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Fed Thoughts: The Last Mile

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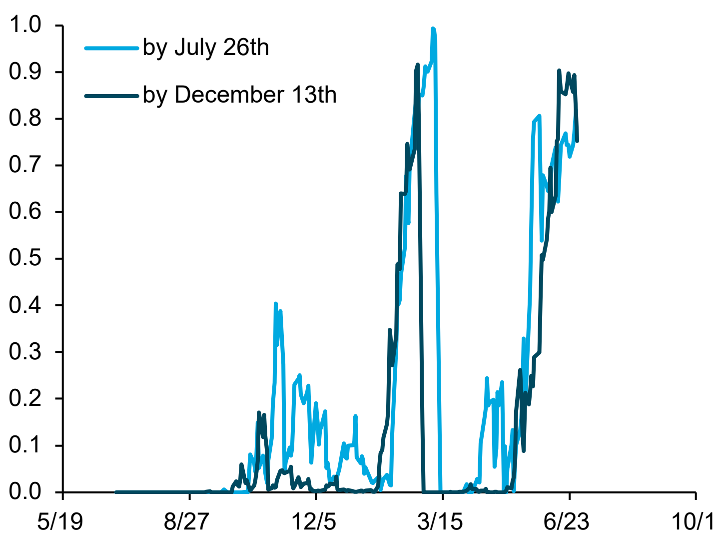
The Federal Reserve (Fed) is at the beginning of the end of the current rate-hiking cycle. Officials slowed the pace of firming purposely to make the stop less abrupt. If the Fed is successful in returning inflation to its target, policy restraint will increase in real terms and stay restrictive, probably for longer than market participants currently appreciate. The path, however, entails significant risks.

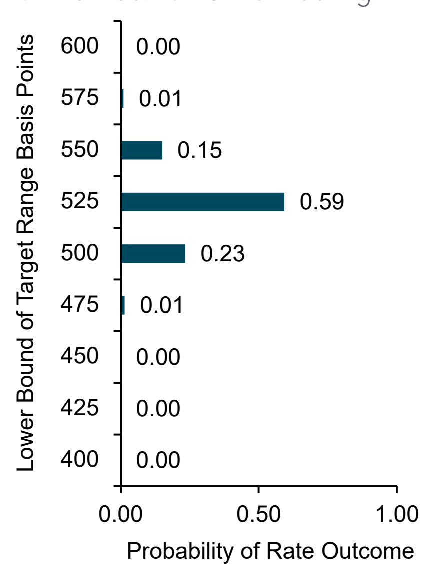
What's in Store for the Nominal Policy Rate?

With inflation well north of its goal and economic activity growing faster than trend, even as resources are taut and costs have increased, the Fed raised the policy rate 5 percentage points in 15 months. The most recent Summary of Economic Projections (SEP) revealed that the median participant of the Federal Open Market Committee (FOMC) expected two additional quarter-point moves in 2023. The pace of hikes has slowed sequentially—now apparently to every other meeting or a 12½-basis-point pace—as the next step in decelerating from 75 to 50 to 25 basis points of firming. Having taken a pass in June, the policy rate will almost surely be raised 25 basis points, to 5¼ percent, at the next FOMC meeting, which ends July 26. Market participants appreciate the new cadence of Fed actions and put nearly 100 percent probability on the action.

Probability of the Policy Rate (lower bound)
At or above 5¼%



Policy Rate Implied from Interest-Rate Futures
For the Dec. 13 FOMC Meeting



Source: CME, FedWatch Tool, accessed 7/14/2023. Quotes as of 7/13/2023.

