FOMC Preview — The Fed Versus The Debt Ceiling

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Can the Fed either hike or begin to reduce the size of its balance sheet with another potentially nasty debt ceiling fight looming?

The very issue of a government shutdown amidst a fight over the debt ceiling halted the Fed in its tracks just two years ago. Back then, we were in the tiny minority of shops to correctly predict that then-Chairman Bernanke would call time out on expected plans to taper the pace of bond purchases at the September meeting until the dust had settled into the December FOMC meeting. Could Chair Yellen's Fed do likewise?

One difference between then and now is that we haven't heard Yellen even remark on the topic. In 2013, Bernanke had specifically referenced the debt ceiling issue as an impediment in his semi-annual monetary policy testimony to Congress in July of that year. Recall his direct warning in that testimony:

"The risks remain that tight federal fiscal policy will restrain economic growth over the next few quarters by more than we currently expect or that the debate concerning other fiscal policy issues, such as the status of the debt ceiling, will evolve in a way that could hamper the recovery."

It was such guidance that we latched onto in deferring consideration of a taper decision until after the shutdown issue was settled. The absence of similar guidance now could lead one to conclude that either the Fed doesn't think it's the same risk today or that it is wishing it will just go away, or perhaps it isn't even on their radar yet.

Such thinking may be wishful. This Congress and administration appear to be less able to advance significant policy imperatives than any prior Congress or administration. President Trump has openly referenced a willingness to shut government down if that's what it takes, and the GOP and Democrats can't agree on advancing health care, taxation and spending reforms—let alone a funding arrangement or broader budget. Yet markets are priced in part for the assumption that material tax relief will be enacted, and not priced for shutdown risk.

It is possible that postponing the August recess is a sign of the determination to get things done. Congress seems to relish the opportunity to engage in brinkmanship tactics such as in 2013 or the New Year's Day fiscal cliff funding deal that I still recall fouled up new year's plans.

But should the Fed court the idea of tightening monetary policy and thus perhaps adding to uncertainty over the effects precisely when fiscal policy uncertainties including perhaps an adverse shock from another government shutdown are in play? That wouldn't be terribly prudent. The Fed should be the steadier hand on the wheel amidst dysfunction in Congress.

In all, I hope and think that next week's FOMC meeting will be a non-event. It will be a statement-only affair absent any scheduled press conference or forecast updates that could be combined to guide markets. No rate hike is expected. It is possible but improbable that the FOMC may tee-up a September implementation of a pre-announced reduction of Treasury and MBS reinvestment. Several FOMC officials have signalled greater comfort toward reducing reinvestment before hiking again. The right thing to do, however, would be to keep its powder dry until later in the year when hopefully we have more information on how cool heads in Congress may be. That's at least in terms of shutdown risk, given a need to raise the ceiling by October, but quite possibly not in terms of agreement on health care, taxes, infrastructure and spending reforms. Financial stability could be at risk in a narrowing window before campaigning for the 2018 mid-terms fully takes over.

Besides, what's the rush for the Fed to do otherwise? The US economy posted one-handled GDP growth over 2017H1 and so it can hardly be convincingly argued that the economy is materially outstripping estimates of its non-inflationary potential growth rate. The output gap is still negative, signalling disinflationary slack. Inflation is still falling and explaining it away in terms of mobile telephone service and drug prices is a pretty rudimentary dismissal of the broader sources of weakness as well as potentially transitory upside influences. Unlike the BoC and its much stronger domestic growth trend, the Fed has already hiked by 100bps which connotes some flexibility to take a breath and not rush next steps for any reason other than stubbornly sticking to script.

And finally, if financial stability is truly the goal of monetary policy of late, then would one wish to potentially and needlessly add monetary policy as a driver of financial instability through uncertain effects of reduced reinvestment upon term premia on the eve of what may be history repeating itself in terms of Congress's toying with the nation's creditworthiness? Leave the dialogue on hikes and tapers for the meeting minutes and retain the option to gather more information for some time to come. There is the risk of rewarding bad behaviour in Congress but not taking this risk by instead plowing ahead with tightened monetary policy risks courting damage to the economy and markets to stake out a costly principle. There should simply be no rush to implement anything on Maiden Lane.