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Fed Thoughts: Highway to the Danger Zone

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Adjusting monetary policy can sometimes be compared to landing a jet on the flight deck of an aircraft carrier. The runway may be lurching at a variable speed, moving up and down, and rocking from side to side. Monetary policy makers might have had a plan to raise interest rates just as employment regains its pre-pandemic heights and inflation settles at goal, but the reality of the pandemic and the vicissitudes of politics intrude. For some time, the Federal Reserve's (Fed's) plan was to accommodate unprecedented fiscal stimulus with equally unprecedented monetary maneuvers to offset as much of the hit to economic activity as possible from the pandemic in 2020, maintain that stance through 2021n in order to extend the rebound in demand, and begin unwinding accommodations in 2022 and beyond.

Two sources are putting the flight deck of the carrier in motion. For one, US politicians will likely deliver more fiscal stimulus but stress financial markets by bickering over an increase in the Treasury debt ceiling. For another, the spread of the Delta coronavirus strain is setting back domestic aggregate demand and, by further impairing global supply chains, aggregate supply. The Fed's policy making group, the Federal Open Market Committee (FOMC) may need to adjust the landing approach at its upcoming meeting.

This note runs through:

- The news over the intermeeting period;
- The Fed's risk management of monetary policy; and,
- The likely slow turn in the policy stance.

Part of this narrative hinges on personalities. Fed Chair Jay Powell recently appeared to lag behind most of his colleagues who now want to land the plane. Powell might understandably desire to delay policy normalization since the chair is responsible for explaining the FOMC's action to the public and his political betters, is held responsible for the good or ill of the outcome, and is currently being considered for a second term on the job.

Our forecast is that the Fed will begin to trim back asset purchases this November or December in order to clear the deck of unconventional policy by mid-2022. This will allow Fed officials to begin hiking rates in early 2023, with the option of beginning a bit earlier if necessary.

How is the Deck Rolling, Pitching, and Yawing?

As has unfortunately been true for the past eighteen months, the path of the pandemic remains the most important factor shaping the economic outlook. Central to this is the country-by-country race to vaccinated populations before the mutated virus spreads beyond control. The predominance of the Delta strain has set back the growth of aggregate demand, as households worried about health outcomes are reluctant to spend. It also raises the still-small chance of a truly adverse turn to the economy that would completely reset the policy table.

Three issues influence the outlook for central banks.

- First, a renewed significant outbreak hits the pause button on economic recovery, leaving central banks, already providing maximum stimulus, little scope to offset.
- Second, to the extent that a good portion of the global population remains at risk because of an uneven vaccine rollout, households, even in more secure nations, will remain hesitant to spend, sapping the strength of demand growth.

- Third, an uneven vaccine response impairs global supply chains that stretch through all corners of the world. This crimps the ability of aggregate supply to meet extra demand, leading to cost pressures.

The policy responses to these forces differ. Weaker demand—either outright because of contagion or indirect by concerns about the rest of the world—require additional stimulus (that is of limited availability) or deferring the expected removal of that stimulus. The third, a negative supply shock, threatens the Fed's dual mandate from opposite directions in that aggregate demand weakens even as inflation stays elevated.

Closer to home, US politicians have delivered and are likely to deliver more fiscal stimulus in at least two tranches this year. President Biden's two fiscal packages, the American Jobs and Families Plans (AJP and AFP, respectively), however, both matter to macro and political economies.

The passage of both the AJP and AFP would restructure and expand entitlements, raise marginal tax rates, and layer in infrastructure spending over time. They would also ramp up the time profile of the already large government debt. The case for a multiplied boost from infrastructure spending is unpersuasive in the historical record. There won't likely be large benefits to productivity, and higher tax rates on households and businesses are a negative. The net effect is likely a small boost to activity this year and the next, speeding up the recovery in aggregate demand even as aggregate production struggles to keep up because of supply-chain obstructions. As a result, the Fed faces a more significant overshoot of its inflation goal than it might comfortably tolerate. This should incline Fed officials to, at a minimum, sound more forceful about the coming removal of accommodation or even accelerate the process.

The consequences for the political economy may be more dramatic. The Congress has limited bandwidth in conducting business during the best of times. Attempting to pass two complicated bills under different parliamentary procedures will probably crowd out some other essential business to the last moment. Any bridges burned during consideration of the AJP and AFP will not be available for the must-do items of keeping the government running and raising the debt ceiling.

