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# The Fed's Third Mandate Is Official

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NY FED PRESIDENT BILL DUDLEY TRYING  
THE NEVER BEFORE ATTEMPTED FEAT OF  
ADDING A THIRD MANDATE.

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**There has been a whole lot of ink spilled on the reason for the Fed's recent break from data dependence.** Many pundits believe the Federal Reserve's hawkish guidance, even in the face of low inflation readings, is a partisan attempt by Yellen & Co. to derail the weak recovery. I don't buy that argument. To think the FOMC board would leave rates easy for Obama or Hillary, but raise them for Trump is just foolish. **The Fed might be incompetent, but they aren't so blatantly biased.**



I have speculated the Federal Reserve's deviance from data dependence can better be explained by the adoption of a third mandate - financial conditions (Rejoining the Dark Side [7]), but my theory involved a fair amount of reading in between the lines. Until now...

This morning, at a speech at the BIS Annual General Meeting [8], Bill Dudley came right out and stated unequivocally that the Federal Reserve was targeting financial conditions.

*As I see it, financial conditions are a key transmission channel of monetary policy because they affect households' and firms' saving and investment plans and thus influence economic activity and the economic outlook. If the response of financial conditions to changes in short-term interest rates were rigid and predictable, then there would be no need to pay such close attention to financial conditions. But, as we all know, the linkage is in fact quite loose and variable.*

*For example, during the mid-2000s, financial conditions failed to tighten even as the Federal Reserve pushed its federal funds rate target up from 1 percent to 5¼ percent. Conversely, at the height of the crisis, financial conditions tightened sharply even as the Federal Reserve aggressively pushed its federal funds rate target down toward zero. As a result, monetary policymakers need to take the evolution of financial conditions into consideration. For example, when financial conditions tighten sharply, this may mean that monetary policy may need to be tightened by less or even loosened. On the other hand, when financial conditions ease — as has been the case recently — this can provide additional impetus for the decision to continue to remove monetary policy accommodation.*

**There is no ambiguity there.** That's as clear as Central Bankers get. Dudley, who is generally considered the third most influential FOMC board member (behind Yellen and Fischer), is telling

you plainly - as long as financial conditions keep easing (and employment doesn't collapse), the Fed will keep raising.



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Look closely at the last line of Dudley’s quote, “when financial conditions ease — as has been the case recently—this can provide additional impetus for the decision to continue to remove monetary policy accommodation.”

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**The FOMC wants stocks to stop rising, and they will keep raising rates until they stop.** Although Neel Kashkari has gone rogue, as one pundit so eloquently put it, the rest of the board are all on the same page.

This weekend the San Francisco Federal Reserve President John Williams made a speech in Australia that was surprisingly hawkish:

*I once had a T-shirt printed up that reminded folks that the decisions we make at the Fed are "data-driven," and they are. Although we live in a hyper-political era, the Fed is strictly apolitical...and as one of America's great exports, Lady Gaga, would say, we were "born this way." Our enterprise is unique within the U.S. government in both function and structure, and our design allows us to make decisions independent of short-term political influence. We base our decisions on what's best for the long-term health of the economy, rather than "living for today."*

*The U.S. Congress has mandated that our job is to keep the economy stable and on track, with a focus on two big goals: maximum employment and price stability. We want everyone who wants a job to be able to find one and for inflation to average 2 percent per year over the long run.*

*Today, the U.S. economy is about as close to these goals as we've ever been. Among other things, we've fully recovered from the recession.*

*When it comes to our employment goal, this is typically viewed in terms of the unemployment rate relative to the natural rate of unemployment—by this I mean the level consistent with an economy that is running neither too hot nor too cold. We can't know precisely where this magic number is, but I put it at about 4¾ percent.*

*Today, the U.S. unemployment rate is 4.3 percent—meaning that we've not only reached the full employment mark, we've exceeded it by a fair amount. Given the strong job growth we've been seeing in the United States, I expect the unemployment rate to edge down a bit further and remain a little above 4 percent through next year.*

*Meanwhile, inflation has been running somewhat below the Fed's goal of 2 percent for the past few years. In the past, this low rate of inflation was the product of a number of factors—the recession and the strength of the U.S. dollar being the two main ones. Recently, some special transitory factors have been pulling inflation down. But with some of these factors now waning and with the economy doing well, I expect we'll reach our 2 percent goal sometime next year.*

*Now, I'd love to be able to tell you that the news is all rosy and that our work here is done. Unfortunately, they don't call economics "the dismal science" for nothing. I'm paid to consider what potholes may be dotting the road ahead.*

*For starters, the very strong labor market actually carries with it the risk of the economy exceeding its safe speed limit and overheating, which could eventually undermine the sustainability of the expansion.*

*When you're docking a boat in Sydney Harbour, the San Francisco Bay, or elsewhere, you don't run it in fast towards shore and hope you can reverse the engine hard later on. That looks cool in a James Bond movie, but in the real world it relies on everything going perfectly and can easily run afoul. Instead, the cardinal rule of docking is: Never approach a dock any faster than you're willing to hit it. Similarly, in achieving sustainable growth, it is better to close in on the target carefully and avoid substantial overshooting.*

*What this means is that we do not want our economy to run too hot or too cold. Like Goldilocks, we want our porridge to be just right.*

*During the recession and recovery, jump-starting and speeding the recovery required historically low interest rates. Today, interest rates in the United States remain low—and this is even true after the most recent Fed action, which I'll get to in a moment.*

*I'm sometimes asked why we don't just leave things as they are and not raise interest rates. After all, if things are going well, why change? The answer is that gradually raising interest rates to bring monetary policy back to normal helps us keep the economy growing at a rate that can be sustained for a longer time.*

*If we delay too long, the economy will eventually overheat, causing inflation or some other problem. At some point, that would put us in the position of having to quickly reverse course to slow the economy. That risks stalling the expansion and setting us back into recession.*

*My goal is to keep the economic expansion on a sound footing that can be sustained for as long as possible. The last thing any of us want is to undermine the hard-won gains we've made since the dark days of 2008 and 2009, when it seemed like the U.S. and world economies were on the verge of collapse.*

*Therefore, we're in the process of normalization. At our June meeting, the FOMC undertook the second ¼ percentage point increase in our main policy interest rate this year. And we announced that we expect that economic conditions will warrant further gradual increases in the future.*

Re-read the paragraph about docking in a harbour. **These are not the words of a Fed President willing to let growth run.** He is on the same page as Dudley.

**It is stunning that markets are not taking these words more seriously.** I don't know if it was too many times crying wolf, but we have hit a point where markets are ignoring extremely hawkish rhetoric from Fed officials.

The Fed seems to have lost credibility, and I fear that **when the market finally realizes the Fed might in fact follow words with deeds, an abrupt repricing of financial assets will be on deck.**

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