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Fed Thoughts:
The Long & Short of Policy Choice

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First, the short of it.

The crowded calendar of economic data in this intermeeting period importantly shapes the actions and words of the Federal Open Market Committee (FOMC) at its upcoming meeting on March 21 to 22. Thus far, they have mostly confirmed that the good news on disinflation has run its course and that aggregate demand retains considerable above-trend momentum. The Federal Reserve (Fed) has more work to do.

What Will the FOMC Do?

The FOMC will likely raise the funds rate target one-quarter percentage point at its upcoming meeting and queue up more like-sized hikes. The posture will be more muscular than at the prior meeting but consistent with policymakers' ongoing concerns and the data important to them.

Why Will they Do It?

Fed officials of late have mostly repeated the arithmetic offered by Chair Powell at his last press conference that explains why the funds rate needs to be moved to, and then held at, a restrictive plateau.

- The prior good news on inflation owed to the adjustment of the global economy to imbalances in the commodity and goods markets. As resources and sectoral demand shifted, those prices turned from an impetus to a drag on headline inflation. But that only accounts for one-quarter of the consumer-price basket.

- Forward-looking readings on shelter prices were similarly encouraging, but that only constitutes another one-quarter of the total.

- As noted in the February FOMC minutes, there is "…less evidence of a slowdown in the rate of increase of prices for core services excluding housing categories that accounts for more than half of the core Personal Consumption Expenditures (PCE) price index…as long as the labor market remained very tight, wage growth in excess of 2 percent and trend productivity growth would likely continue to put upward pressure on some prices in this component." Demand growth exceeds that of potential and resources are taut, setting a high bar for them to be convinced of meaningful disinflation.

- Data since, including blockbuster gains in employment, an end to the run of good news on inflation, and upside revisions that make it harder to justify the Fed's stepdown to the pace of hiking, strengthens this resolve.

Why a String of 25-Basis-Point Moves?

The Committee's actions are hemmed in by its precedent and words, along with a mistrust that financial market participants understand subtlety. The latter was evident in the concern in the same minutes that "…it was important that overall financial conditions be consistent with the degree of policy restraint that the Committee is putting in place."

- Even hinting at a planned pause would likely fuel enthusiasm of an end followed by a quick reversal of firming. This body in motion stays in motion.

- Having stepped down firming orderly in quarter-point increments established a pattern that only invites confusion if violated.

Won't A 50-Basis-Point Hike be on the Table?

Of course, a half-point move will be a discussion point, but we believe only as a means of signaling determination. They can make up for a smaller move (and some regret at downshifting too quickly in February) by planning on additional quarter-point hikes.

- We believe they'll accomplish this by repeating in the March statement that "ongoing increases in the target rate will be appropriate." This contracts them to at least two more moves.
- This determination will likely be underscored by the dots floating up a touch in the Summary of Economic Projections. This is a device that was unavailable to Powell and company at the prior meeting.

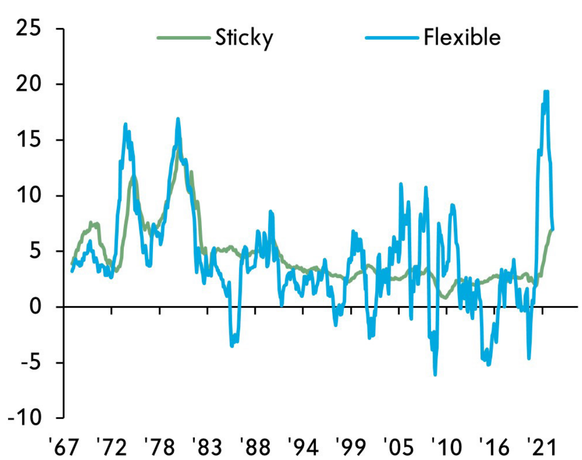
And now...the long of it. The why behind the policy path requires digging a little deeper into a fundamental question.

What's Behind Chair Powell's Inflation Worries?

