July 2021

Fed Thoughts:
The Sociology of Central Bankers

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Three behavioral traits of central bankers, who set policy based on the decisions of a committee, are shared around the world. Those in the tribe love ambiguous phrasing, about which they talk a lot, and are loathe to surprise anyone. The list of such actors notably includes the Federal Reserve's (Fed) policy-setting group, the Federal Open Market Committee (FOMC), and the Governing Council of the European Central Bank (ECB). These three features were on display from the Fed in the recently published minutes of the latest FOMC meeting, the semiannual report on monetary policy, and Fed Chair Powell's appearances on Capitol Hill about the report. The ECB followed up in early July with its hurried-up announcement at the conclusion of a strategy review of monetary policy, also evidently shaped by those three features.

This note makes the case that understanding the sociology of policymaking committees helps to understand the intent behind and future path of their decisions. First, we spell out these three salient features. Next, we apply this description to the Fed's upcoming actions on tapering its asset purchases and timing the liftoff of policy rates. Neither will begin soon, certainly not at the upcoming FOMC meeting, but officials will begin to put a narrative frame around those future actions. Last, we explain how the inherent constraints imposed by tribal behavior narrow the import of the ECB's new policy framework.

The Sociology of Central Banking Tribes

For all their reputation for secrecy, central bankers are gregarious, at least amongst themselves. They regularly congregate in Basel (for meetings of the Bank for International Settlements), Paris (at working party meetings of the Organization for Economic Cooperation and Development), and at resort locations for conferences. Much of what outside observers take as policy coordination is policy emulation, as no one wants to stray from the herd. Thus, not surprisingly, their behavior in framing and setting policy exhibits three similarities.

Ambiguity: Policymaking groups favor statements shrouded in ambiguity, reflected in statements chock-full of adjectives and adverbs such as significant, considerable, moderately, and meaningfully. Such fuzzy phrasing, which has created a cottage industry of outside interpreters, seems at odds with monetary policy transparency. Their existence is mostly not about the external audience. Rather, their use in public statements pitch a big tent internally in which members of the group with a wide range of views can take cover. After all, who among the tribe would not sign on to a statement, say, assuring that "given the meaningful support of monetary policy, there will likely be a significant rebound in economic activity and meaningful progress toward the goal of price stability?" But what did they just agree to?

Talkativeness: Central bankers love to talk, reflected in typically arriving at decisions over multiple meetings after always being briefed by staff who provide reams of supporting material. Some institutions also summarize their deliberations in meeting minutes and all give press conferences, testimonies, speeches, and interviews. They use the platforms of their major mountain-view research retreats—in Jackson Hole for the Fed and Sintra for the ECB—to showcase their thinking. As a result, the ship of state typically turns slowly and is bedecked with multiple signal flags.

Surprise aversion: To central bankers, the most successful announcements of policy decisions are those eliciting a collective yawn from the media and market participants. The announcement conveys no news when the decision is made incrementally and telegraphed through talk, forecasts, and position papers. If, in the view of the central bank leadership, the public seems dense on the uptake of their message, they grant interviews in the run-up to meetings to favored media outlooks (whether public or private) to nudge public opinion to the appropriate place. Simply put, they view the element of surprise as overrated because they fear a shock to the financial system might trigger an unpredictable and outsized reaction in financial markets and to public confidence.

The importance of these behavioral constraints can be seen in their violations. At a time of stress—think of October 2008 for the Fed, July 2012 for the ECB, and March 2020 for both—rapidly changing events concentrated power to the center. Directness was required, there was no time for forewarning, and a shock to the system was viewed as a necessary redirection of a downward spiral in financial market functioning. Among those case studies, action from the center last spring pinned the policy rate at its effective lower bound for an indefinite time, set the size of central bank balance sheets on an upward ascent, an created a raft of special programs. But the fact that those exceptions can be counted on the fingers of one hand show them to prove the rule. The healing of financial markets and the rebound in the global economy once again leaves it to broader groups to agree on paths to the exits. As normalcy returns, the three features of group dynamics have reasserted themselves.

