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That Was the Week That Was

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Monetary policy is created by people of differing statures within a central bank. Each of them come to the table with an interpretation of the forces shaping the economy and the appropriate pursuits of their mandated goals. Inside their marbled palaces, they seek common ground and then work hard to arrive at a manicured message for the public, stressing agreement and continuity by smoothing the rough edges of their compromises. Sometimes, though, policymakers improvise when surprised, and the resulting commotion reveals who is really in charge and what is important to them before falling back to the settled order of surface agreement. That moment of disorder, however, may point to fault lines of future disagreement.

This was just the case for the Federal Reserve (Fed) and its prime mover, Chair Jay Powell, during the three-day window from Monday, June 13, to the announcement of the decision of the Federal Open Market Committee (FOMC) on Wednesday, June 15. This note works through the main questions emerging from the dustup of a quickly engineered market repricing.

- How did events unfold?
- What did we learn?
- Why will this matter later in the year?

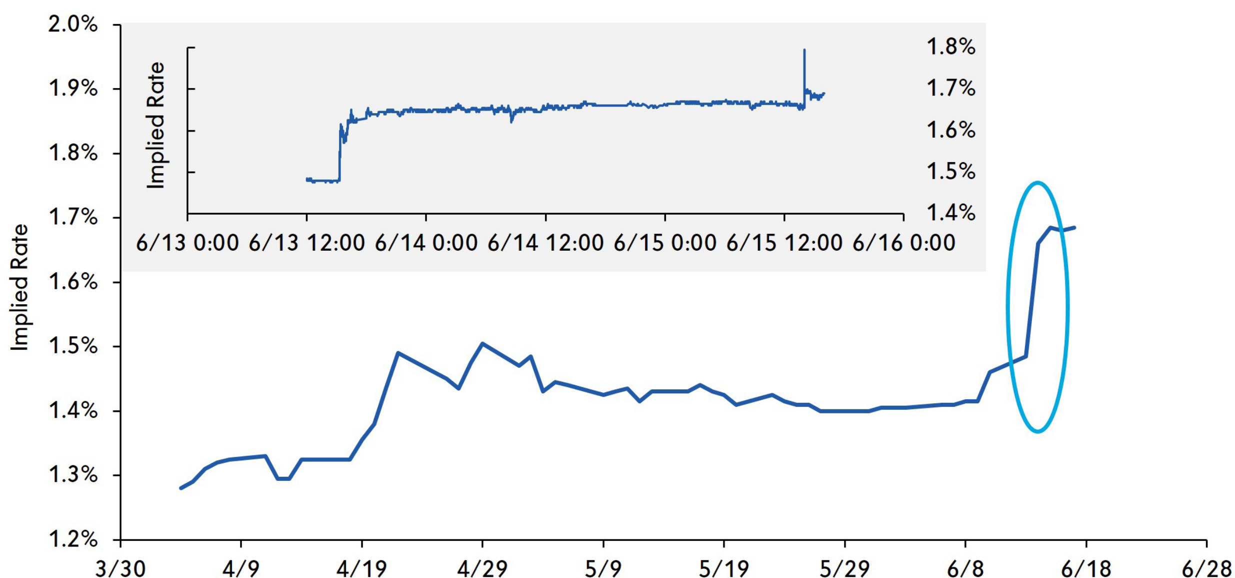
Some issues are structural, as in how the Fed chair will always be loathe to surprise markets on the same day of a press conference, and some are not knowable at this time, as in whether back-channel machinations were socialized within the entire policymaking group. Our suspicion, however, is that the ripples in the smooth surface of Fed communications indicate problems underneath.

How Did Events Unfold?

At its May meeting, FOMC participants apparently settled on a plan of hiking its policy rate 50 basis points at each of its next two meetings. They left no room for doubt in the subsequent six weeks, with every speaker delivering an identical message, which it gave in an official imprimatur in the published minutes of that meeting. We were told that "most participants judged that 50-basis-point increase in the target range would likely be appropriate for the next couple of meetings."[1] This muscular gradualism could be agreed upon by people holding a wide range of views about the ultimate extent of required firming because they all shared the view that the current policy rate was well short of the mark. Conveying this near-term unanimity of intent led market participants to bring forward firmer financial conditions, "shifting expectations regarding the policy outlook into better alignment with the Committee's assessment," as stated in those same minutes.

