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Fed Thoughts: We Are Where We Are

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The press conference following the meeting of the Federal Reserve's (Fed's) policy-setting group, the Federal Open Market Committee (FOMC), provides its chair, Jay Powell, an eight-times-a-year opportunity to answer the same question over and over. At the most recent one after the December FOMC meeting, the wheel of the financial media turned repeatedly toward why inflation was significantly, surprisingly, and stubbornly above previous expectations. Powell's exasperated summary was that "we are where we are." If he follows this instinct for succinctness, then his forthcoming testimony in support of his renomination might just be "I am what I am."

In a spirit of holiday helpfulness, this note fills in the space the chair left in his explanation, which we feel is virtually everything of note: Where we are, what the Fed decided at its December meeting, and what may go wrong.

Where we are is out of sight of the Fed's inflation goal of 2 percent. The twelve-month change in the consumer price index runs near 7 percent, and more seems in the pipeline, with wages increasing at a 5 percent clip, ample job vacancies, and producer price inflation scaling new heights. The Fed retired its description of the rise in inflation as "transitory", as apparently did households in forming their inflation expectations.

This shift in the inflation climate has partially factored into official forecasts, as is evident in the shortened version of the Summary of Economic Projections (SEP) below.

Economic Projections of Federal Reserve Board Members & Federal Reserve Bank Presidents Under Their Individual Assessments of Projected Appropriate Monetary Policy
December 2021 | Percent

Variable	Median				
	2021	2022	2023	2024	Longer Run
Change in real GDP	5.5	4.0	2.2	2.0	1.8
September projection	5.9	3.8	2.5	2.0	1.8
Unemployment rate	4.3	3.5	3.5	3.5	4.0
September projection	4.8	3.8	3.5	3.5	4.0
PCE inflation	5.3	2.6	2.3	2.1	2.0
September projection	4.2	2.2	2.2	2.1	2.0
Implied change in nominal GDP (approximate)	10.8	6.6	4.5	4.1	3.8
September projection	10.1	6.0	4.7	4.1	3.8
Memo: Projected Appropriate Policy Path					
Federal funds rate	0.1	0.9	1.6	2.1	2.5
September projection	0.1	0.3	1.0	1.8	2.5

Source: Federal Reserve, December 15, 2021. Note: Projections of change in real gross domestic product (GDP) and projections for both measures of inflation are percent changes from the fourth quarter of the previous year to the fourth quarter of the year indicated. PCE inflation and core PCE. For illustrative purposes only. Does not represent actual results. Longer Run is four years out or more determined by the Fed.

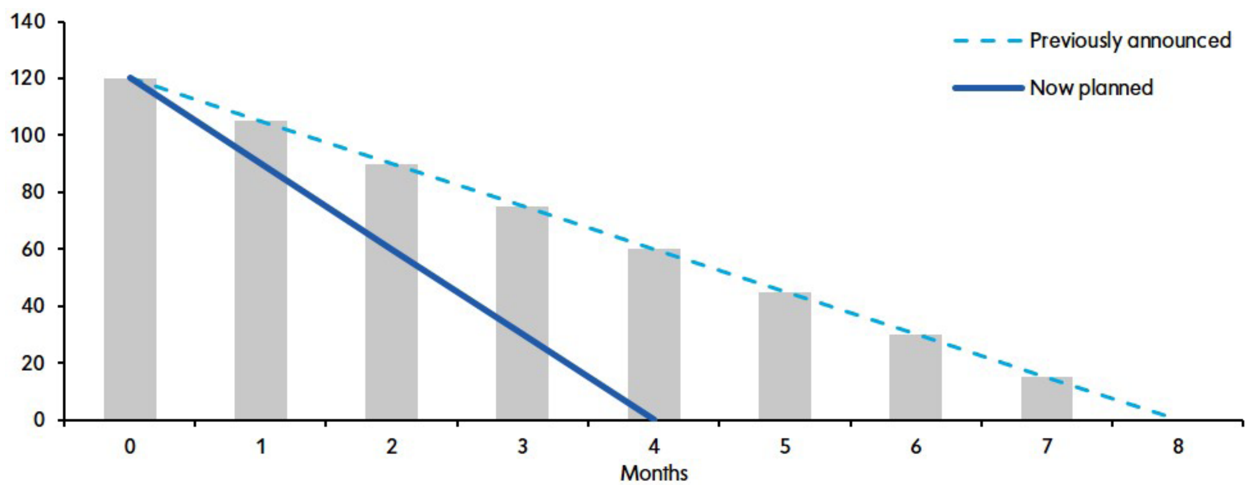
Even though the median participant now sees the level of real GDP running slightly below the prior outlook, personal consumption expenditure inflation is about 1 percentage point and ½ percentage point hotter, respectively, this year and next. In our view, part of the impetus must come from the labor market, as people remain reluctant to return to the workforce for now. A lower track to aggregate demand makes quicker inroads into aggregate supply, with the unemployment rate ending those years ½ to ¼ percentage point lower. With no significant change in the outlook two years and beyond, these near-term adjustments combine to tilt up the slope of the implied path of nominal GDP enough over the next two years to add almost $1/2 trillion to its level by the end of 2024. Given this outlook, policy rules, including that of John Taylor and those based on nominal GDP, call for a significantly upward shift in the appropriate policy rate.