The Fed seems to be a bit ahead of the ECB because of a smoother (not smooth) vaccine roll-out and a more aggressive fiscal response provided by US political authorities.

The Fed's Path to the Exit

The Fed has already moved beyond its lending and asset-purchasing programs, letting an alphabet-soup collection of facilities lapse in a staggered fashion from December to March. In Fed Chair Powell's terms, these directed tools have been put back into the toolkit. Recognize, however, that precedent matters. Having resorted to them in one crisis, Powell and his successors will be more willing to resort and expand on them in future crises, probably with a lower hurdle to act and with more force. The next steps are to stop net asset acquisition of securities and, when done, begin the liftoff of the policy rate from its effective lower bound of zero.

Precedent also binds this process.

First, purchasing assets beyond what is required to maintain reserves at a level consistent with achieving the fed funds target is considered unconventional monetary policy. Officials will want to cease accommodation through unconventional means before touching conventional policy (the level of rates).

Second, the plan will be to taper net asset purchases to zero and then hold the net stock steady. Adding assets to the balance sheet has been described as policy accommodation. Working down net asset holdings logically represents policy firming. Fed officials prefer to leave that gear in neutral and set the conventional one to climb the hill of firming. This implies that the Domestic Desk managing the Fed's portfolio will continue to make large-scale asset purchases to replace maturing and pre-paying Treasury and mortgage backed securities. If so, the stock of reserves will slowly shrink over time as the secular growth of the demand for banknotes, which is faster than that of nominal GDP, replaces some of those Fed liabilities.

Third, during and after the levelling of the Fed's security holdings, it will never sell any of them in the open market. This is set in stone by official disinclination to risk roiling financial markets.

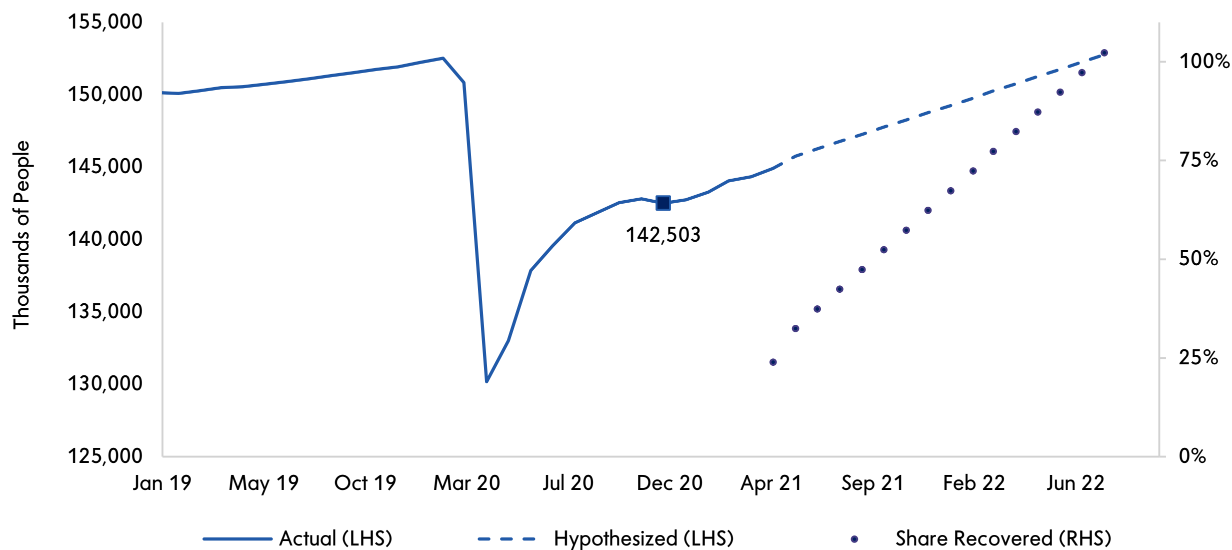
Last December, the FOMC placed the bar that slowing asset purchases required evidence that "…substantial further progress has been made toward the Committee's maximum employment and price stability goals." This is outcome-based, not outlook-based monetary policy, in that the trigger must be demonstrated. The Fed has been explicit in the weight placed on its two goals in this stage of the cycle, favoring the return to full employment over the pursuit of price stability. Hence, it is safe to assume that the benchmark is making substantial further progress in paring back the 10 million jobs lost, on net, from February to December of last year. True, Fed officials bristle at the notion that full employment can be captured in one number. Their discussion has notably shifted the frame of reference to