As is evident in quotes for the thirty-day interest rate contract in the futures market (the main body of the following chart), expectations firmly settled on a half-point move in June. On the Friday before that meeting, events intruded with the publication of consumer prices for May showing that inflation was running at 8½ percent over the prior twelve months, up not down as expected. A little later, a widely followed measure of household inflation expectations ticked higher. Events often intrude when making monetary policy in real time. In fact, the inflation surprise was eerily reminiscent to events in advance of the November 2021 FOMC meeting, when the Committee had similarly laid tracks down to tightening policy—the onset of slowing asset purchases—and consumer price and survey data dramatically disappointed. Chair Powell's ex-post explanation of the policy process then seemingly provided the template for this time around. He explained at his press conference in December, "...I thought for a second there whether we—whether we should increase our taper. [We] decided to go with what we had—what we had 'socialized'."[2] The settled order remained settled and they proceeded according to plan that time.

30-day Fed Funds Futures



Source: CME, accessed via Bloomberg, 6/18/22.

Not this time. In his usual one-on-one conversations with FOMC participants late Friday and Saturday, and at the Board briefing on Monday, Chair Powell presumably got an earful of regret about firm guidance limiting deliberations. The apparent solution was to socialize a larger move on Monday, with a leak to the Wall Street Journal that 75 basis points was on the table.[3] While we believe that the article was balanced and cited no more recent authority than a month-old interview with the chair, it was posted just after two o'clock in the afternoon (NY time) with considerable fanfare, suggesting it was definitive. Given FOMC rules, the source could only have been the chair, or more likely his designee. Whoever, it did the trick, and market prices adjusted, as in the inset to the chart showing trade-by-trade quotes on the 30-day futures rate contract for the first three days of FOMC week. In the event, the FOMC delivered as advertised at 2:00 p.m. (NY time) on Wednesday, eliciting little market reaction.

What Did We Learn?

We believe there are three main lessons to draw from the week that was, which should be held in decreasing order of conviction.

First, we may surmise that Chair Powell never wants to surprise financial market participants on FOMC announcement day. Consider a logical and plausible alternative that would have produced a similar repricing by market close on June 15: The Fed could have stuck to its prior guidance, hiked rates 50 basis points, and added stern warnings of a 75-basis-point move in the offing to both the statement and Chair Powell's opening remarks at the press conference. Instead, it appears that he was willing to tear up a communications plan and work a back channel (at a cost considered at length below) so that market prices fully incorporated the action before the event. Why? In our hypothetical world, the market reaction would take place while the chair was speaking, the crawling scrawl at the bottom of the cable business stations showing market numbers deeply in red would color all media coverage, and Powell would completely own what happened during his open-mic event.

Get used to it. In the world of press conferences after every meeting, it is in the self-interest of the presenter (the Fed chair) to ensure that announcement day is, well, just another day.

And it is. The following table provides summary statistics of the absolute value of the change in the discount rate on the four-week Treasury bill over Powell's tenure as chair, February 5, 2018, to the latest, which provides an element of market surprise day by day. Note that the average and median of the absolute value of the daily changes are indistinguishable from the changes taking place only on FOMC announcement days during the Powell reign, all of which had press conferences.

As long as the chair faces the risk of personifying an adverse market reaction, this risk will likely be minimized. This is another unintended consequence of increased openness. The chair will always want to squeeze out uncertainty on announcement day so that an untoward market reaction does not twist the desired tone of the press conference. That is—do not expect much event risk in FOMC events.

Discount Rates on the Treasury Four-week Bill

Daily change (regardless of sign) in basis points, 2/2/2018 to 6/17/2022

	All Days	Announcement Days of Regularly Scheduled FOMC Meetings
Average	1.78	1.74
Standard Deviation	2.30	2.84
Median	1.00	1.00

Source: Federal Reserve, accessed via FRED, 6/20/22, and Firm analysis.

The second lesson? In our view, Fed guidance about its future action is credible for about 36 hours in advance of the meeting, as every statement over the intermeeting period before then consistently queued up an action that was not delivered. This effectively ends effective guidance. Fed officials might offer opinions as to their intent, but they are only opinions. We are back to basing expected immediate action on breaking events up to the week of the meeting, not on remarks or statements during the fortnight before. Good luck to guiding expectations so as to bring forward future monetary policy action.

