available policy tools to combat future recessions, and overall policy framework. We find this message somewhat disheartening. Given the Committee's limited space to cut short-term rates, a persistently low equilibrium policy rate, and likely challenges relying on asset purchases and forward guidance in the future, we had hoped to see some evidence of greater openness to change. Overall, we are left with a sense of "business as usual", which if indeed is the case implies a Committee that may be unprepared to aggressively counter another recession should potential growth and equilibrium policy rates remain depressed.

This note briefly outlines the messages we gleaned from the Chair's remarks. We touch on the short-term policy outlook but our focus is more squarely on the overall approach to policy normalization, the policy toolkit for supporting growth and inflation in different states of the business cycle, and considerations for the longer-term policy framework.

- A rate hike this year is highly likely. Data has evolved since the surprisingly weak May payrolls report in a manner that is consistent with the Committee's expectation for moderate growth, continued strengthening in the labor market and gradual firming of inflation. In light of this, the Chair believes that "the case for an increase in the federal funds rate has strengthened in recent months." We had already assigned a 75 percent probability to a rate increase this year, so Yellen's remarks were not particularly surprising. Still, the Chair's decision to address the near-term policy outlook at a conference focused on longer-term policy considerations suggests that the Committee has grown more confident in the economy's performance and marginally concerned by somewhat complacent market pricing of the path of policy rates. We still see December (45 percent) as somewhat more likely timing than September (40 percent) for a rate increase given below-objective core inflation and risks management considerations discussed below, but we will revisit these probabilities following the August payrolls report. Another strong number (+225,000 private sector jobs) in combination with firming wages and a decline in the unemployment rate could suffice to tip us into the September camp, though we caution that the meeting is still several weeks away.

- There is very little evidence that the Committee is shifting away from its strategy of arriving at a neutral policy rate around the time that core PCE inflation hits two percent. Overall, we find this disappointing. As discussed in a previous note, we see compelling reasons for the Committee to hold off on raising rates at least until there is more convincing evidence of inflation moving towards mandate-consistent levels (and as the July PCE inflation data confirmed, this is just not the case at present). These reasons include constrained policy options at the lower bound, growth risks that are still tilted to the downside, low inflation expectations, and uncertainty about the current and future level of the equilibrium policy rate. In practice, the Committee will tolerate inflation rising somewhat above two percent. But the policy setting could achieve better outcomes if the current strategy explicitly allowed for (or even sought) inflation above two percent over the medium term, which would reinforce that the Committee treats the inflation objective symmetrically. Absent such a shift, investors are likely to continue to expect inflation to run below two percent on average over the coming years, as has been the case since the financial crisis. Until there is evidence to the contrary, two percent inflation will continue to be viewed as a policy ceiling, implying an actual inflation objective somewhat below this level.

- The peak policy rate this tightening cycle may only be about 150 basis points away. Judging from the June Summary of Economic Projections, the median Committee member sees the longer-run policy rate at three percent, or one percent in real terms. However, both in her June press conference and again at Jackson Hole, the Chair has suggested that the equilibrium real policy rate might not rise above its current level near zero for many years. Specifically, she noted last week that "the average level of the nominal federal funds rate down the road might turn out to be only two percent". If indeed the case, we are likely to see a continued flattening of the Committee's median projected interest rate path in future projection rounds.

- Asset purchases and forward guidance are no longer "unconventional" tools. With a persistently low equilibrium policy rate, and continued aversion to taking the policy rate into negative territory, the FOMC will have very limited scope to ease policy through rate cuts even if it succeeds in raising rates all the way back to a neutral policy setting before the next recession. Asset purchases (possibly including a wider range of instruments) and forward guidance will therefore remain the primary policy tools in future recessions. One implication is that right-sizing the balance sheet – returning to a world in which the Fed's assets largely align with currency in circulation – is unlikely to occur for well over a decade.

- Cautious optimism on the efficacy of asset purchases and forward guidance. Overall, Yellen struck a tone of optimism on the ability of the Federal Reserve to provide future stimulus largely through asset purchases and forward guidance, even noting that simulations of various policy options show that these tools can provide better outcomes for employment and inflation than cutting the policy rate deeply into negative territory. Still, Yellen noted a number of reasons for caution in relying on these tools - namely, that model simulations may overstate the effectiveness of asset purchases and forward guidance when rates are already low, that these tools may need to be taken to extremes to be fully effective, and that such use may increase financial stability risks.

- Cautious optimism implies cautious rate normalization and eventual tolerance of an inflation overshoot. Yellen's note of caution on relying on asset purchases and forward guidance to fight future recessions has implications for current policy normalization. Even if the Committee's strategy has not changed, in practice the FOMC will be very careful to avoid an unduly restrictive policy setting in order to lower the possibility of having to revert to asset purchases and forward guidance. Any weakening of key economic indicators, tightening of financial conditions, or heightened risks to global growth will lead the Committee to delay its next steps in policy normalization, as has been the case for much of this year. The road to a neutral policy setting – even if neutral is as low as two percent – will be long and winding. And if downside risks increase meaningfully, the Committee will remove its tightening bias – and possibly begin cutting rates – more quickly than it traditionally has. All of the above implies that the Committee will be more tolerant of inflation overshoots going forward. Should global disinflationary pressures wane, the "new normal" could be one in which inflation averages above two percent, even if growth hovers around trend.

- The longer-run policy framework is unlikely to change. Two weeks ago, President Williams of the Federal Reserve Bank of San Francisco created quite a stir with a paper suggesting consideration of possible changes to the FOMC's policy framework – including a higher inflation target, and price-level or nominal GDP targeting. Yellen acknowledged these ideas as "important subjects for research", but emphasized that the Committee is not actively considering any such changes. Thus absent a recession, we see little scope for a meaningful rethink of the policy framework. We find this disappointing, to say the least. In an environment where the policy rate is still close to the effective lower bound and the neutral rate remains significantly depressed by historical standards, from a risk management perspective the Committee has a responsibility to carefully examine possible changes to their operating framework that could deliver better outcomes for growth and inflation when the next recession inevitably hits.