In the event, the Congress will act because it must, but it may be close to the wire and raise angst in financial markets not yet evident. As for the debt ceiling, the Treasury will likely instruct the Fed to pend other payments to protect coupon and principal payments, staving off default. This would unleash howls of protests from those counting on those stalled receipts and waves of indignation from the Progressive wing on the Hill about protecting capitalists. Treasury and Fed officials, pressed further if the Congress cannot act decisively, may well consider actions conventionally deemed unthinkable. For instance, Secretary Yellen might resort to even-more doubtful accounting gimmicks such as revaluing gold holdings or issuing a platinum coin. Chair Powell (who was a debt issuer in the first Bush Treasury) might look the other way on overdrafts in the Treasury cash account at the Fed, especially if they could be dismissed as short-term and technical on the cusp of Congressional action.

Such circumstances are good neither for financial market stability nor household and business confidence, which could have material consequences for the near-term economic outlook and the appropriate monetary policy stance.

How will the Fed Manage the Landing?

The tone of the Fed policy conversation has already shifted and, in an important way, under the feet of Chair Powell. When the Fed laid out its new policy framework in August 2019, it was cast in asymmetric and ambiguous terms regarding the dual objectives of maximum employment and stable prices. The former was described entirely in terms of dealing with shortfalls in employment while the latter was to be assessed as an unspecified backward-looking average of inflation that policymakers would allow to be overshot by actual inflation. This gave them more scope to treat the goals hierarchically: deal with employment and let inflation do what inflation does.

This proved convenient during the economic upheaval wrought by the pandemic, but, as rebound has turned into recovery, the narrative has gotten old as inflation runs above 4 percent. Some FOMC members are pushing for a more even treatment of the twin goals and a quicker trip to the exit. Chair Powell's job, however, is to explain his committee's decision and catch the brunt of public criticism, even as he is currently up for consideration for a second term as chair. While this is not to say personal ambition drives his decisions, it probably inclines him to take a more encompassing view of the risks associated with action.

The map of the risks to the outlook can be reduced to a simple contingency table directed to the question of when to slow asset purchases, the first step in the normalization of policy. Two sets of distinct possibilities are laid out in the table to the right, covering the next three-to-nine month window. The baseline Fed forecast is that the recovery continues, albeit at a slower but still robust pace, and inflation falls back to its goal next year.

The Risk Management of Monetary Policy: When to Taper?

		The Economic Outlook	
		Worse than expected	**At or better than expected**
The Timing of Asset Purchases	**Start soon**	Wrong footed	Well-timed exit
	Delay	Delivering appropriate accommodation	Behind the curve

Source: Internal Calculations. As of 9/18/2021.

As in the column headings, the recovery could be slower (with the significance of the Delta strain or the US Congress) or meet or exceed expectations. The policy plan for asset purchases can, as in the row headings, start sooner or later. The four cells describe potential policy considerations. The minor diagonal (from lower left to upper right) offers the appealing prospect of policy aligned with economic outcomes.

The major diagonal, from upper left to lower right, is problematic, to say the least. To commit to landing and watch the deck fall away, as in the upper left call, leaves policy too tight for economic conditions. It is a bad day on the job when a carrier pilot misses the tripwire and circles back for another run. This becomes especially worrying, if as Fed officials fear, that there is little fuel left in the policy tank for a significant booster burn when the policy rate is already pinned at zero. The bottom right panel, being behind the curve, makes for a hard landing. But Fed officials probably believe their conventional policy instrument, if they raise rates by more down the road, would keep inflation concerns in check.