Third, because of the week that was, we know what credence to attach to Fed statements to its external audience, us— not much. But did Chair Powell damage his internal credibility? That is not a risk that can be assessed definitively from the outside. It might have been that he got the last-minute message that his colleagues were agitated in light of late-breaking events. The larger move, as unsettling as it was, represented a good-faith response. Or, Chair Powell may be more hawkish than the median of other FOMC participants and took advantage of events to reshape the result more to his liking. That is, he may have damaged his internal, as well as his external, credibility.

Important in resolving this issue is whether the chair kept his committee in the loop about giving advanced notice of FOMC action to the press. We would know that had Powell answered an early question at his press conference, "Would you please give us, as detailed a sense that you can, of what role you played in reshaping market expectations so quickly on Monday?"[4] He did not, so it will not likely be revealed for another five years when the transcript of the FOMC meeting is published. Five years is too long in market time, so harbor as least some suspicion.

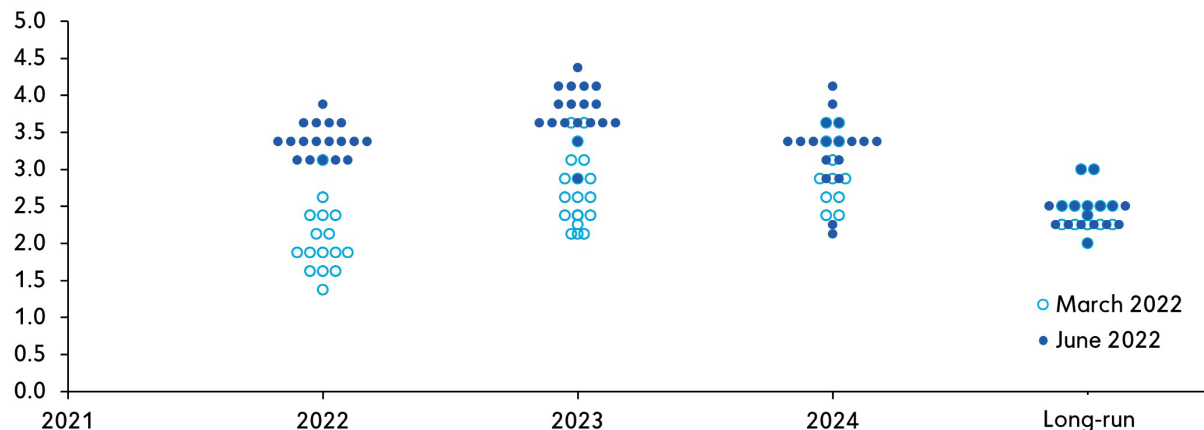
The group's overall message was muddled, suggesting it may not have been a group effort. True, the dots in Summary of Economic Projections (SEP) depicting the appropriate policy rate at year end floated up. Participants now expect the fed funds rate to end 2022 above 3 percent, and they see this as overshooting the longer-run neutral nominal interest rate. But the rise in the appropriate rate is reined in by their wishful thinking that inflation falls on its own, by half in 2023, even as the unemployment rate runs below their assessment of its natural rate. Apparently, the last-minute turn to hawkishness did not work its way to the back of the book of their published materials. Perhaps, it similarly did not permeate the hearts and minds of Powell's colleagues.

Economic Projections of Federal Reserve Board Members & Federal Reserve Bank Presidents, Under their Individual Assumptions of Projected Appropriate Monetary Policy, June 2022

Variable	2022	2023	2024	Longer-run
Change in Real GDP	**1.7%**	**1.7%**	**1.9%**	**1.8%**
March Projection	2.8%	2.2%	2.0%	1.8%
Unemployment Rate	**3.7%**	**3.9%**	**4.1%**	**4.0%**
March Projection	3.5%	3.5%	3.6%	4.0%
PCE Inflation	**5.2%**	**2.6%**	**2.2%**	**2.0%**
March Projection	4.3%	2.7%	2.3%	2.0%
Core PCE Inflation	**4.3%**	**2.7%**	**2.3%**	—
March Projection	4.1%	2.6%	2.3%	—
Memo: Projected Appropriate Policy Path				
Federal Funds Rate	**3.4%**	**3.8%**	**3.4%**	**2.5%**
March Projection	1.9%	2.8%	2.8%	2.4%

Appropriate Fed Funds Rate

End quarter of each year, percent



Source: Federal Reserve, accessed 6/15/22, at https://www.federalreserve.gov/monetarypolicy/.

