Remarks for 2020 MPF Panel

"Hall of Mirrors: Feedback Between Monetary Policy and Financial Markets"

- Are central banks stuck in a Hall of Mirrors? It’s certainly true that financial market moves reflect central bank policy. And we know that the Fed watches closely financial markets: the same is true for other central banks, including the Bank of England.

- To avoid the risk of entering a Hall of Mirrors, some may argue that the best way to proceed is to ignore or discount the financial market reflection. I’d like to address two questions.

- First, should central banks pay attention to markets at all? Here, my answer is a clear yes.

- Second, even if we accept the general principle, is there any sense in which the Fed has been responding too much to markets recently – and bond markets in particular? Here, my reading of the evidence is no.

First, why should central banks pay attention to financial markets?

- The most obvious point is that financial markets are a key part of the transmission mechanism: the moves in yield curves, corporate bond spreads, equity prices and exchange rates all determine how policy affects the economy.

- More generally, if we can extract it correctly, financial markets contain a host of other useful information about expectations and risks for aggregate growth, inflation and firm-level profitability.

- But putting information about policy and the economy to one side, I think there are two main reasons why the Fed should care about moves in financial markets.

- **The first reason** is that if there’s one lesson we learned from the financial crisis, it’s that markets are not just mirror images, passively reflecting what central banks are doing and expected to do, with no further effect.
Financial markets movements also cause and amplify fluctuations in the real economy. Falls in financial asset prices can cause wealth effects, reduce the value of collateral and hence the borrowing capacity of firms and households via financial accelerator effects.

We have understood the existence of these effects for decades now (going back to the work of Bernanke and Gertler). But academic research since the crisis is continuing to uncover how important and pervasive balance sheet channels are.

So although it is true that the Fed and other central banks typically have mandates to target inflation and employment, with no direct target for financial asset prices, it is also clear that we cannot meet those mandates without also taking asset price fluctuations into account.

Taking an international perspective adds a second reason why central banks should care, which applies particularly to the Fed: we know from the work of Silvia Miranda-Agrippino and Helene Rey, Gita Gopinath and others that Fed policy, and the dollar, have outsized effects on the rest of the world.

So even if the Fed can afford to ignore the domestic effect, market fluctuations in the US feed through to financial conditions around the world, especially in emerging markets. Estimates in a recent speech by Governor Carney suggest a one standard deviation tightening in US financial conditions reduces GDP in a typical emerging market by around 0.2%. These effects spill back to the US via trade and financial channels – and spill back effects are only likely to grow over time, as emerging markets expand.

In sum, financial market movements are often not just passive reflections of what’s happening in the real economy or Fed actions. They may be the source of shocks or act to propagate them at home and abroad.

Even if we accept that central banks should respond to asset prices, some might argue that they respond too much: there is a central bank put under asset valuations irrespective of the outlook for employment and inflation. I found convincing research from Anna Cieslak and Annette Vissing-Jorgensen, which suggests Fed actions over the past can be explained purely via its inflation and employment mandate.
• So far I have been discussing general reasons why central banks should look at asset prices. (The main arguments mostly apply to risky assets, where the Fed can offset the impact on borrowing conditions.)

• But I now want to turn from the general to the specific, and address the argument that we heard from commentators last year, that the Fed and bond markets were in their own Hall of Mirrors.

• This leads me to the second question:

Is there any sense in which the Fed was being pushed around by bond markets last year?

• The narrative was that bond markets were pricing in looser policy than would be normal given the economic data. But that rather than ignoring markets and following the data, the Fed was then validating those expectations.

• First to make one obvious point. The fact that markets were pricing in changes in expected policy before the Fed had acted or signalled is not evidence of the Fed being pushed around. Bond markets see and respond to all of the same data the Fed does, and respond in real time. FOMC members’ actions and words are typically going to lag behind, owing simply to the timing of the meetings. If Fed actions and words end up validating market expectations, it could just as easily be a sign that the Fed reaction function is well understood.

• So were moves in rate expectations and in policy unusual in any way? Looking on from the outside, directionally at least, one might argue no. At the end of 2018, my colleagues and I on the MPC were forecasting 2¾% year-on-year US GDP growth in 2019. It has come in a touch weaker than that, despite looser policy than anticipated at the time. So on the face of it, I’m not surprised that bond yields have fallen and policy has had to adjust.

• It is true that the change in expected policy has been quite large, relative to the GDP downgrade. I am not sure this is a puzzle, however. (The counterfactual GDP without the policy change would have been much weaker). Moreover, FOMC minutes and speeches were pretty clear about the reasons for the adjustment in policy stance. Let me list three reasons I noted as an outside observer.
• First is that there are of course two parts to the FOMC mandate. And as we also see in the UK and to varying degrees in other countries, despite the strong performance of the labour market, inflation had remained relatively subdued. (As I and others have argued, this doesn’t mean that the Phillips curve is dead or disappeared. But it does suggest that some other factor was pulling down on trend inflation relative to labour costs. If the cause is persistent, then the Fed had to adjust to meet the target.)

• Second is that the Fed, just like markets, is forward looking. And both were responding to a weakening global economy. We went from robust global growth in 2018 to a synchronised slowdown in most of the world a year later. While growth in the US has held up better than in many other countries, it cannot be totally immune to weakness elsewhere.

• And third, was the role of risk management. It seems likely that bond markets were partly responding to heightened uncertainty and increasing escalation of the US-China trade dispute. Given the scale of those risks, it would be reasonable to assume that the Fed was also acting somewhat pre-emptively to mitigate the worst-case impact. This argument is of course more pertinent if there are worries about policy space and the effectiveness of other policy tools, [as we discussed this morning].

• With the benefit of hindsight, these explanations all seem to have been borne out by the data. Inflation remained subdued and global growth continued to weaken over 2019, while some downside risks from trade tensions did translate into higher implemented tariffs.

• An alternative argument one heard is that maybe central banks tend to validate moves in risk-free curves in order to avoid market volatility. While market volatility is something to avoid, all else equal, this factor is more likely to affect the exact timing of any policy changes than the overall stance.

• In the long run, the proof must be in the data. If central banks do enter a Hall of Mirrors and validate overly pessimistic bond markets, then we should see inflation rising above target. If central banks were looking exclusively at financial markets, then we might worry about such an outcome. But we know that there is a wealth of other information that the Fed and other central banks look at. That information helps break the reflection and ultimately pins down the decision.
Finally, I’d like to close by asking:

**What should we expect going forward?**

- In 2019, US-China trade tensions and monetary policy were the key drivers of moves in asset prices. With phase one of the trade agreement signed, further volatility induced by US-China trade tensions seems off the table for 2020. But a new risk to the outlook has emerged, namely the uncertain impact of the coronavirus.

- First and foremost, the priority is of course the many individuals and families suffering the consequences in China and around the world. On the narrow economics, there is still lots of uncertainty about what the effect will be. So far, as was the case with negative trade news, investors have shifted towards safe haven assets on signs of further worsening.

- Even if the virus is contained within China, the impact on global GDP might be large, given the size of the Chinese economy and its importance in global trade. As with trade tensions, financial markets may again focus on downside risks to growth, leading to falls in bond yields. If so, some of last year’s patterns in financial markets may be repeated in 2020.

- Thank you