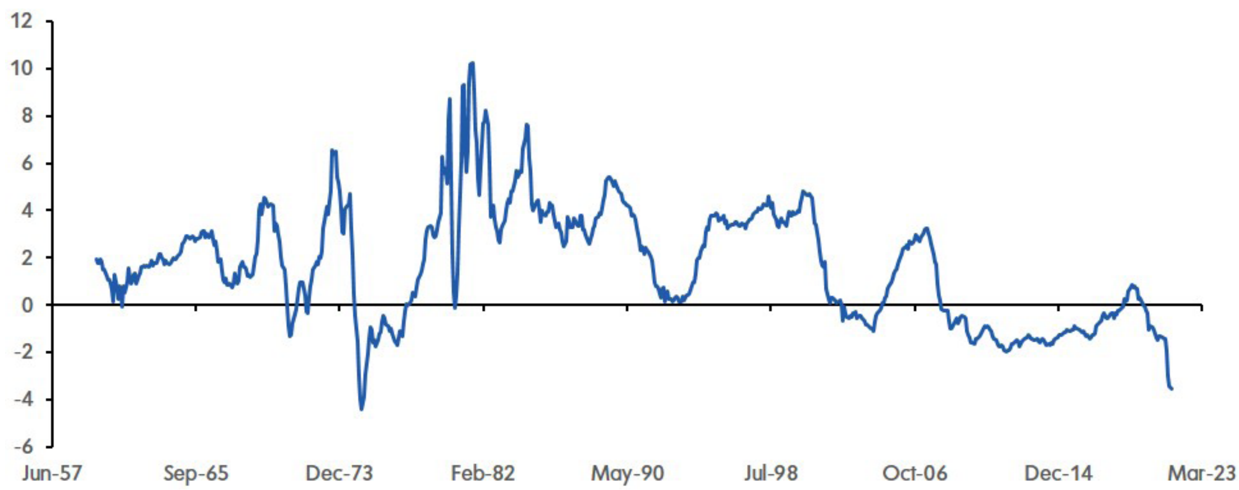
Given the problems associated with leading the charge, a little introspection over the table probably inclines Chair Powell to the bottom row: Better to be right in hard times and apologetic and forceful when the economy is at a full head of steam. At this meeting, expect him to temper his colleagues' enthusiasm for an immediate policy turn by stressing the near-term uncertainties—the outcome of undone work on Capitol Hill and the changing slope of the Delta strain's incidence—that would mostly be resolved in an FOMC meeting or two. That is, he will probably place a speedbump, not a roadblock, to tapering. If he is successful, expect the decision to announce the start of tapering to be deferred to November or December and to begin the next month, which would keep in line with the existing guidance that the program starts in 2021. Powell might not be successful in holding back his colleagues, so the decision is not a lock.[1]

The Slow Turn in the Flight Plan

No doubt, there will be a countdown clock on business news on cable television for the two o'clock release of the FOMC statement on Wednesday afternoon, with whatever action, or inaction, characterized as a seismic shift.

Real Federal Funds Rate

Nominal less 12-month lagging change in core PCE prices, percent



Source: Bureau of Labor Statistics and the Federal Reserve, accessed via FRED on 9/18/2021.

Temper your enthusiasm: Fed policy will remain accommodative for a considerable period. Everyone appreciates that the Fed's asset purchase program has a sell-by date of sometime in 2022, so the revision to expectations about the total stock of assets to be purchased is not too sensitive to precise timing. Meanwhile, the federal funds rate in real terms (or adjusted for inflation on a twelve-month backward-looking basis using the Fed's preferred measure, as in the chart) is at a fifty-year low.

As for the taper, whenever the Fed starts, the desire to communicate the process clearly imposes three constraints on the arithmetic of securities buying. Officials will want to: (1) use round numbers; (2) work in equal monthly decrements; and, (3) slow purchases of Treasuries and MBS in the same proportions.

Arithmetic of Tapering

Billions of dollars and months

(1)	(2)	(3)	(4)	(5)
Monthly Stepdown in Purchases			Months to Completion	Total Purchased Over Interim
Treasuries	MBS	Total		
Billions of Dollars			Number of Months	Billions of Dollars
2	1	3	40	2,340
4	2	6	20	1,140
6	3	9		
8	4	12	10	540
10	5	15	8	420
12	6	18		
14	7	21		
16	8	24	5	240
18	9	27		
20	10	30	4	180

