Federal Financial Analytics, Inc.

MEMORANDUM

TO: Federal Financial Analytics Clients

FROM: Karen Petrou

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There is no doubt after last year's last-minute debacle that U.S. fiscal policy is in still tinier tatters. But, unnoticed so far is the still greater danger of confused fiscal policy combined as it now is with feckless monetary policy. An economy resting on fiscal- and monetary-policy disarray is an economy at grave risk that sure-and-certain volatility will break through fragile guardrails. Strained financial systems could then quickly compound the inflationary pressures likely from Trump trade and fiscal policy along with an array of supply-chain and employment risks. And these are just the slow-burning hazards. What happens if the financial system is shocked?

Although there has long been much about Fed policymaking that strains credulity, global financial markets have looked to the Fed as to a star in the East. After 2008, markets had so much faith in the Fed that it was rightly dubbed "the only game in town" in a highly-influential 2016 book. Now, though, investors and traders are increasingly fearful that, while the game based on Fed actions is still being played with its usual ferocity, there's no longer an umpire or safety net.

Like adolescents suddenly facing the fact that parents are far from infallible, markets have had a rude, hard awakening in 2024's last quarter. Much has been written in recent weeks about the Fed's steadfast assertion that it's "data-driven" even as its decisions veer wildly from easing to tightening and back again. That a stalwart Democratic economist recently endorsed longstanding Republican calls for bright-line monetary-policy rules is just the latest evidence of desperation for predictability in the absence of certainty.

Despair derives only in part from the Fed's wild policy swings. Underlying the meeting-to-meeting ups and downs is a knowledge chasm. The rates the Fed sets are supposed to ease or tighten policy in hopes – so far often dashed – of curbing inflation, ensuring maximum employment (whatever that is), and setting moderate long-term interest rates (yes, that's what the law also says).

To know what it's doing when it moves the short-term target, the Fed has to know which rate neither eases nor tightens – i.e., the "neutral rate." A Fed that doesn't know its neutral rate is like a physician who can't tell if a patient has a fever because she doesn't know that normal is 98.6 and just guesses based on how the patient feels.

The Fed is in fact staring at various thermometers without understanding a one of them. Asked at its last meeting if he knows what the neutral rate is, Mr. Powell said:

> There are countless models of what a neutral rate might be at any given time. There are empirical models, there are theoretical models, there are things that combine them and they have as many different answers as you'd like. So, there is no real certainty, and I mean it's actually a good thing to know that we don't know

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> exactly where it is. So you're not, you're not tempted to think, oh I think this model or this estimate is right. You just have to be open to the empirical data that are coming in and also how it's affecting the outlook.

It's profoundly disconcerting that the Fed chair could so blithely acknowledge that the central bank lacks even a good guess about whether it's easing or tightening based on a reliable objective measurement of the current economy. No wonder markets are increasingly setting long-term rates where they think the economy will drive them, not on what the Fed says the economy is likely to do and what it then will do about that. One of the Fed's key tools is forward guidance, but even a quick backward glance shows that forward guidance is consistent only because the Fed fails to back away from what it says at a meeting even if facts on the ground shift dramatically from whatever might be construed as a consensus forecast.

The market made it through year-end jitters, which is of course all to the good. Will it be able to do so again in the midst of debt-ceiling drama, new cross-border trade and finance barriers, fears that Treasury issuances will flood fragile markets, and profound jitters about the U.S. central bank? Maybe some of what Mr. Trump promises is only bluster, but Oval Office bluster disrupts markets almost as much as Oval Office action. This will be a very trying time for U.S. fiscal policy, but troubling signs of market volatility will prove still more hazardous if the Fed fails to convince key players that it can provide an essential, stabilizing monetary-policy hand.

The Fed's remaining tools are market-supporting rate cuts and emergency liquidity intervention. The central bank has shown itself ready and willing to bail anyone out pretty much anytime. If it does so again, the central bank may well restore financial stability, but there will be hell to pay as well there should.