July 15, 2025

Dutta's Monetary Thoughts

Fed may fall into U3 trap

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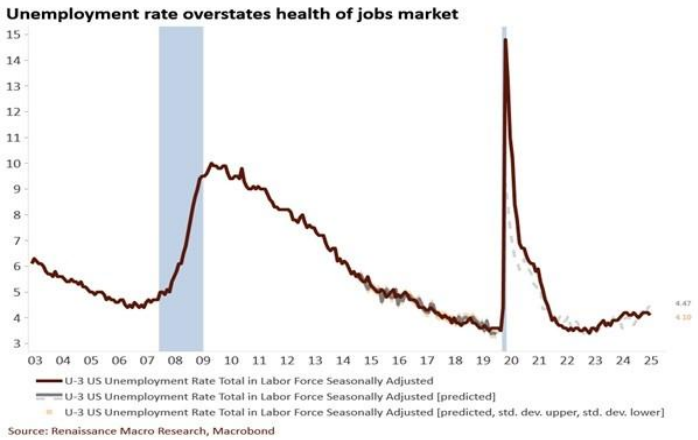
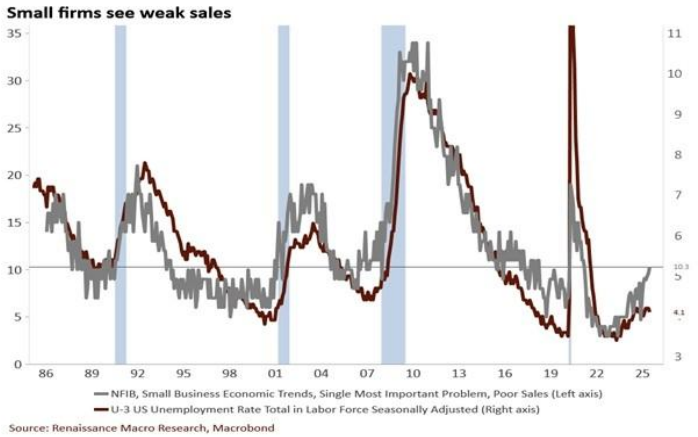
Unemployment rate overstates strength

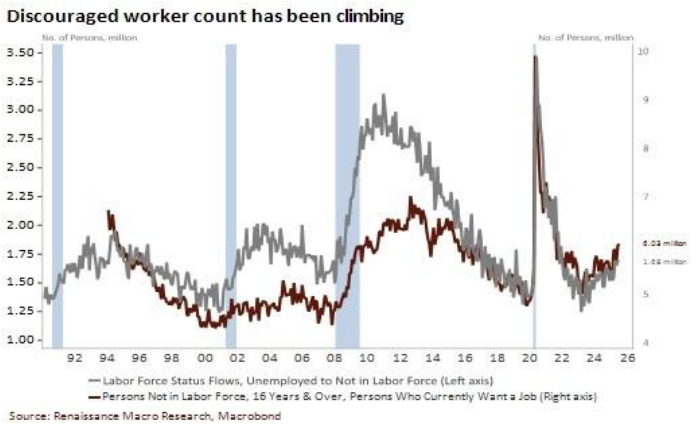
Claiming labor market conditions are "solid" simply because the unemployment rate is low might lock policymakers into a false sense of confidence about the outlook. The U-3 unemployment rate overstates the degree of strength in the labor market, and this is clear across several dimensions.

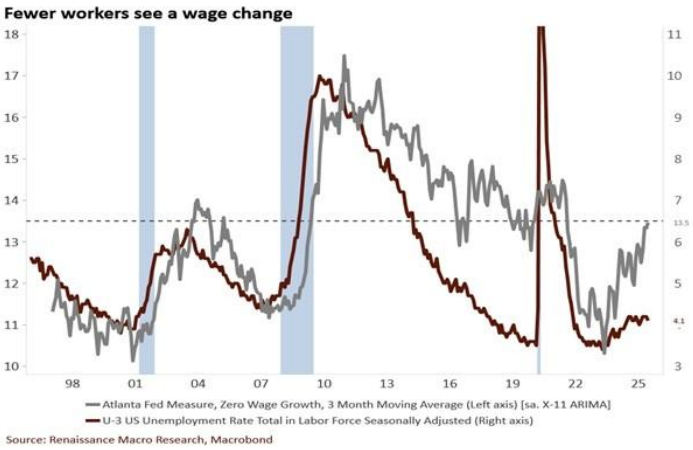


- Attitudes about the jobs market have been souring. As of June, the Conference Board's Labor Differential stands at a cycle low of 11.1 percent. Consumer views about the labor market tend to lead the actual statistics on the jobs market. Firms are not much different. Specifically, small businesses have been more likely to site "poor sales" as their biggest problem, a sign demand is slowing.



