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BUSINESS REVIEW

OCTOBER 2021 – THIRD EDITION

How the Jackson Hole Symposium impacts the US Federal Reserve

During the last week of August 2021, financial markets worldwide were looking at the Jackson Hole (J.H.) Symposium with trepidation. The J.H. Symposium has been an annual event hosted by the Federal Reserve Bank of Kansas City since 1978. It is a conclave of key central bankers, policymakers, academics, and a few journalists who discuss critical issues facing global economies and financial markets, focusing on monetary policy. This event has been held since 1981 in Jackson Hole, Wyoming, an area that is one of America's most beautiful national parks, possibly to allow cooler climes for intense deliberations. This year's J.H. Symposium was kicked off, as usual, by a speech by Jerome Powell, who is the Chairperson of the United States Federal Reserve (FED). In this speech, the global financial markets were expecting to get some hints about the future path of U.S. monetary policy. To put things in perspective, since the COVID pandemic-led recession, most central banks of the Advanced Economies (AE) and Developing Countries (DC) have indulged in unprecedented expansionary monetary policies. Central banks of AEs used both conventional and unconventional monetary policy measures to boost the economy. Using traditional monetary policy instruments, policy rates were brought close to the lowest possible rate (the "zero lower bound") to encourage spending. Moreover, to boost the system's liquidity, many central banks, including the FEDs, undertook large-scale asset purchase programs, broadly called quantitative easing (Q.E.). These policies were meant to stimulate the economy and absorb the shock of the recession. While these policies have been reasonably successful in their primary goal, the resultant excess liquidity has spilled over in the financial markets across the world and has led to a significant rise in prices of assets of different types. As some of the AEs are now coming out of recession and showing signs of a strong recovery, inflationary pressures are building up in these economies. Given this, it is expected that the central banks of these countries may change their accommodative monetary policy stance. A sustained economic recovery will allow Central banks to start winding up their asset purchase programs (called tapering), and they can also begin to push up the policy rate of interest from the present levels. These contractionary monetary policy measures would reduce the liquidity in the system, and any tightening of the liquidity will profoundly impact the global financial markets. Therefore, Jerome Powell's speech received particular attention from the financial analysts and the financial markets this year.

In his J.H. 2021 speech, Powell pointed out the following important facts about the U.S. economy. First, strong policy support has fuelled a vigorous but uneven recovery of the US economy—one that is, in many respects, historically anomalous. In a reversal of typical patterns in a downturn, aggregate personal income rose rather than fell, and households massively shifted their spending from services to manufactured goods. Secondly, the pace of the recovery has exceeded expectations, with an output surpassing its previous peak after only four quarters, less than half the time required following the Great Recession 2007-09. Thirdly, as is typically the case, the recovery in employment has lagged in output, but employment gains have also come faster than expected. He points out that the unemployment rate in the US economy has declined to 5.4 percent, a post-pandemic low, but is still much too high, and the reported rate understates the amount of labor market slack. Fourthly, Inflation in the US is high, and it is a cause for concern, but he feels that the higher inflation numbers are temporary, and inflation is likely to moderate in the medium term. However, he added that if "sustained higher inflation were to become a serious concern, the Federal Open Market Committee (FOMC) would certainly respond and use our tools to assure that inflation runs at levels that are consistent with our goal."

Based on these observations, he suggested that if the US economic recovery is sustained, the FED may start the "tapering" or reduce the number of monthly asset purchases from this year (2021) itself. However, he refused to give any timeline for a change in the policy interest rates. In light of the spread of the Delta variant of the COVID virus and uncertainties regarding the pandemic, he suggested that the interest rate hike timing will be decided after substantially more stringent tests. This continued accommodative stance by the US FEDs relieved the global financial markets, and the US stock indices rallied further, but some eminent economists questioned the continued accommodative stance of the FEDs and their views on transitory inflation. Former US Treasury Secretary Larry Summers thinks that the FED is misreading the inflation scenario and the risk of more persistent inflation is graver than what Powell suggested. In the opinion of Summers, the Q.E. should have been stopped by now, as its continuation harms the economy. Raghuram Rajan, the former Governor of the Reserve Bank of India, feels that the FED is going too slow on the taper this time, and they may have to make up later by accelerating the policy changes, which may be more destabilizing in the longer run. As the US dollar is the global reserve currency, and the US is still the most influential global economy, Fed policies can have an outsized impact on international interest rates. The J.H. 2021 address by Powell helped calm the nerves of the global financial markets in the short run. But as Summers and Rajan warn, there may be more painful adjustments ahead. Some central banks of the world, like the central bank of South Korea and those of Brazil and Chile, have recently raised their policy rates, and in due course, these ultra-loose monetary policy regimes will reverse in other countries. But when that happens will depend primarily on the trajectory of the pandemic and how the growth-inflation tradeoff plays out in each of the nations. The timing will be difficult to predict, but as the late economist Rudi Dornbusch famously warned, "In economics, things take longer to happen than you think they will, and then they happen faster than you thought they could."

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References:

Assets like treasury bonds and other government - guaranteed securities

The speech is available here: Speech by Chair Powell on the economic outlook - Federal Reserve Board

Annual Consumer Price Index based inflation in USA was around 5.4% in July 2021 against the FED's target rate of 2%

Larry Summers Says Serene Jerome Powell Arguments Misread Inflation Risk - Bloomberg