include underrepresented segments of the population. Their specific tools, however, to address those problems seem limited, and, even with all this talk of inclusiveness, they repeatedly cite total payrolls.

Chair Powell asserted in his most recent press conference that "…substantial further progress is still a long way off." As a result, we know the net gains of 3¼ million workers on payrolls through the first six months of 2021 fell well short of the bar. If it is not one-third, is it one-half or three-quarters of the shortfall that needs to be recovered? "Substantial" sacrifices specificity, as in our first principle of the sociology of central bankers, but it feels like it is a majority concept.

The chart below plots payroll employment since the beginning of last year as the solid line, extrapolating the path in the dashed line assuming that one-half million jobs are created on net each month. This about matches the monthly pace thus far this year and seems the appropriate norm for a period in which booming aggregate demand meets bottlenecks in supply. The initial rebound in labor markets last year mostly involved people returning to their old place of work. Further progress requires the unemployed to find new jobs, a complicated and time-consuming matching process influenced by lingering health concerns and the generosity of some state unemployment compensation schemes.

Measuring "Substantial Further Progress"
Total Payrolls & Share of Job Loss Recovered since December 2020



Source: Bureau of Labor Statistics, via FRED, and Mellon calculations.

The dots in the chart, measured along the right axis, provide the share of the employment loss from February to December 2020 that was recovered this year. By October, the economy should be at the halfway mark, but three-quarters of the lost jobs are not recovered until next March. This drives our forecast that, somewhere in between, the FOMC will begin tapering its asset purchases. While Fed officials will not start until progress is demonstrated, they must plan the program and prepare markets before then. That is, the herd obeys the second and third principles of central banking sociology. As a result, policymakers have entered the phase where they are talking about talking about tapering. This was the essential message from the June meeting, more important than the evident diminution of disaster risk putting the rate liftoff somewhat nearer in sight.

The past few policy transitions, aside from the abrupt one driven by the onset of the pandemic, demonstrate that multiple FOMC meetings are the norm to frame the discussion, discuss, forewarn market participants, and announce a decision. Thrown into the mix is the platform offered by Fed Chair Powell at the Jackson Hole Symposium in late August (to be done in person, not virtually), an offer he has thus far never refused. In our view, the calendar would proceed as follows:

July meeting: Organize the discussion and lay out the criteria to consider in staff work, including the pace and composition of tapering and the path of the Fed's balance sheet.

August in Jackson Hole: Chair Powell offers a high-level metaphor to describe the dynamics of the program (remember his journey across the "stars"), supported by a staff document working through balance-sheet arithmetic for various scenarios. Part of the arithmetic will show that reserves increase more slowly than assets given the secular uptrend in currency. This is the place to put the markers down that the balance sheet levels off thereafter, they will not sell securities, and that the rate liftoff awaits the completion of the taper.

September FOMC: Receive the complete staff package, squirm through a few hours of briefings, share views.

November FOMC: Provisionally agree to a plan and to formalize agreement at the next meeting.

December FOMC: Announce that a stepped-down path of slower asset purchases begins in January.