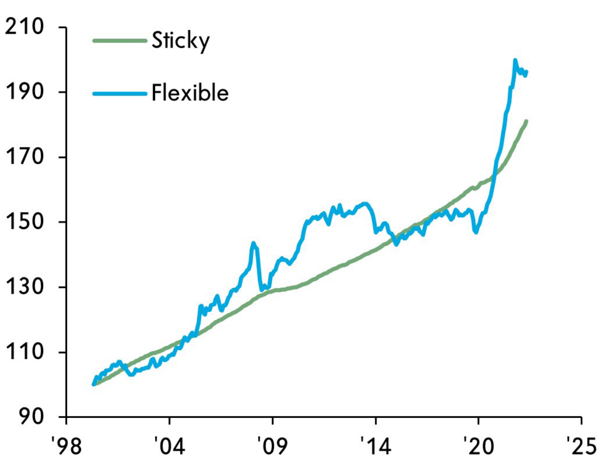
As noted, Chair Powell's price arithmetic apparently has traction within his institution, reflected in the description of the staff forecast in the minutes and the public repetition by other policymakers. However, it involves more than arithmetic. In our view, getting the dominoes to fall as the Fed fears depends on three behavioral relationships, introducing room for doubt in a world rocked by changes in the product and labor markets.

The first concerns levels and changes, which Powell doesn't mention often enough. An economic system as complicated as our own grinds out a multitude of relative prices that shape decisions in individual markets on supply and demand. Some of those prices adjust almost continuously in auction-like settings. Think of oil and other commodities globally or fresh produce and Taylor Swift tickets locally. Others are costly to adjust and done so infrequently in an uncoordinated manner by many different actors as part of the longer-term relationship between the seller and the buyer.[1] Think of wage bargains for staff with special skills, menus at restaurants, and fees on many service contracts. Almost no one would trust an accountant, doctor, or lawyer with a chalkboard in the waiting room listing the fees for today. Opportunities to adjust such prices occur infrequently and asynchronously on a provider-by-provider basis.[2]

Flexible & Sticky Prices
Twelve-month changes, percent



Flexible & Sticky Prices
Implied levels, January 2000 = 100



Source: Federal Reserve Bank of Atlanta, accessed via FRED, 2/26/2023, and Firm analysis. Twelve-month change and levels are imputed from monthly changes. Data as of January 2023.

We're living in this world. Goods prices rose sharply, because they could, in response to global shocks triggered by the pandemic and Russian invasion of Ukraine and facilitated by an impetus to demand because central banks lingered too long in providing accommodation. Other posted prices are struggling to catch up to those already high levels, when they can, to realign relative prices back toward prior norms. The spur to overall inflation from the goods sector appears mostly behind us. That from the rest of the economy is unfolding — this is worrying.

Researchers at the Federal Reserve Bank (FRB) of Atlanta have done the yeoman's work of splitting the consumer price basket line-by-line into those components that are flexible (30 percent of the total) and those that are sticky historically (the remaining lion's share at 70 percent). As in the chart, flexible prices proved true to their name, with inflation on a twelve-month basis peaking at 20 percent at the beginning of 2022. They've adjusted and the slow-moving 70 percent of the rest, sticky-price items, as sluggishly catching up.[3]

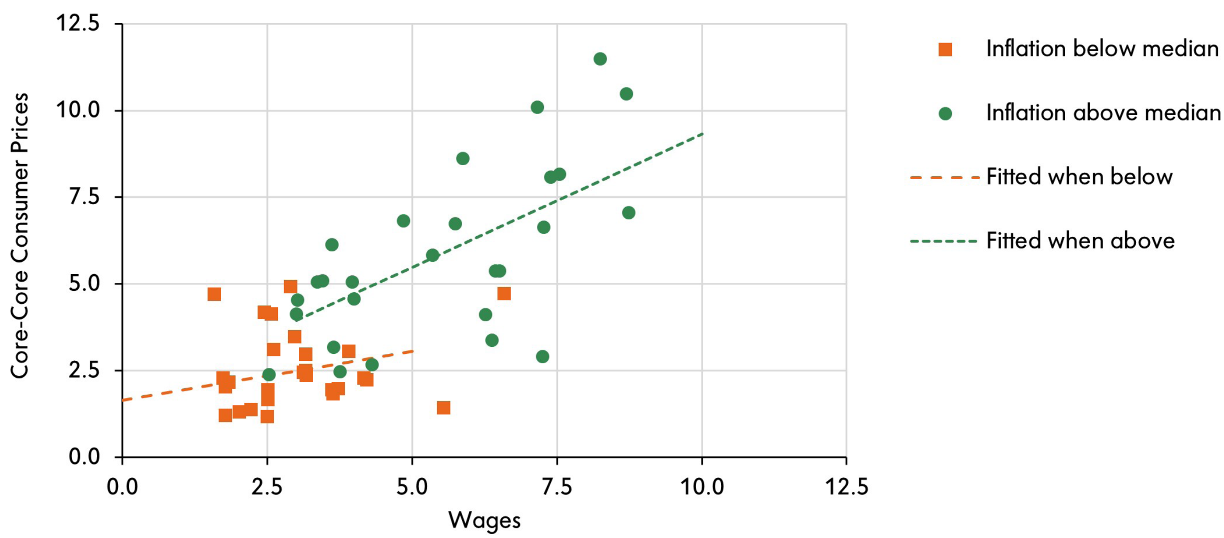
The bottom right chart on the previous page provides imputed price levels for the two portions of the consumer price basket, set as equal twenty-three years ago. Sticky prices would have to increase about 8 ½ percent to regain their rough alignment with flexible prices as prevailed at the opening of the century. That portion of inflation dynamics is backward looking.

