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Fed Thoughts: A Feature, Not a Bug

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For most of the pavement, the flat and straight stretch of a racetrack does not test a driver. Pedal to the metal requires neither thought nor training. When a sharp turn approaches, deceleration and downshifting are in order. In the turn, the force of gravitation will no longer be parallel to the direction of the car. A passenger might express heightened concern as the turn approached if, at some time earlier in the flats, the driver announced they would use only the rearview mirror.

As it relates to the April 27-28 Federal Open Market Committee (FOMC) meeting minutes, two of the participants along for Federal Reserve (Fed) Chair Jay Powell's turn around the track expressed angst about rearview-mirror driving. Outcome-based rather than outlook-driven policymaking runs the risk of "…inflation pressures building up to unwelcome levels before they became sufficiently evident to induce a policy reaction." Most meeting participants probably shrugged, as this was an objection best raised before getting into the car with Powell at the wheel.

Sharp g-force that add to the risk of misadventure are a feature, not a bug, in the current design of monetary policy. Starting with the preemptive monetary policy tightening engineered by Alan Greenspan in early 1994, Fed monetary policymakers worked from the same script for four decades.

1. Monetary policy influences economic activity with a lag.

2. Lagged effects on inflation are even further delayed.

3. Waiting for inflation to materialize implies waiting too long, in that the momentum that raised it will carry it further higher.

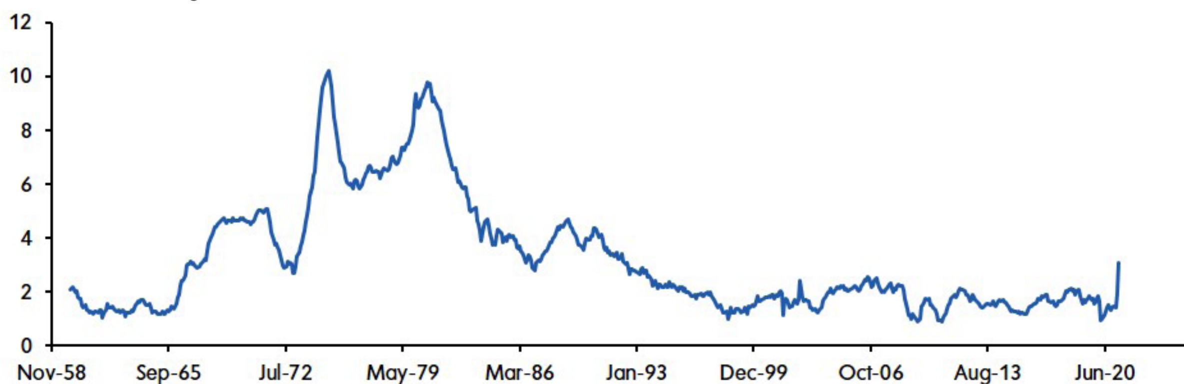
4. Dealing with above-goal inflation will be costly and time consuming.

5. Therefore, monetary policy should move in anticipation of incipient inflation pressures, effectively cutting off the top of a potential overshoot of inflation above the Fed's goal.

This was tightening on a theory: Because inflation was well described by the Phillips curve linking it to the amount of resource slack, policy could move to prevent excesses that produced inflation. In some sense, it worked too well. Since the late 1990s, inflation as measured by the Fed's preferred index—the basket for personal consumption expenditures—varied in a narrow range, apparently capped by the Fed's goal of 2 percent.