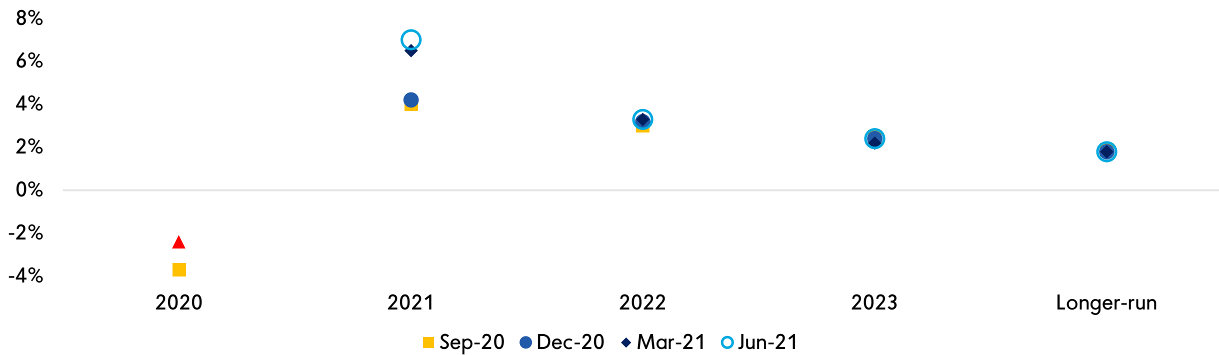
To be sure, there is a lot of space on this calendar, consistent with a policymaking group that talks through every issue, leaves room for public discourse, and waits for progress in reducing unemployment to be demonstrated.

The rate liftoff follows, brought home by the latest "dot" plot in the quarterly Summary of Economic Projections (SEP) from the June meeting. The key to unlock the dot plot is to consider its less-loved relatives. The FOMC also publishes the forecasts of individual participants for real activity—real GDP growth and the unemployment rate—and inflation—as measured by the Fed's preferred index, personal consumption expenditure (PCE) prices. The sum of real GDP growth and PCE inflation is an implicit and approximate reading of nominal GDP growth.

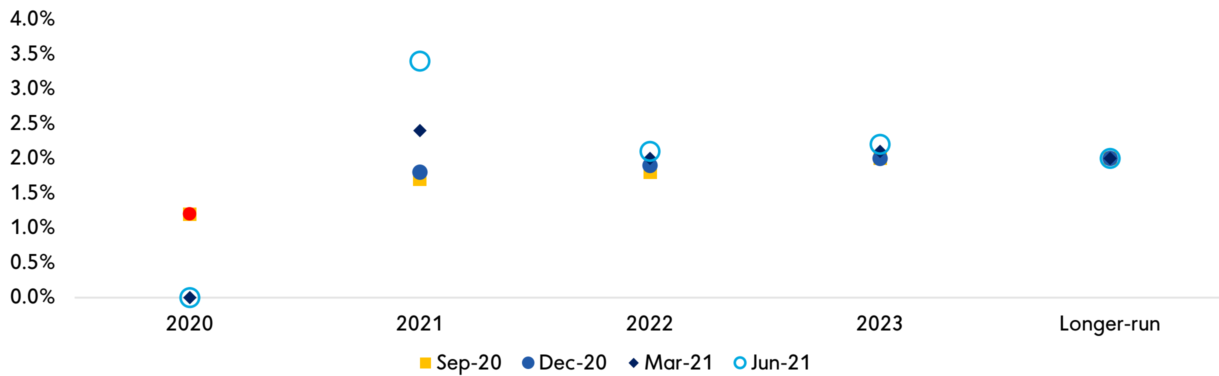
Various vintages of FOMC participants' projections for real growth, inflation, and their sum are shown in the three charts on the next page. Obvious in these charts is that the moving parts in the puzzle were the outlook for last year and this one. The path post 2021, which reflects their view of the medium-to-longer-term outlook, changed little. Relative to their outlook from nine months ago, real GDP growth for this year moved up 2½ percentage points. Meanwhile, inflation is seen as running 1½ percentage points hotter. The upward drift of these near-term dots, with no change beyond, portrays a policy group sequentially marking down the risk from the pandemic in favor of a more benign outcome. That is, FOMC participants see the US economy as getting to a "new normal" more expeditiously.