Rough alignment is the correct characterization. Real shocks, to the extent they persist, could permanently change the relative price of flexible- to sticky-price items. Picking the starting point for the indexes is, as a result, arbitrary.

Chair Powell emphasizes the additional current and future impetus to an important portion of sticky prices, those stripped of their shelter component. The FRB Atlanta serves us well here, too, publishing a core sticky price measure without shelter.[4] These data, which we will refer to as core-core prices hereafter, allow us to consider the two additional behavioral relationships implicit in Powell's arithmetic that are particularly compelling now that inflation has been allowed to revive.

Wages & Core-Core Prices

Twelve-month change, percent



Source: Bureau of Labor Statistics and Federal Reserve Bank of Atlanta, accessed via FRED, 2/26/2023, and Firm analysis. Core-core inflation is Sticky Price Consumer Price Index less Food, Energy, and Shelter (from FRB Atlanta). Wages are Average Hourly Earnings of Production and Non-supervisory Employees, Total Private (from BLS).

Explaining Core-Core Inflation
Annually, 1968 to 2022

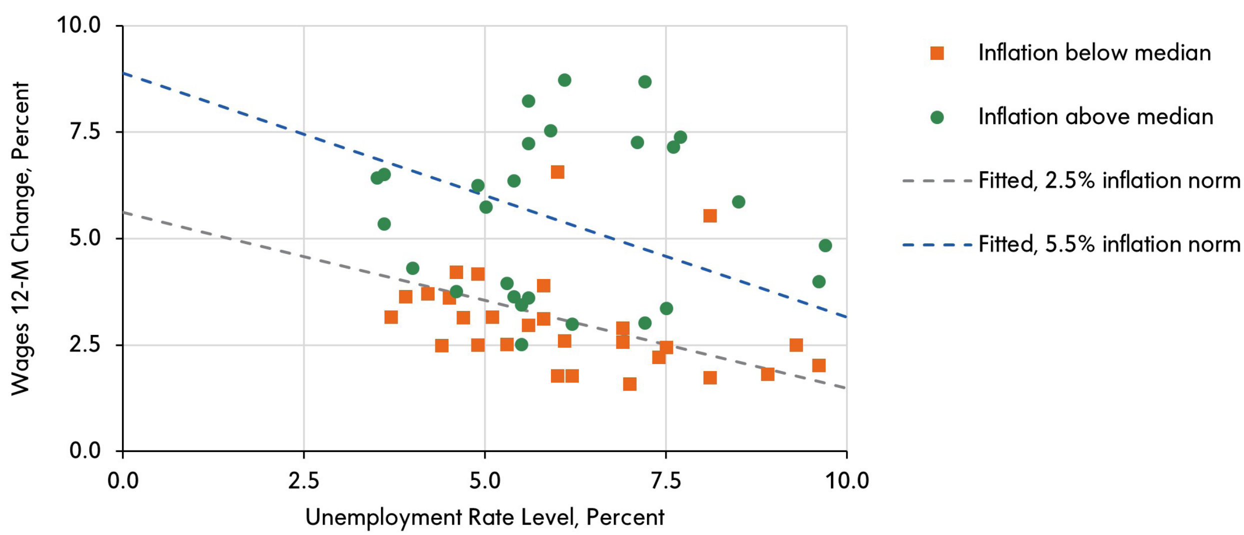
	Constant	Below	Above
Coefficient	1.65	0.28	0.77
Standard Error	0.62	0.20	0.11
t-statistic	2.66	1.39	6.76
R^2	0.63		

Note: Inflation relative to median. Source: Bureau of Labor Statistics and Federal Reserve Bank of Atlanta, accessed via FRED, 2/26/2023, and Firm analysis. Core-core inflation is Sticky Price Consumer Price Index less Food, Energy, and Shelter (from FRB Atlanta). Wages are Average Hourly Earnings of Production and Nonsupervisory Employees, Total Private (from BLS).