- The decline in the unemployment rate has been driven in part by exits from unemployment to not in the labor force. Indeed, the number of workers out of the workforce that want a job now has been rising. These marginally attached workers are likely to put downward pressure on the wages of those that are working. A stronger jobs market likely pulls them back in.

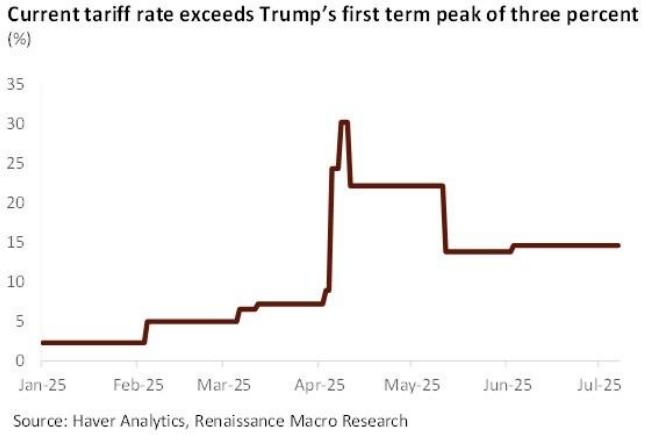




• The surest sign of a tightening jobs market is rising wage growth. However, more workers have seen zero wage change compared to last year. Firms prefer to hold employee pay flat as opposed to cut outright (nominal wage rigidity). According to the Atlanta Fed, in June, 13.6% of individuals saw no wage change in June, a fresh high.

Using these indicators, we estimate a predicted value for the unemployment rate. Running the regression, we see that the predicted unemployment rate is 4.5 percent, nearly half a percentage point above the actual. The actual unemployment rate is running about one standard deviation below the estimate implied by this model.

I don't use this to make a prediction, but simply to argue that across a variety of metrics, the unemployment rate by itself does not give an accurate representation of labor market conditions. Thus, relying on Taylor Rules might lead policymakers astray, adopting a more hawkish policy stance than is necessary.



No house money to play with

Now that the One Big Beautiful Bill has been passed into law, President Trump perhaps believes he can pivot back to a more hawkish posture on trade. One can liken this to a "house money" effect. However, this is problematic in two important ways.

- First, the scale of the trade threats is an order of magnitude higher than was the case in Trump's first term. The effective tariff rate today is about 10% on its way to 15% while in his first term it never got as high as 3.0%. **Because goods imports represent about 10% of US GDP, this represents a 1.5ppt shock to growth**.
- Second, the OBBB locks in current policy; it does not introduce anything materially new. If TCJA was assumed to be permanent, we're looking at a 0.2ppt boost to growth in the first and second year.

In short, the tariffs will neutralize the fiscal legislation on top of an economy that was already slowing down to begin with. It's a problem if Trump thinks OBBB gives him a longer leash to play around with on tariffs.

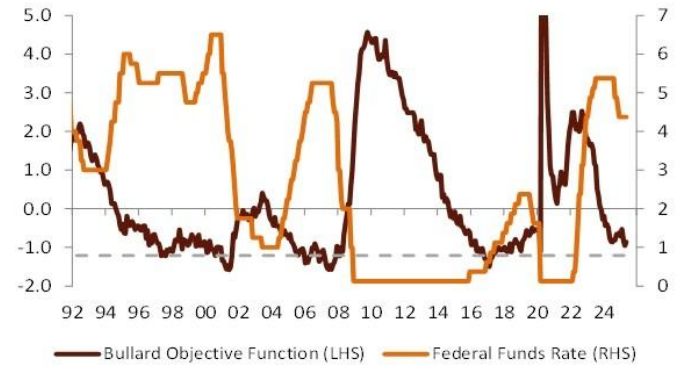
Kevinflation

Over the weekend, Kevin Warsh and Kevin Hassett had a contest on the Sunday shows over who could debase themselves more in a quest to succeed Jerome Powell as Fed Chair.