The FOMC, however, has some work to do with its unconventional policy—asset purchases—before it can make such an adjustment in its conventional policy instrument, the fed funds rate.

At the December meeting, the FOMC announced stepping down its asset purchases at double the pace previously announced, to $30 billion per month. On this schedule, as in the chart, the balance sheet will level out in March after a net increase of $180 billion from January. From the Fed's perspective, the decision does not notably move the needle on unconventional policy accommodation. The public already understood the program would soon end, so that there must have been only a small reduction in expected total net asset purchases. That stock amount, according to the Fed, is the lever influencing private relative portfolio holdings and interest rate spreads. What matters is what ending the program subsequently permits.

Fed Monthly Net Asset Purchases

Billions of Dollars

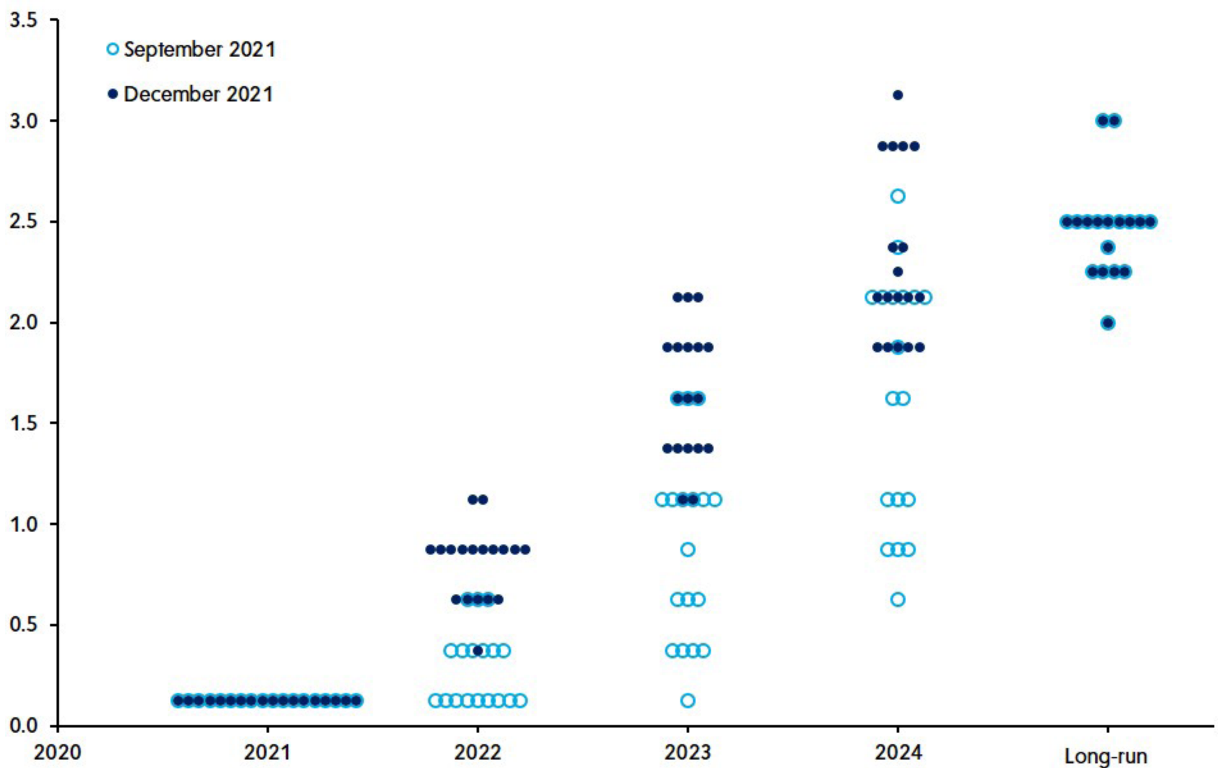


Source: Mellon calculations based on Federal Reserve announcement. As of December 15, 2021. For illustrative purposes only. May not represent actual results.

The Fed's long-held view, ratified by Chair Powell in his after-meeting press conference, is that it will not consider removing policy accommodation by conventional means—raising the policy rate—as long as it is continuing to provide additional accommodation by unconventional means—buying assets on net. Thus, by putting asset purchases on a faster path to closure, the FOMC has brought forward the window in which it can start raising the policy rate. Judging by the group's assessment of the appropriate policy rate in its SEP, it intends to use that longer runway next year.