Core PCE Price Index

12-Month Change, Percent

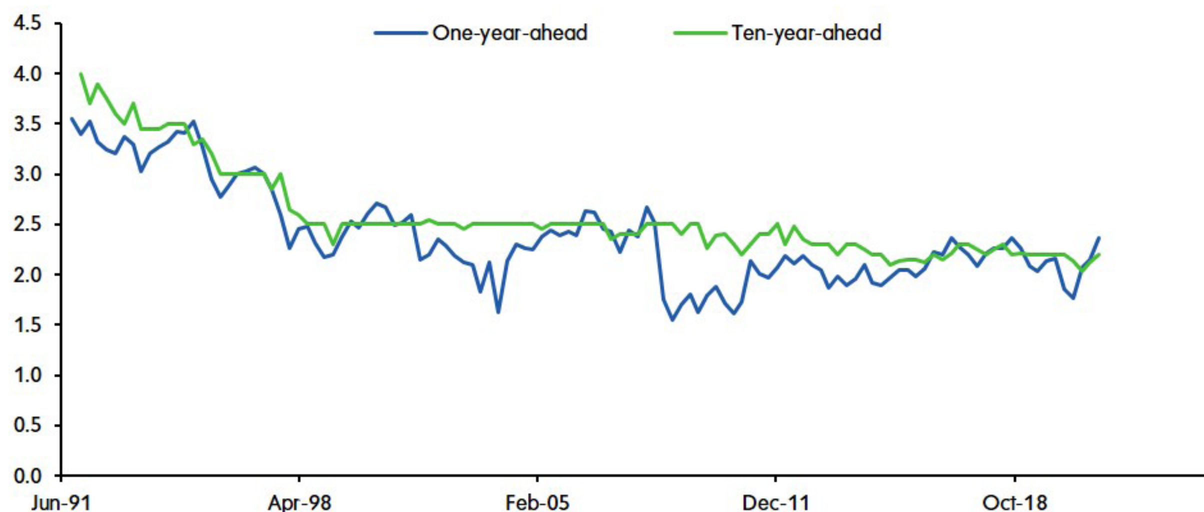


Source: BEA accessed via FRED. As of April 1, 2021.

This anchored inflation expectations, witnessed by the Survey of Professional Forecasters never reporting inflation expectations about 2-1/2 percent for three decades. Well-anchored inflection expectations made actual inflation less responsive to resource slack, undermining the evidence for the theory behind tightening on a theory. The new generation of policymakers want inflation to be observed, not just forecasted based on a counterfactual of what would happen absent policy action. This is not because they reject the theory, but rather that they do not trust it to be reliable.

Survey of Professional Forecasters Inflation Expectations

Percent



Source: BEA accessed via FRED. As of April 2021.

The risk that the FOMC is taking, the heart of the concern of those two participants about outcome-based policy, can be explained by the theory that all of them are so ambivalent about the forecasts they provide in the Summary of Economic Projections (SEP). The striking feature of the SEP from the March meeting (which will be updated at the upcoming one) is that the median participant expects core PCE inflation to be above the 2 percent goal this year despite resource slack. The shortfall in employment is substantial in that the unemployment rate is expected to average 4.5 percent in the fourth quarter of 2021, ½ percentage point above its natural rate, after having been about 2-1/2 percentage points above its natural rate at the end of the prior year. The Phillips curve slopes down when drawn in terms of the unemployment rate along the horizontal axis and inflation along the vertical axis. Its position is anchored by prevailing expectations, or "pi-star" as described by Chair Powell in his ruminations on the nighttime sky of Jackson Hole in 2018. If inflation expectations were anchored at the Fed goal of 2 percent, then inflation should be below 2 percent, not above, when resources are slack.

To arrive at the projected inflation and unemployment pair (high for both when their relationship is negative), the median participant must believe that the Phillips curve has shifted up. Chair Powell and his close coterie assert that the shift is only transitory, related to relative-price changes temporarily adding to inflation. These include base effects, as calculations looking back a year incorporate low prices distorted by lockdowns at the onset of the pandemic. Bottlenecks may push up prices as demand surges past pandemic-restricted supply.

The caution is that it is difficult to separate temporary from permanent effects. Base effects are not as simple as turning the calendar page because prices only gradually adjust given contraction and competition for market share. Supply should become more available in a market economy, but enhanced unemployment benefits keep some people out of the work force, global supply chains are being reconfigured, and uncertainty about government policies are high.