Warsh called for "regime change," a change in "their mindset and their models." I find this line of attack on Powell somewhat off-putting for a couple of reasons.

- First, Powell has shown an ability to change mindset. After all, we're talking about Powell, the guy who promised to hit the employment mandate first before raising rates. That's unusual for the Fed, which generally hiked rates long before the economy was at full employment. You might not like the change in mindset, but that's a different conversation.
- Second, I think we ought to grade on a curve. There are downside risks to the outlook, which the Fed ought to lean against, but let's face facts, the Fed is quite close to their macroeconomic goals right now.
- I update the Bullard objective function: a quadratic function used to measure the distance of an economy from its goals, specifically regarding inflation and unemployment. It is defined as (inflation - target inflation)^2 + (unemployment - target unemployment)^2, where the goal is to minimize this value. As the figure shows, we're close to the historical average by this standard!

Fed is actually close to their goals



Source: Renaissance Macro Research, Haver Analytics

Last week, he came out in support of rate cuts, a breathtaking about-face for someone that's been a perennial hawk. This latest salvo – calling for "regime change" might get Warsh a lot of eyeballs, but it wreaks of a desperate attempt to stay relevant. He's out of his depth and that's been obvious across a range of issues for years now.

Meanwhile, the Director of the National Economic Council, Kevin Hassett, is someone who probably knows better but understands that saying things you don't necessarily believe is the price of entry for a seat at the table.

On ABC News, he put some life into the notion that the White House could use building renovation cost overruns as a pretext to fire Jerome Powell. If cost overruns were an offense worthy of dismissal, I am not sure how many people in DC would be left with a job.

There are a few major problems with what's happening right now with this Fed horse race.

- First, for all the talk of a Shadow Fed Chair, if either Hassett or Warsh end of getting the nod – at the rate they are going – they may well end up being a "Chairman in Name Only." Putting in someone seen as loyal to Trump above all else might invite the ire of the other governors and perhaps be enough to keep Powell in his seat.

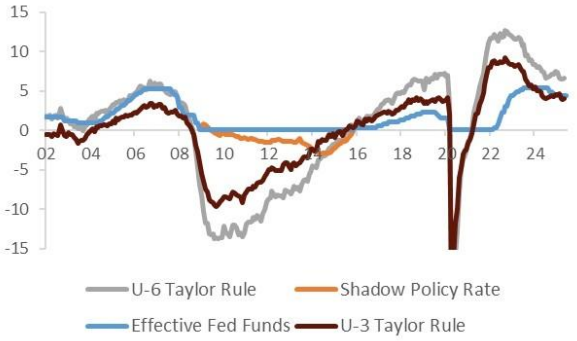
- Second, there is zero intellectual consistency here. Last year, the economy was dead in the water under Biden, but rate cuts not needed. Now, the economy is allegedly booming under President Trump, but cuts as desperately needed.

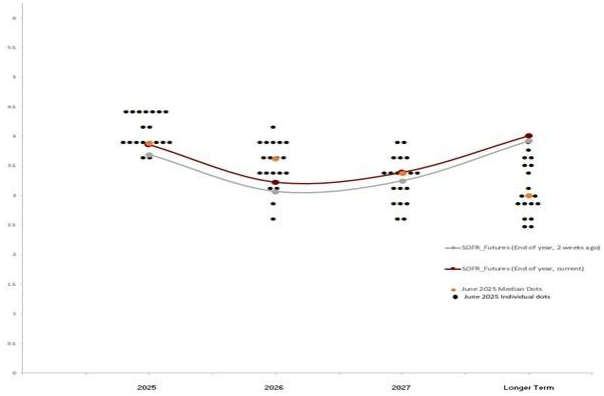
- Third, there are legitimate issues to talk about when critiquing the Fed's policy stance. They are going through a framework review right now – perhaps there are better ways to think about the nominal anchor than just consumer prices. Warsh and Hassett don't really have much to say here (it's not as sexy).

Trump likely sees Waller as the best, worst option

President Trump is conducting his search for Powell's successor in, to put it mildly, not the best way, essentially creating a litmus test for any eventual nominee. This taints the nominee with their new colleagues, especially if they are within Trump's personnel orbit. For this reason, elevating Waller might make the most sense. If you want to leave your mark on the Fed, guarantee yourself more vacancies to fill. Nominating Waller affords President Trump that opportunity because it will be highly probable that Powell leaves before his term as governor is up.

