The Fed Wears the Pants: Why Confidence Doesn't Matter

It is common when reading financial media to see references to “confidence”, be it the confidence of consumers or business. These analyses usually go something like “If X, Y or Z happens, confidence will rise/fall, which in turn will lead to more/less spending by consumers and business”. These sorts of articles were particularly common in the 2011-2014 period, when many big-name business economists were looking for signs the public was returning to the housing market. The argument went: because interest rates were so low, the public was sure to take out mortgages and lift the housing market. This would mean accelerating housing starts, rising house prices, home equity loans, then more spending on consumer durables and services. This model for the recovery certainly gave analysts many data points to write about (and charge clients and readers for), but it ultimately proved to be the wrong way to look at things.

The confidence-focused model for the recovery failed because it mixed up causality. The mistaken analysts thought the Fed had done its job by lowering interest rates. With rates low and QE putting pressure on long term rates, it was now up to households to *become confident*. In this view, the actions of households were somewhat independent of Fed policy, if people would only spend money, then spending multiplier effects would take their course and before long the economy would have such a head of steam that the Fed could unwind its unconventional stimulus and begin raising rates in an effort to rein in the increasingly *confident* private sector. The problem here is that it is the Fed who is the first and last mover in this game, not households and not the government.

The question that should have been asked was “why hasn't the Fed *made* households and businesses appropriately confident?” It was as though the press and the economic consultants were blaming the engine and transmission for the slow pace of the car, when they should have blamed the driver for not pressing the accelerator hard enough or shifting to a higher gear.

In a monetary system where the money supply is managed by a central bank, wherein the central bank is actively trying to steward the economy (as opposed to pegging the exchange rate against some reference country), the total spending level is determined by the central bank's actions. NGDP Advisers' position is that the private sector is almost entirely reactive to the central bank. There is literally nothing the public could do, short of switching to a different currency, to boost total spending if the central bank isn't willing to allow that to happen. Forget how confident they become, forget how much of their credit lines and cash they spend, if the resulting spending increase isn't what the central bank wants, they'll use their monopoly on currency creation to pull spending back down.

We say that “confidence doesn't matter” because of this reactive quality of the private sector. Everyone could wake up tomorrow with a terrible foreboding about the future, plan to rein in their spending, yet the Fed or any other independent central bank could force *de facto* confidence upon them. This reality is well-demonstrated by the Fed's actions in early 2009, at the bottom of the Great Recession, when “confidence” was at a multigenerational low. The Fed's largely symbolic quantitative easing programs worked to reverse the decline in asset prices and force even the gloomiest inflation-fearing bears to short the dollar and go long commodities, actions that worked out to give similar returns to simply going long equities.

If the Fed is able to move confidence from (let's make up some numbers here) a '3' to a '7' what's to stop it from taking confidence from '7' to '12'? The experience of Japan in 2013, suggests a straightforward answer: nothing stands in the way.

The Japanese central bank gave us one of the most important monetary experiments in decades; by simply stating a goal to increase long run inflation to 2%, they ended years of mild deflation and a flat-lined NGDP trend. Financial markets reacted immediately to this news, and showed they now expected the Bank of Japan to increase the long-run supply of Japanese Yen. Central banks can *force* confidence on the public by simply having the will to lay out a clear strategy to achieve a nominal goal for the economy.

The central bank can't create boundless wealth. But the central bank controls perceptions of future spending in the economy, whether it wants to or not. So next time you read an article wherein an analyst pours over the details of the latest economic report, speculating as to how these data points might affect 'confidence', ask yourself “will this change how the central bank steers the ship?”. If you don't think so, feel safe disregarding the analysis.