Median Projection Vintages in the Summary of Economic Projections

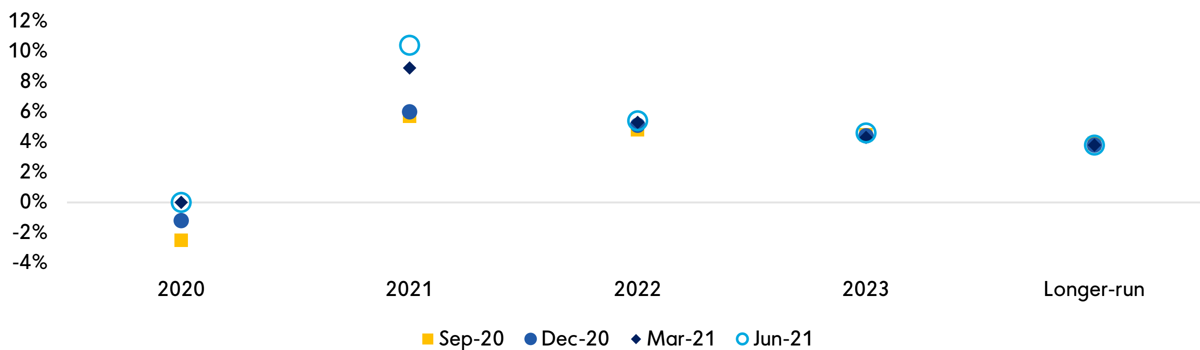
Real GDP Growth: Q4/Q4 Change



PCE Inflation: Q4/Q4 Change



Implied Nominal GDP Growth: Q4/Q4 Change



Source: Federal Reserve, various vintages of the Summary of Economic Projections at https://www.federalreserve.gov/monetarypolicy/fomccalendars.htm

The faster expansion of quantities and prices implies, as in the bottom graph, 4 percentage points quicker growth is a proxy for nominal GDP. Such a near-term revision compounds over time, producing an implied forecast of the level of nominal GDP that is $1¼ trillion higher by the end of 2023 than thought last September. While the Fed does not explicitly target nominal GDP, most policy rules include its components in a way that produces results closely approximating the outcome if it did.

A revision of such magnitude probably requires a rethinking of the policy rate's appropriate level. Enough FOMC participants this June, at least, thought so, and the dots in the SEP interest rate chart floated up to pull the median result to two one-quarter percentage point firmings in 2023. This sounds right to us, as we forecast that rates lift off early that year, but we believe the ascent will be gradual thereafter.

As Fed Chair Powell, who usually distances himself to the point one wonders if he is ever in the District of Columbia or its close environs when the SEP is collected, avers, this is not a contract of his committee, but a collection of expectations conditioned on differing aspects of economic performance and assumptions about other important determinants of activity. Of note, what the chair would never say but which we must factor into our own forecast, is that this also depends on future Fed personnel. Between now and 2023, the terms the Fed Chair and his two Vice Chairs (Rich Clarida and Randy Quarles) expire. The Biden Administration, with of course the consent of the Senate, can materially change the tenor of the FOMC's conversation.

The ECB's New Policy Framework

Commensurate with a Euro area economy lagging that of the US, the ECB is less far along in planning to exit from its unconventional and conventional policies. As for the former, a preset clock is ticking regarding asset purchases under the pandemic emergency plan (PEPP), which is set to buy €1.85 trillion of securities by its provisional end date of March 2022. Expect the participants in the governing council under its big tent to become increasingly restive. And consistent with the three features of the sociology of central bankers, also expect a lot of talking about the matter.

The news of the moment, however, is the announcement of the results of the ECB's review of its strategic framework in early July, sooner than expected. As with the Fed's review last year, the package was shrouded in ambiguity, giving officials scope to do what they previously intended but to explain it in a somewhat new fashion. There are four notable features.