Monetary metrics



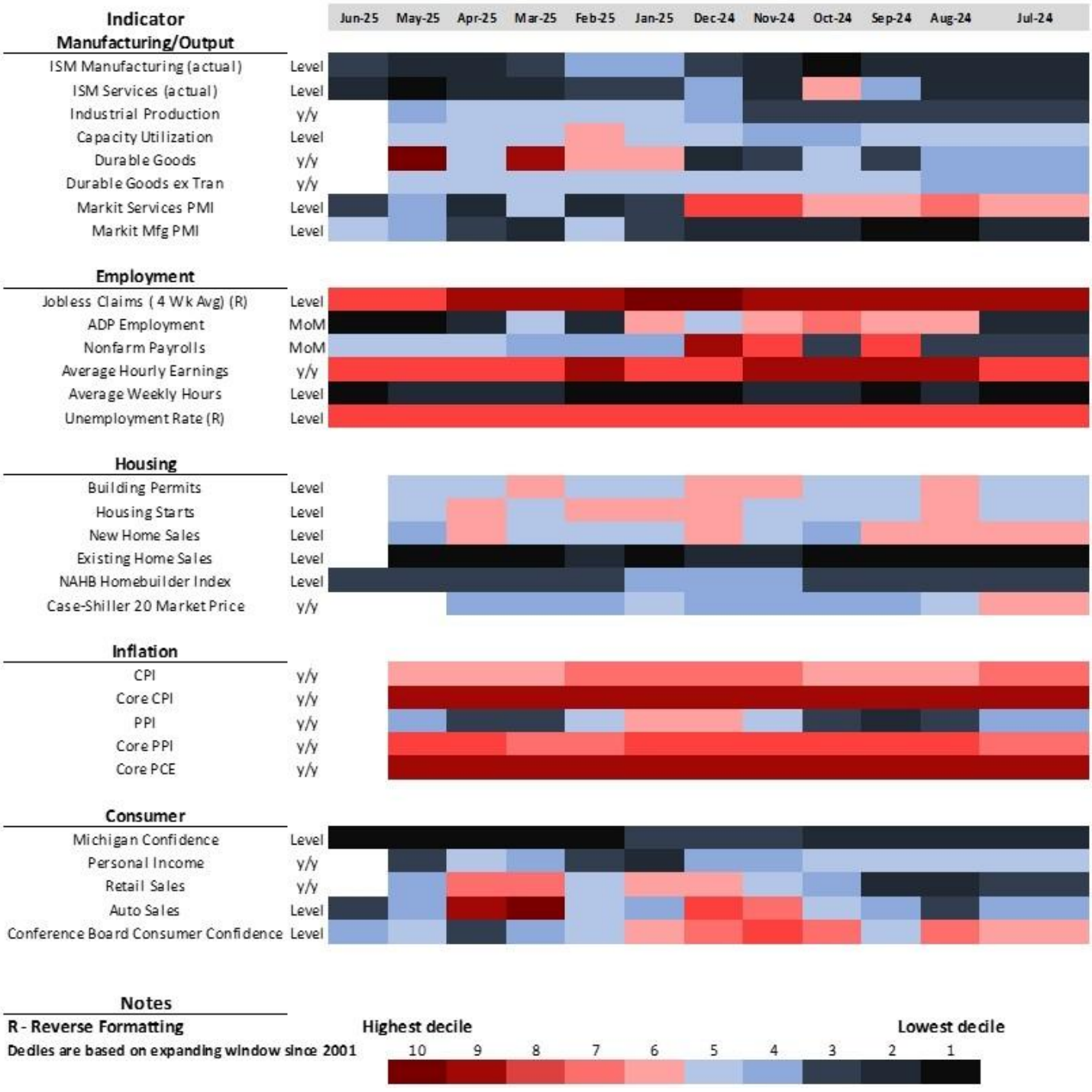


Hawks and Doves

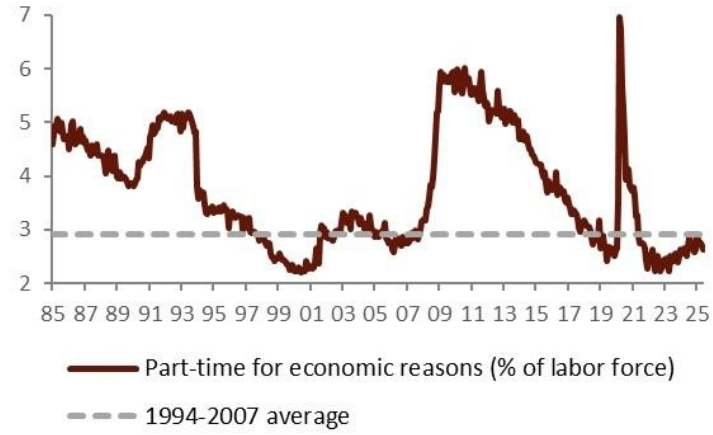
*Federal Reserve Bank of NY President always votes
Boxed individuals represent FOMC core

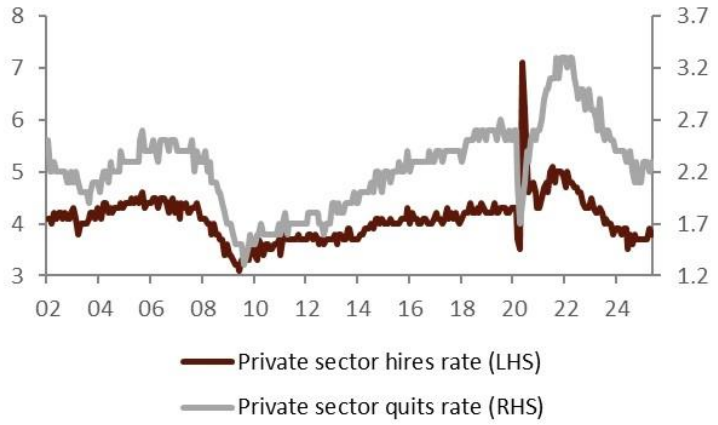
FOMC Forecasts	Median				Central Tendency			
	2025	2026	2027	Longer run	2025	2026	2027	Longer run
Change in real GDP	1.4	1.6	1.8	1.8	1.2–1.5	1.5–1.8	1.7–2.0	1.7–2.0
March projection	1.7	1.8	1.8	1.8	1.5–1.9	1.6–1.9	1.6–2.0	1.7–2.0
Unemployment rate	4.5	4.5	4.4	4.2	4.4–4.5	4.3–4.6	4.2–4.6	4.0–4.3
March projection	4.4	4.3	4.3	4.2	4.3–4.4	4.2–4.5	4.1–4.4	3.9–4.3
PCE inflation	3.0	2.4	2.1	2.0	2.8–3.2	2.3–2.6	2.0–2.2	2.0
March projection	2.7	2.2	2.0	2.0	2.6–2.9	2.1–2.3	2.0–2.1	2.0
Core PCE inflation	3.1	2.4	2.1		2.9–3.4	2.3–2.7	2.0–2.2	
March projection	2.8	2.2	2.0		2.7–3.0	2.1–2.4	2.0–2.1	
Projected policy path								
Fed funds rate	3.9	3.6	3.4	3.0	3.9–4.4	3.1–3.9	2.9–3.6	2.6–3.6
March projection	3.9	3.4	3.1	3.0	3.9–4.4	3.1–3.9	2.9–3.6	2.6–3.6