Households living through faster price changes and hearing that Fed officials are determined to keep it going may have revised their inflation expectations higher. In that regard, some of the faster-moving contributors to inflation are goods and services that may be especially salient to households, including energy. As in the earlier chart, even the inertial measures of inflation expectations from the Survey of Professional Forecasters have ticked higher. If currently higher inflation has pulled up inflation expectations and they durably hold, the Fed has a much more difficult cyclical job to handle.

But our concern about the Fed is not as much the cycle as the trend.

The Forest, Not the Trees

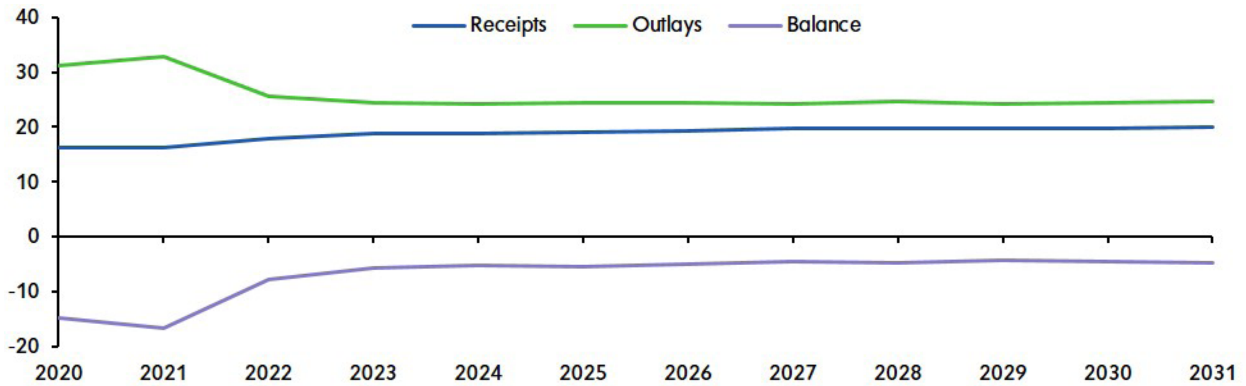
The Fed was exhaustive (and exhausting) in reviewing its monetary policy framework. There were research papers, conferences, town halls, and speeches and more speeches. The problem is that this framework, rolled out by Chair Powell pre-pandemic at Jackson Hole, cannot explain the conduct of monetary policy over the past year. The review was built upon the solipsism that the Fed was an independent actor pursuing, as best as possible, the achievement of the dual mandate given to it by Congress.[1]

It is best to pull the focus back a bit in considering economic policy making over the past fifteen months. The Fed has been providing monetary accommodation to fiscal stimulus. By pinning the policy rate at zero and acquiring $120 billion of government securities per month, the Fed is the wind under the wings of the fiscal ambitions of the Biden Administration. The worrisome sign for the Fed should be that ambition is woven into the design of the Administration's plans and that it includes them. This is all formalized in the federal budget blueprint announced at the end of May. Only a small portion of it has any hope of passing, but the document shows the type of policymaking partner the Biden Administration expects from the Fed. As in the charts on the following page, increased outlays this year produce budget deficits in the high teens relative to nominal income. While the debt in the hands of the public (relative to nominal GDP) climbs to a post-war record, its ascent is constrained by a Fed seen to keep real short-term interest rates around zero for a decade.

This elected-class expectation of the Fed interacts with a cultural problem within the Fed. Central bankers always fight the last war, which is why they appear slow when the battle lines pivot. Once upon a time, it was raising rates to contain inflation and dollar depreciation. Now, it is the potency of monetary policy near the zero bound when inflation was not presenting itself. Will Fed officials be willing to raise rates quickly, given their doubts about the mechanics, if it balloons the budget deficit to the opprobrium of the elected? Perhaps the current contingent at the Fed Board of Powell, Clarida, and Quarles would. But, given their terms of office, they might not be part of those decisions. The next leadership cohort will be chosen by politicians with outsized ambition about fiscal stimulus and monetary policy accommodation.