First, the inflation target is now 2 percent and treated symmetrically, rather than the prior goalpost of "below, but close to 2 percent." The problem with the old formulation was that investors rightly interpreted it as the intent never to allow inflation to move above 2 percent. This introduced a classic truncation bias, in that average inflation expectations only count in undershoots with no offsetting overages. This pulls the average down as a result and anchors inflation expectations too low to achieve the ECB's notion of price stability. The new formulation is an improvement, but the ambiguity of the ECB's tolerance of inflation overshooting the now-symmetric goal might feed investor skepticism about whether this represents a fundamental reorientation.

Second, the ECB explicitly rejected Fed-like average inflation targeting. Here is what it was avoiding: the Fed heaped ambiguity upon ambiguity by expressing a tolerance for overshooting (but for how much for how long?) relative to a recent average of inflation (but how recent?). The Fed clearly was putting its thumb on the scale by weighing the appropriateness of overshooting with a dovish intent. This was evidently not to the liking of the ECB, further underscoring that its tolerance of above-goal inflation, both in size and duration, might be limited.

Third, having persistently fallen short of its inflation goal, the ECB asked statistical agencies to add a component to the basket of the harmonized index of consumer prices (HICP) that tends to increase faster than most other items. The ECB recommended inclusion of owner-occupied housing over time. Getting the various national agencies into gear and then into sync so that Euro Stat has the raw ingredients to finish the recipe will take several years. When done, this should add a couple-tenths to HICP inflation, if housing prices continue to rise in real terms. This brings the inflation target closer to what households actually use, but it has an element of shifting the bull's eye on the barn door rather than adjusting the aim of the archer.

Fourth, the ECB elevated combatting climate change as a concern. Presumably, this means that preferred asset purchases and collateral for lending will have a green tint, notwithstanding the difficulty in separating the wheat from the chaff. In her press conference, President Lagarde noted the inevitably of boarding the climate-change bus driven by others. The remark was telling, raising the suspicion that the framework was designed from back to front. That is, the guiding principle was to get a favorable reception.

- Inflation overshooting? Yes, everybody is on board.

- An average inflation target? No, the Northern Europeans would object.

- A sensitivity to climate change? It goes without saying that everyone is getting on the bus.

The herd moved a bit, to be sure, but if it is all about image, if the hearts and minds of the governing council have not come to embrace higher inflation, the public will not be convinced inflation will overshoot until it is demonstrated. There is a circularity of failure built into the project because that demonstration is less likely as long as inflation expectations remain low.

Conclusion

A wave has washed over a new generation of monetary policymakers. They should be sensitive to the uneven distributional effects of their policies. They should be aware of avenues to progress on climate-change mitigation. They should be more empathetic to their citizenry.

The tools to deploy, however, have not changed, unless they want to go down the path of credit allocation, a path their predecessors were loath to travel. If they base decisions on outcomes, not outlook, the tools they do have can impart a higher cyclicality to inflation. The Fed seems eager to experiment but the ECB less so. Neither will be believed by investors until the break from their past is demonstrated. As of now, the US is further ahead in the proof of concept that monetary policy can engineer higher inflation.

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Previously, Vincent served as the Chief US Economist and a managing director at Morgan Stanley. For the prior four years, he was a resident scholar at the American Enterprise Institute (AEI). Vincent also worked in several roles at the Federal Reserve over 24 years, including Director of the Division of Monetary Affairs and Secretary and Economist of the Federal Open Market Committee (FOMC). His responsibilities at the Federal Reserve included directing research and analysis of monetary policy strategies and the conduct of policy through open market operations, discount window lending and reserve requirements. Prior to these roles, he was the principal liaison with the domestic desk at the Federal Reserve Bank of New York and was responsible for preparing a document outlining policy alternatives for each FOMC meeting. He was Deputy Director in the Division of International Finance and Associate Economist of the FOMC and spent five years at the Federal Reserve Bank of New York in both the domestic and international research departments.

His academic publications primarily concern the conduct of policy and issues related to the monetary transmission mechanism as well as an analysis of alternative auction techniques and Treasury debt management. After an undergraduate training at Fordham University, he received graduate degrees in economics at Columbia University.

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