As shown in the solid dots on the following page, in the just-released outlook, the median member expects to hike the funds rate 75 basis points in 2022, more than one-half percentage point more than in the September projection (the open dots). If the FOMC follows the quarter-point-a-quarter form of the past few firming cycles, this implies three quarter-point increases beginning in June. The funds rate marches up thereafter until leveling out shy of 2-1/2 percent by the end of 2024, still below the assessment of its equilibrium level. At least one hardy soul expects the funds rate to overshoot that mark, presumably on the view that policy will have to impart restraint on net to pull inflation back to target. For most, the dots paint a picture of the slow withdrawal of conventional policy accommodation—that is, firmer, not firm, policy. Indeed, the dots float up by less than called for by standard policy rules.

Fed Funds Rate Guidance: Summary of Economic Projections
Percent



Source: Federal Reserve. As of December 2021. Each data point represents one FOMC member.

This lesser official shift is the engine in the dynamics of our forecast. The Fed's communications pivot correctly addresses the inflation problem, but we fear Fed action in extremis will be too timid in restraining aggregate demand because of excessive optimism about aggregate supply. People exiting the workforce do not always come back. The scale and scope of price increases domestically has broken public confidence in three decades of effective price stability. And internationally, many other economies are in similar situations, importantly because global supply chain problems are, well, global, and central bankers elsewhere are also slowly pivoting from unprecedented conventional and unconventional policy accommodation. Additionally, US policymakers will be under enormous internal and external political pressure that may hinder an appropriate mid-course correction.

Considering **what may go wrong** is well described by the two sides of the economic coin.

The internal logic to the SEP is, to be charitable, obscure. Even though inflation starts well above the Fed's goal and the unemployment rate tracks below their assessment of its natural rate after this year, disinflation favorably and inexplicably returns it to around 2 percent. The heralded new policy framework launched in 2019 notwithstanding, the Fed is following an outlook-based strategy in which aggregate supply is expected to fill in over time to ease cost pressures. That is, under the hood of an unchanged unemployment rate is a rapid expansion of employment and output. The Fed stepped back from emphasizing the outlook because of serial errors in forecasting the labor market. Yet, it is now betting that a shallow and delayed rise in the nominal funds rate that keeps policy accommodative, on net, through 2024 will subdue inflation because favorably-forcasted supply developments will gain traction. If those do not eventuate, or by less than Fed officials think, future FOMC statements may have to trade "transitory" for "durable" in their characterization of inflation.

We also worry about politics on two counts.

For one, US federal finances are fraught with huge deficits as far as the eye can see, which are building on an already high debt relative to nominal GDP. Paul Volcker was able to do whatever it takes, in part, because the tightening process started with government debt at one-quarter its current footprint on the economy. Even then, he ripped a hole into budget plans as interest service climbed. The current budget outlooks of the Congressional Budget Office and the Office of Management and Budget are predicated on short-term interest rates lingering at low levels that are insufficient in addressing the current inflation environment. This spells trouble ahead in the form of fiscal dominance of monetary policy.

As another, politics is also about personnel. When reading the latest dot chart, remember that the committee of 2021 cannot pre-commit that of 2022 and beyond, which is a feature, not a bug, of the FOMC process.[1] Its twelve members change annually, with the seven Board governors and the president of the Federal Reserve Bank of New York sitting permanently and four of the twelve Bank presidents rotating. The White House reassuringly settled on renominating Jay Powell for another four years, likely at the price of giving the Progressive wing of the Democratic party more sway in naming the three remaining open slots on the Fed's Board of Governors.

Subject to the White House being organized and Senate Democrats disciplined, the three new governors starting next year will likely be markedly more dovish than the current median member. Meanwhile, as the new vice chair, Lael Brainard will probably be auditioning for what is widely viewed as a much-deserved more senior role in the Administration. That's a gang of four. In the prevailing system of setting the funds rate with a corridor system, the funds rate doesn't go up unless the floor rises—i.e., the interest rate on reserves is increased by the Board. Additionally, two Bank president jobs are open and, with the political wind blowing from the left, will presumably be filled by people of a more dovish tilt than their predecessors.

If on (B)board early enough in 2022, the Gang of Four and their new Bank colleagues can slow the process without appearing to completely disregard inflation risks. In the early summer, inflation will likely be well above goal but dropping from its cyclical high. The unemployment rate will likely be below 4 percent but with many people still out of the workforce. Powell's middle ground in herding these cats will be to talk tough but set a longer runway to liftoff. In our view, the safe bet is a September start to a quarter-point-a-quarter tightening cycle (and persistently higher inflation).