Federal Budget

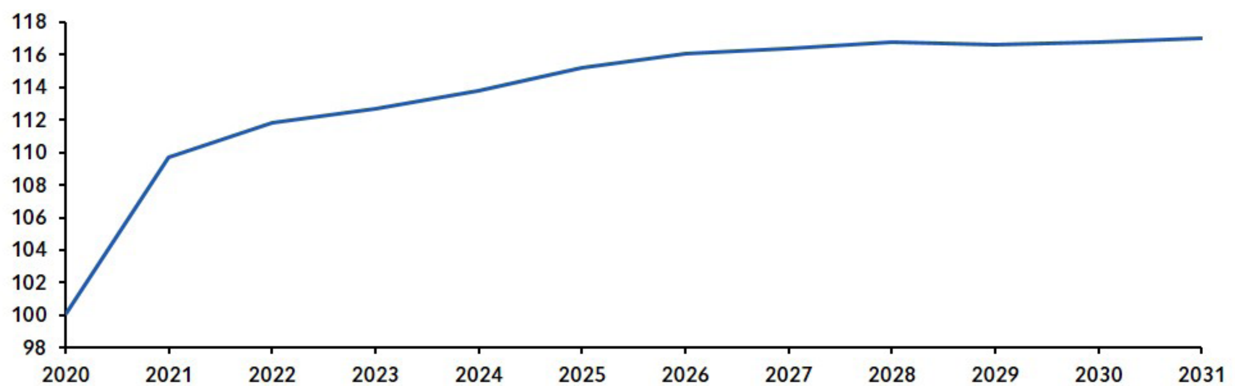
Relative to GDP, Percent



Source: Office of Management and Budget. As of May 2021.

Federal Debt Held by the Public

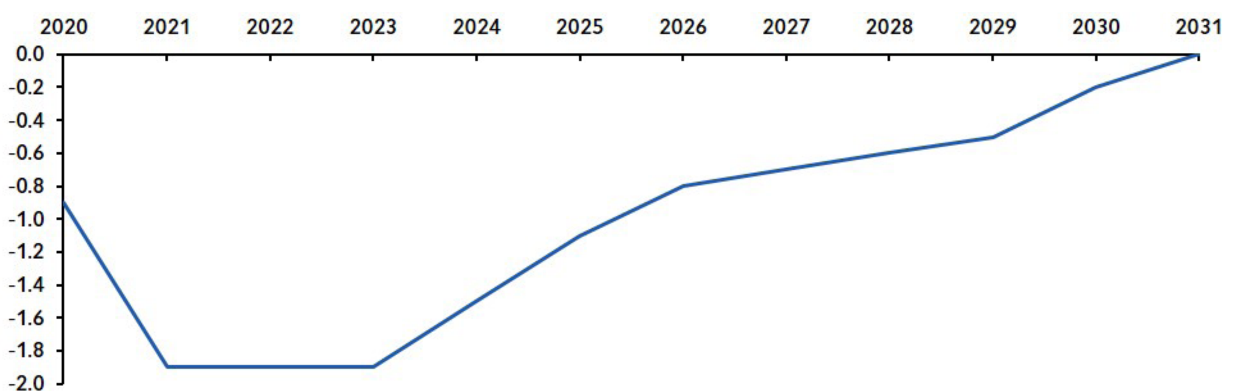
Relative to GDP, Percent



Source: Office of Management and Budget. As of May 2021.

Real Short-Term Interest Rate

Percent



Source: Office of Management and Budget. As of May 2021.

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Vincent is Mellon'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] Here is the crucial tell: Fed officials always speak of their institution as a creature of Congress and its dual mandate as being handed down to it by the legislature. True, some of this is Constitutional etiquette, in that Congress delegated the authority in the founding document "to coin money" to the Fed. However, the Fed owes its existence to Congress and a president, as agreement between those two branches of government are required to pass a law. Being beholden to an unruly group of 538 legislators seems less threatening to the Fed's independence than being a creature of Congress *and the* President.

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