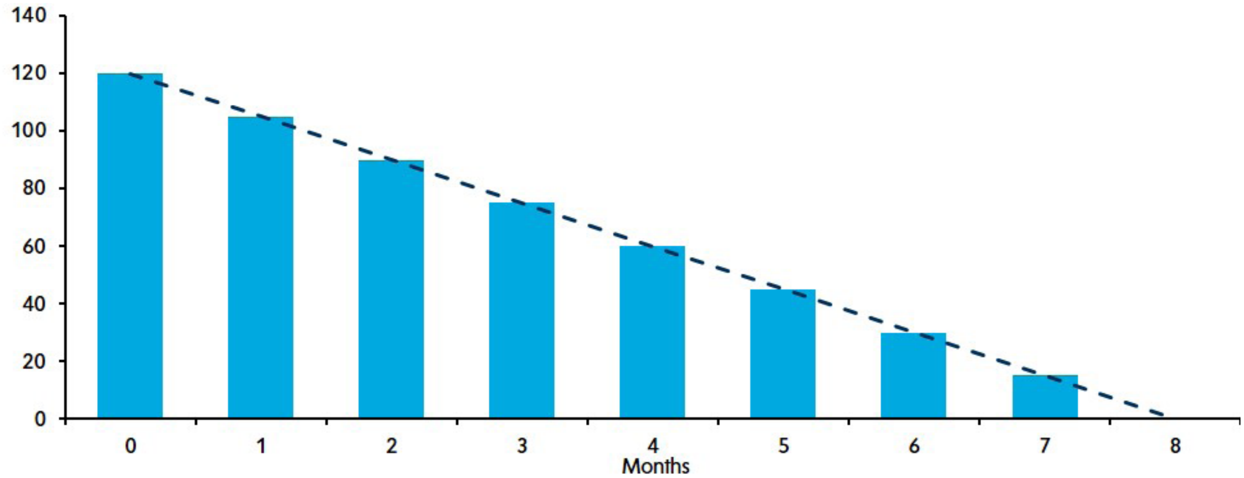
Source: Internal Calculations.

The third has the only hint of economics. The Fed has always asserted that there is no significant financial market difference in the type of assets it purchases because what matters is moving securities from private portfolios to its own balance sheet. An unequal composition of tapering implies one set of purchases would end sooner than the other, perhaps undercutting that assertion.

This is enough to define the contours of a monthly tapering program.[2] The second column of the table considers possible step-downs of net MBS buying from the integers $1 billion to $10 billion (constraint 1). The first column doubles that to keep the proportions between the two asset classes equal (constraint 3), and the third column gives the sum. The fourth column computes the number of months to get to zero in equal increments. The shaded rows are ruled out because the step-down in the last month would not be equal to the prior ones (constraint 2).

The chart on the following page depicts the process for the middle row of the table, or cuts of $15 billion per month that transit from $120 billion to zero in eight months. As is evident, this is accomplished in seven steps. As is also evident, the Fed buys a lot of securities in the interim. Column 5 of the table records the cumulative tally, showing that the Fed will have a $420 billion larger balance sheet when done.

Hypothesized Monthly Asset Purchase Tapering
Billions of dollars



Source: Internal calculations.

Two points to take from this arithmetic exercise. First, while it is ongoing, tapering is about slowing additional accommodation, not stopping it. Second, the Fed has some scope to compensate for a delayed start with a faster pace of cuts to get to about the same ending balance-sheet size.

The Landed Plane

On the part of the Fed, they will probably seem slow to start asset purchase tapering on the fear of being wrong-footed should the Delta strain or political wrangling set back economic recovery. Once the process starts, they will hit the deck hard by being done with net asset purchases in seven months to have an open field to raise rates.

Get used to it. As a result of lingering monetary accommodation, inflation will be above the Fed's goal of two percent for some time. The Fed bet that the initial faster increases in prices were transitory because they reflected benchmark effects and temporary bottlenecks. They did, but they were larger in size, more widespread in scope, and more persistent. Moreover, those price gains hit goods and services especially salient to households, who then raised their inflation expectations.

As a result, the Fed's delay of raising rates, probably at the start of 2023 and to be initially gradual, will be followed by a rush to catch up. This assumes, of course, that the Fed's leadership is so inclined to exert its monetary independence in an environment of large federal budget deficits and high debt levels. This is an open question for another day and, possibly, another Fed flight crew.

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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. The British phrase for a speedbump, a sleeping policeman, might be more appropriate. Powell will lay down in the road, but he might get run over.
2. This considers a monthly program, consistent with the current operating instructions. All that follows works symmetrically with a quarterly cadence.

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