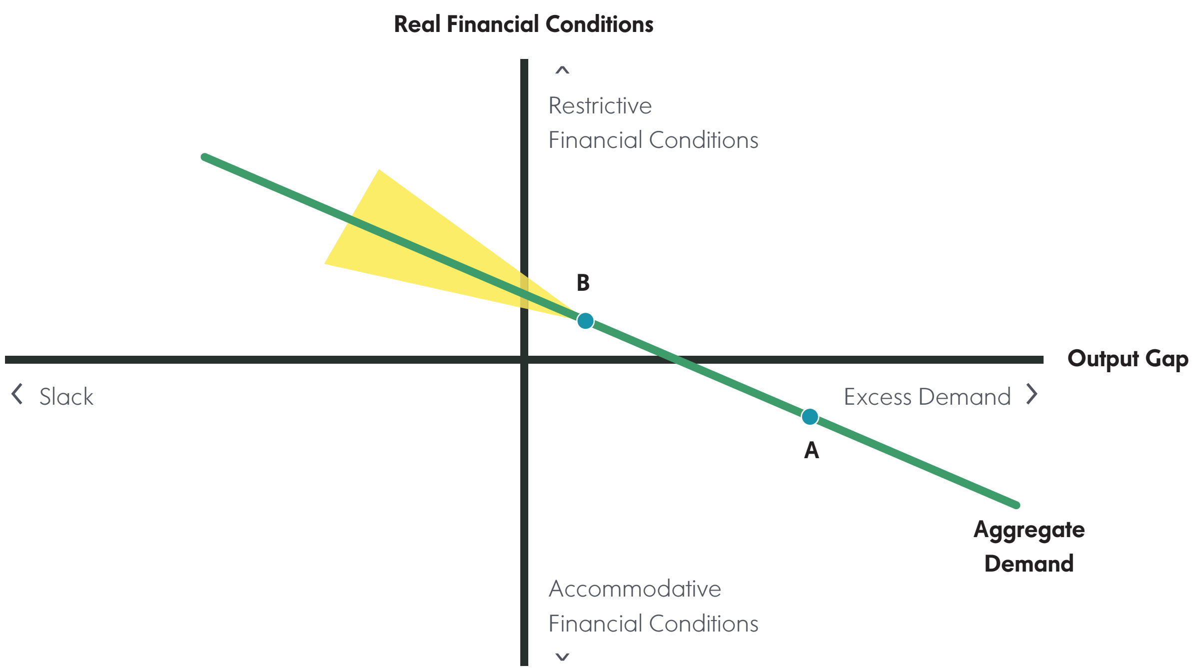
If it takes two meetings to act once, we should view the two after that—in September and November—as cojoined, with the first a pause to pull down the average given action at the second to satisfy the SEP plan. However, November is a long way away, with data on activity that will probably soften, inflation that will likely recede (albeit sluggishly), and remarks by the chair at Jackson Hole before they revise the outlook with another SEP. We're not so sure the Fed will act after July but believe, that once they're done hiking, the nominal funds rate will stay elevated for the remainder of the year. Judging by futures quotes, market participants agree with the former judgment but not the latter by placing appreciable probability that the Fed pivots toward easing.

What about the Fed's Policy Stance?

If the Fed gets it right, when this cycle of firming the nominal policy rate ends, the rate will rest on a plateau long enough for inflation to fall back to 2 percent. Along that path, the real policy rate will rise, and real financial conditions will tighten even more as investors come to appreciate that the Fed will not change course abruptly. At least that is the plan, but a variety of risks surrounds the journey, and as Fed Chair Powell recently admitted, "Remember that our jobs generally involve worrying about things." Those worries shape the path of policy and will be the subject of the remainder of this note.

Mapping the Risks

One picture can be put to multiple uses to understand the Fed's view of its policy stance and the uncertainties it faces. As the following chart shows, aggregate demand relative to an economy's potential to produce (along the horizontal axis) varies negatively with real financial conditions (along the vertical axis). The current rate of inflation is the by-product of where the economy sits in this space. Fed Chair Powell's characterization at a recent conference of the European Central Bank (ECB) was that "although policy is restrictive, it may not be restrictive enough and it has not been restrictive for long enough." Putting words to the picture:



- Right now, policy has maneuvered to point B, where it is restrictive, but only for a short time. A significant portion of the tightening thus far has been to remove accommodation given the starting point A.

