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Lagged Effects of Fed Tightening May Be Ready to Kick In

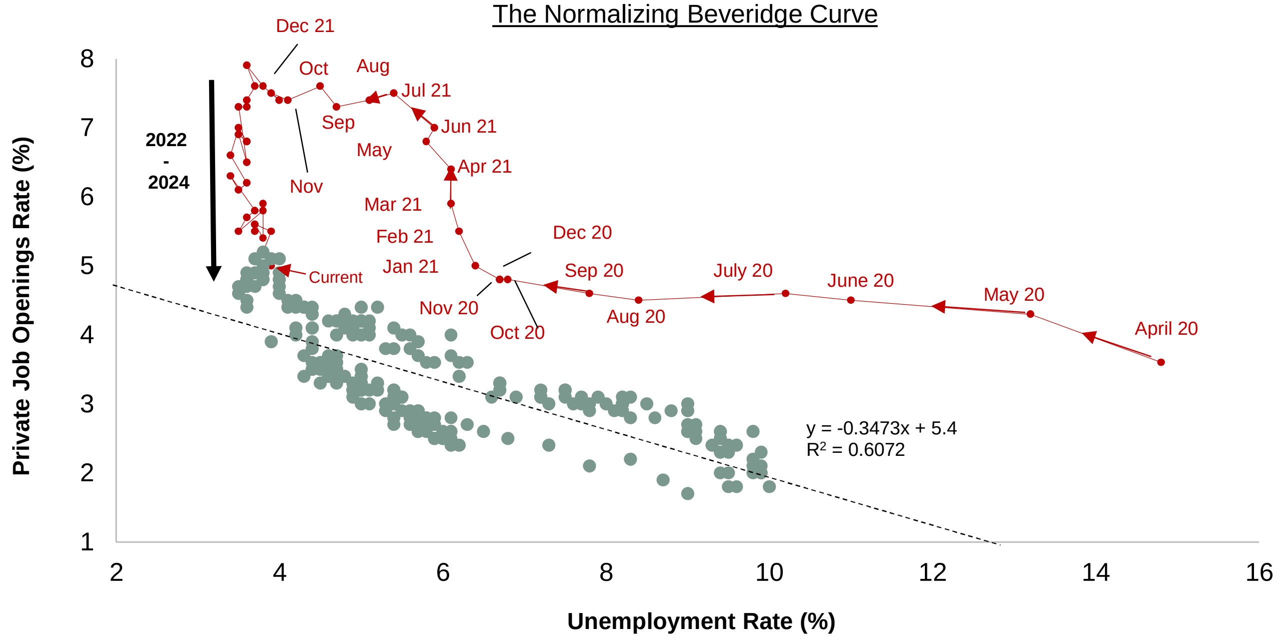
Why hasn't the economy gone into recession? We have cited excessive fiscal stimulus and overtly stimulative financial conditions as two factors. The former is evident from the fact that this year's budget deficit is projected to approach 7% of GDP alongside a 4% unemployment rate. Never has the government run such massive deficits with the economy at or near full employment. Surely, this is keeping aggregate demand stronger than it otherwise would be. In fact, fiscal and monetary policy are working at cross purposes.

At the same time, the Fed's desire to be overly transparent has caused investors to front run policy, which is effectively undoing any tightening that may be in train. For example, when Chair Powell signaled a pivot last December, this further boosted in an ebullient equity market, and thereby increased household net worth, offsetting the demand depressing effects of high household borrowing costs. This is also evident from the fact that the real fed funds rate is historically high, while at the same time, financial conditions are historically easy. But we think **another factor to consider is the profound distortion that the pandemic had on the labor market**.

The Beveridge Curve measures the relationship between job openings and unemployment. During the pandemic, there were many restrictions on economic activity, while at the same time demand was lifted by historic income support which was followed by excessive fiscal stimulus. This situation led to high job openings, and high unemployment because of Covid-related activity restrictions. This created a significant mismatch of labor demand and labor supply in the job market, as illustrated in the chart below. Notice how **data points were knocked far off their pre-pandemic moorings in April 2020, only to slowly find their way back to trend**. They were well above the fitted pre-pandemic trendline. But now, we can see the labor market is normalizing: **As a sharp decline in job openings has occurred alongside a modest increase in unemployment. This suggests that restrictive monetary policy is finally beginning to impact the jobs market.**

Consequently, unemployment is likely to bear the brunt of a persistently high fed funds rate as job openings have now moved close to their pre-pandemic readings. If so, this means that **the lagged effects of higher interest rates have simply been stretched out, owing to the unprecedented distortions from the pandemic**.

The Normalizing Beveridge Curve



Source: BLS, Haver, SMBC Nikko

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