First, those sticky prices are sensitive to their most important input cost, wages. The chart on the previous page compares the annual increases in average hourly earnings along the horizontal axis and core-core price inflation along the vertical axis. There is a positive association, to be sure, but very loose and perhaps nonlinear. Under the hood is a disquieting regularity. The orange squares plot the combinations when headline inflation was at or below its sample median of 3 ⅓ percent. In the event, there is only a modest discernable association. In sharp contrast, the green dots look at the higher-inflation outcomes. When inflation is high, the pass-through of wages to consumer prices is much more reliably forceful.

More detail is given in the table on the following page, which reports the regression of core-core inflation as explained by the growth of average hourly earnings, split into observations when headline consumer price inflation is below and above, respectively, its median. (The sample consists of annual reading from 1968 to 2022.) Wages matter for core-core inflation in the current environment, and they are growing faster than consistent with price stability.

Unemployment Rate & Wages
Level & twelve-month change, percent



Source: Bureau of Labor Statistics, accessed via FRED, 2/26/2023, and Firm analysis. Wages are Average Hourly Earnings of Production and Non-supervisory Employees, Total Private (from BLS).

Explaining Wage Inflation
Annually, 1968 to 2022

		Inflation Norm		Unemployment Rate	
	Constant	Below	Above	Below	Above
Coefficient	4.95	0.26	0.72	-0.41	-0.57
Standard error	0.66	0.21	0.11	0.11	0.16
t-statistic	7.50	1.28	6.34	-3.75	-3.67
R^2	0.68				

Note: Inflation relative to median. Source: Bureau of Labor Statistics, accessed via FRED, 2/26/2023, and Firm analysis. Wages are Average Hourly Earnings of Production and Nonsupervisory Employees, Total Private (from BLS).

Moreover, with the labor market taut, they are likely to continue to contribute to high inflation. That's the second behavioral relationship on the chair's list of worries. As is evident in the chart on the previous page, the relationship between the unemployment rate along the horizontal axis and core-core inflation is loose, charitably, but negative. But the simple scatter plot excludes other crucial factors, notably inflation expectations. Inflation expectations are both important and unidentifiable, a planetary wanderer in the macro firmament (to abuse Chair Powell's metaphor provided at a Jackson Hole Symposium). We constructed a three-year, backward-looking average of headline consumer price inflation to capture the prevailing norm of expectations. This is formalized in regression results reported above, which shows that both the unemployment rate and inflation norm are much more important when inflation is above its median. This association between core-core inflation and the unemployment rate is more explicable with the dashed lines in the scatter plot. The grey line plots the predicted relationship when inflation is at or below its median. The more ominous blue line gives the fit when the inflation norm runs around its prevailing rate of 5 percent. Chair Powell is right in that labor market tautness is associated with faster inflation.

What Should be Made of This?

Admittedly, we've offered a veneer of science glued on top of intuition. Prices respond to costs, costs respond to resource use, and the association matters more when the prevailing norm for inflation makes worries about changeable prices more salient to households and firms. We don't offer them to provide a point forecast, only to underscore that there is a basis for Chair Powell's concerns and to remind that they are obscured by uncertainty. Powell has made implicit judgments about them, and his judgments shape the path of the Fed's policy rate, which will be going up some more and staying on a higher plateau for some time. Our forecast has 75 basis points more firming and the funds rate holding at 5 ¼ to 5 ½ percent for the rest of the year. That is up 25 basis points from the last version but back to where we were in December, before our disappointment that the Fed tapered its tightening at the last FOMC meeting too quickly. To achieve this new path, we believe the Fed will hike the funds rate one-quarter point in March and include the characterization of its actions as ongoing, contracting it to two more like-sized moves in succession.

Vincent Reinhart
Chief Economist & Macro Strategist

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. This underlies Ms. Swift's angst about her concert ticket prices. The auction algorithm pricing them aligns current supply and demand. The result clears the market but may damage the longer-term relationship with her fanbase.

2. This is talking through the staggered contracting framework of Guillermo Calvo (of Columbia) and John Taylor (of Stanford) which dominates modern macro models. N. Gregory Mankiw. "New Keynesian Economics." Found at https://www.econlib.org/library/Enc/NewKeynesianEconomics.html Accessed on February 25, 2023.

3. Our long-running suspicion, is that the Fed's monetary framework put too many chips on the favorable performance of flexible prices in the first two decades of this century, hindering the recognition of inflation risk.

4. The match is imperfect. Powell slices and dices the price index for personal consumption expenditures, while the FRB Atlanta mines the consumer price index. The difference is not material for our purposes.

Disclosure

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