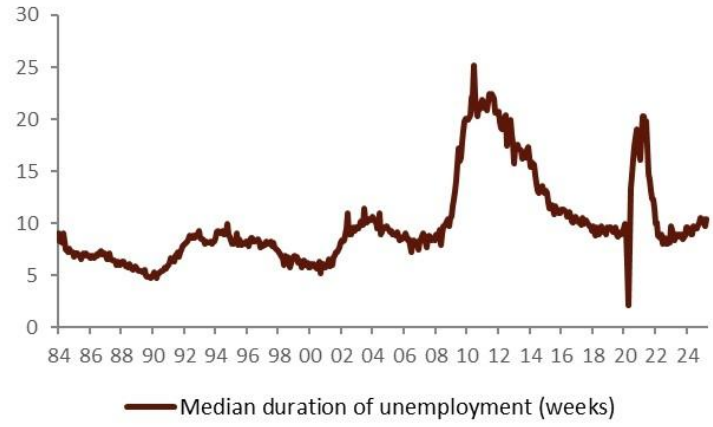
High frequency data heat-map

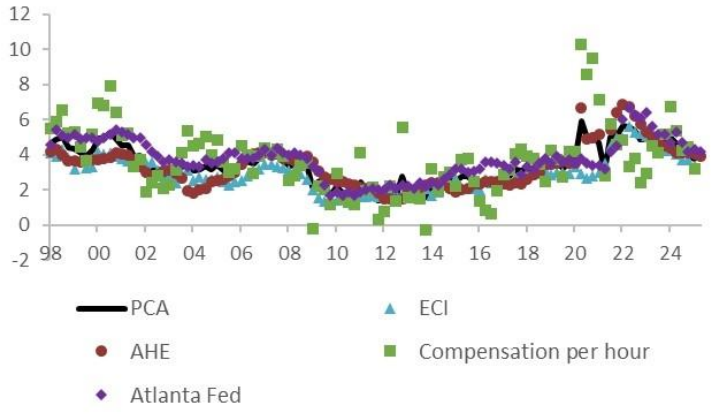


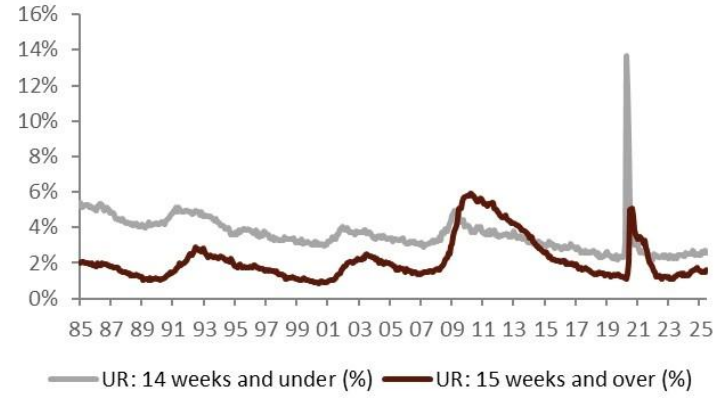
Labor market indicators

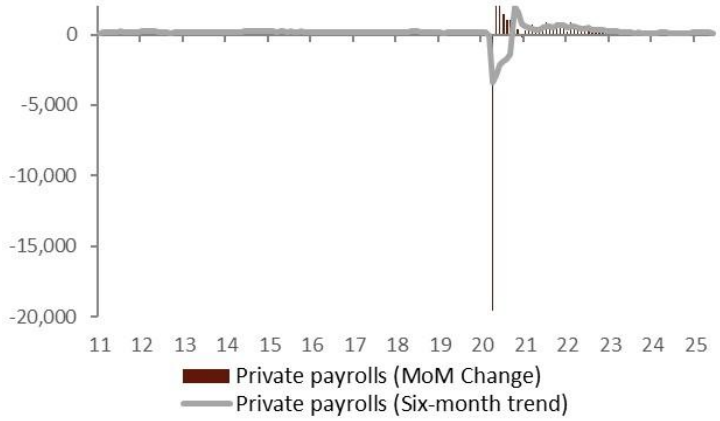




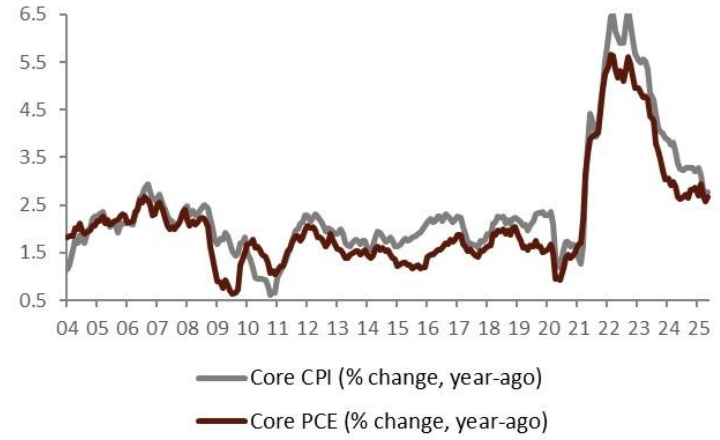


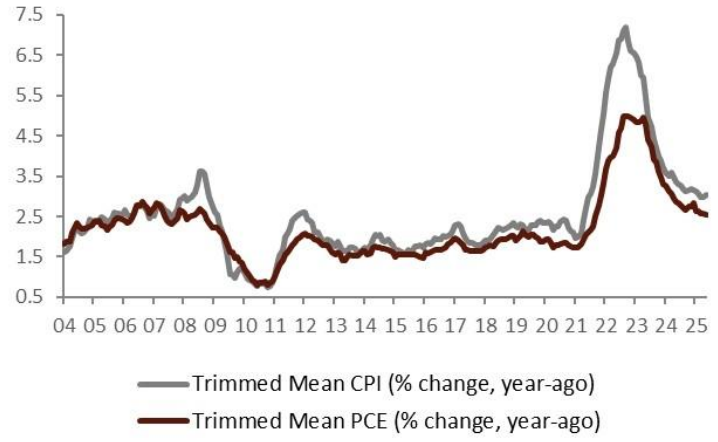


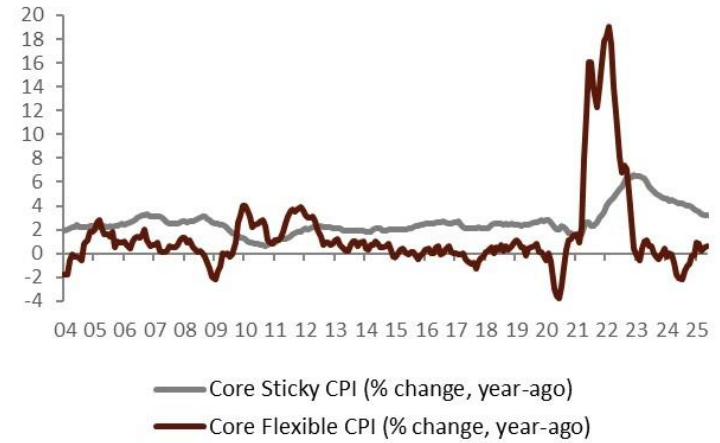