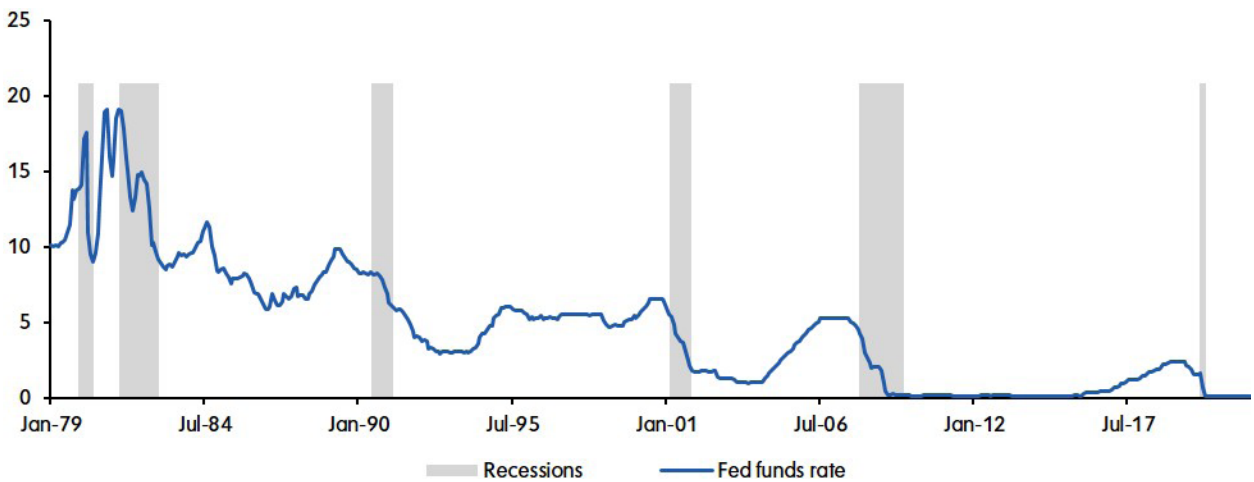
To be sure, betting that the political process is efficient is never very wise. If the White House fumbles or Senate Democrats are fractious, the current incumbents at the Fed will want to create momentum to the firming process that will be harder for their latter-arriving colleagues to impede. To do so, the Fed will start sooner and emphasize that the gradual path is a lower bound on their action. That is how the FOMC would deliver on its dot-plot ambitions.

That said, we think that the budgetary stakes are too high for the White House not to take the nomination process seriously. If that is right, we are more likely to get two, rather than three quarter-point moves next year. Sadly, neither result will be sufficient to the task of achieving the Fed's longer-run goal.

Market participants apparently tilt to the obverse side of the economic coin, harboring the concern that economic activity will ultimately suffer from a Fed tightening cycle. The long end of the Treasury yield curve has sagged, presumably informed by the precedential consequences of Fed firming. As in the chart below, an upward climb in the funds rate is typically followed by recession, albeit unevenly. The prominent exception is the Greenspan preemptive tightening that began in February 1994, which looms large in the Fed's institutional memory. Indeed, that example was the wind under the wings of its outlook-based strategy for two decades. We think that the more appropriate lesson is from the late 1960s when the Fed was behind, not ahead of the curve, and firming will be insufficient to stall the momentum to aggregate demand.

Fed Funds Rate

Percent



Source: Federal Reserve and NBER, accessed via FRED on December 17, 2021.

We suspect that the FOMC may ultimately resemble some of the people purchasing a Peloton during the pandemic. The decision swims with the tide of popular opinion, meets the approval of peers, and signals a future of virtuous discipline. Except, more than a few of those Pandemic Pelotons wind up gathering dust or, when used, as in the case of Mr. Big, may trigger an unfortunate event.

Yes, the announcement promises that the taper is on a faster track, ending in March instead of June, and adding $180 billion, not $420 billion, extra to Fed holdings in the interim. For science's sake, this will be an interesting experiment if this matters for interest-rate spreads, especially in the two markets where the Fed has a bigger footprint, mortgage-backed securities and Treasury indexed debt. In the settled world of Fed understanding of the effects of unconventional policy, it should not matter otherwise, as the world already knew the program would end to level out the balance sheet at some previously unimaginable height.

No, the FOMC did not just contract to raise rates conventionally immediately after this round of unconventional policy finishes. No changeable committee can entrench the decision of its successors. The Fed has widened the window to start the tightening cycle in 2022, but the members today cannot pre-commit the decisions of members next year because the membership will differ decidedly in the dovish direction, fade current Fed guidance.

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Vincent is the firm's Chief Economist and Macro Strategist. In this role, he is responsible for developing views on the global economy and making relative value recommendations across global bond markets, currencies and sectors.

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.

Endnotes

1. In legal terms, a legislative body or a committee cannot "entrench" its successors, as in Posner, et al., at https://chicagounbound.uchicago.edu/cgi/viewcontent.cgi?article=2784&context=journal_articles

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