Why Will this Matter Later in the Year?

Inflation in the US is at a forty-year high and nowhere near the neighborhood of what Volcker and Greenspan called price stability. The latter is of import because, outside that comfort zone, households and firms fret incessantly about changeable prices, which is why the topic has risen to top of mind among the public. The public is also known as the voting base, so politicians have also raised alarms about inflation.

We believe Fed officials must do something hard, raise the policy rate to tighten financial conditions to slow the growth of aggregate demand to bring it into better alignment with the level of aggregate supply. Only then can inflation be brought down. Working against them is the creeping up of the public's expectation of inflation, which indirectly feeds into cost and price pressures. Swinging from a major impediment to a major benefit—sometime soon Fed officials hope—is an improvement in aggregate supply, as global supply chains mend and health hesitancy lifts.

Fed officials admit that they have to do something hard, in that, as noted, all FOMC participants expect the funds rate to end this year above 3 percent, a significant firming in the policy rate that should further crimp financial conditions. There are, however, three strains that threaten this internal resolve.

First, there is a wide dispersion of views among officials as to the year-end policy rate, with the difference from top to bottom amounting to ¾, 1¼, and 2 percentage points, respectively, from this year to 2024. At the time of this publication, the end of this year is only four meetings away. For the five respondents at the bottom of this range in 2022, the FOMC should be done after two more moves like the last. For the official at the top of the heap, we believe four half-point moves would be insufficient to the task.

Second, policy firming, while aggressive compared to near-term precedent, has to address a problem sized to one of a more ancient vintage. The rate hikes prior to 2012 were larger in scale—indeed, much larger further back in time when inflation was in this neighborhood. The FOMC finesses this point by projecting inflation will retreat on its own, essentially assuming it will be pushing inflation downhill because aggregate supply fills in, massively. Aggregate demand does not meaningfully contribute to that decline, in that the real fed funds rate will still likely be negative at year end and the unemployment rate will presumably remain below its natural rate. Is it reasonable to believe supply chains will mend and people will be less hesitant to rejoin the workforce? Yes, but not to the degree that the Fed hopes. Similarly, the word unspoken in the SEP, recession, is always an elevated threat during a protracted firming spell. Such an outcome will trigger immense political pressure from both sides of the dual mandate of fostering maximum employment and stable prices, especially considering the escalating vigor in response to the prior three economic downturns the Fed demonstrated. Stopping short of the reclamation of price stability is a distinct possibility, but only after ugly social dynamics in the Fed's board room. For now, the Fed appears to hope for the best because planning for the more probable pushes the policy rate into an uncomfortable zone.

Later is when Chair Powell needs the committed support of his colleagues. If he retained it during the week that was, then he should have it at the turn of the year when the policy climate turns more ominous. If he was out front of his colleagues in June, then he should worry about how closely they are following him in December. In particular, the funds rate will be considerably higher, financial conditions likely materially tighter, inflation will probably be off its peak, and the unemployment will likely have turned around. Whatever it takes may lose ground to why ever more.

The chair will likely receive less help from market participants, who just learned that Fed promises are akin to the Pirate Code in "Pirates of the Caribbean," more like guidelines than actual rules. It appears that the only hard-and-fast rule surviving the week that was is that a Fed announcement day is just another day in markets because the chair will suppress uncertainty in advance of taking the stage at press conferences. That is, thirty-six hours is about as long as a Fed commitment seems safe.

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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. Federal Reserve, "Minutes of the Federal Open Market Committee", at https://www.federalreserve.gov/monetarypolicy/files/fomcminutes20220504.pdf.
2. Federal Reserve, "Transcript of Chair Powell's Press Conference," at https://www.federalreserve.gov/mediacenter/files/FOMCpresconf20211215.pdf.
3. The final print edition is here: https://www.wsj.com/articles/bad-inflation-reports-raise-odds-of-surprise-0-75-percentage-point-rate-rise-this-week-11655147927.
4. See page 5, Federal Reserve, "Transcript of Chair Powell's Press Conference", at https://www.federalreserve.gov/mediacenter/files/FOMCpresconf20220615.pdf

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