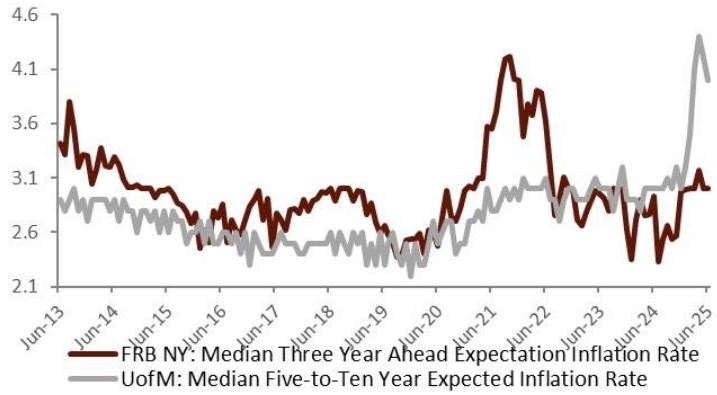


Inflation indicators





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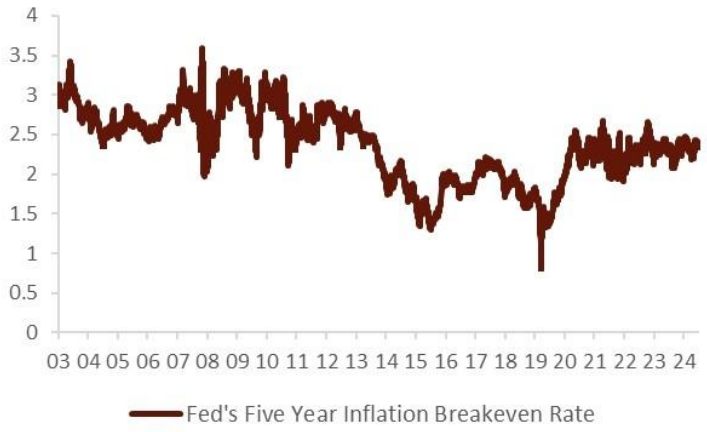
FRB NY: Median Three Year Ahead Expectation Inflation Rate
UofM: Median Five-to-Ten Year Expected Inflation Rate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Fed's Five Year Inflation Breakeven Rate