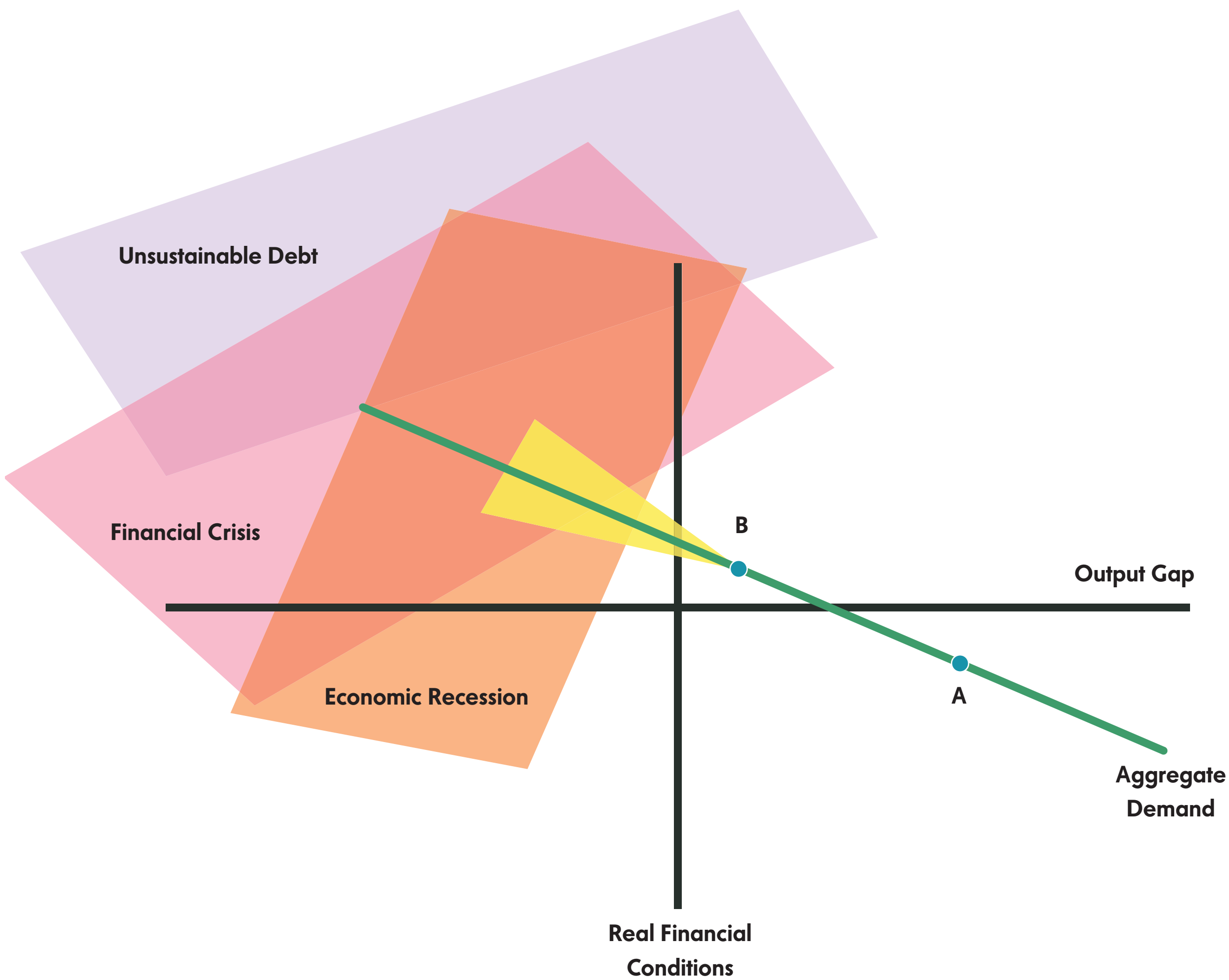
- Removing accommodation and moving to restraint (along the aggregate demand line) has slowed inflation but not returned it to goal. As Powell explained, goods and housing prices have fallen, but there hasn't been "any real improvement" in the services sector. To reclaim price stability requires traveling the "last mile," in the words of the latest annual report of the Bank for International Settlements (BIS), somewhere in the cone moving into the northwest quadrant of tighter financial conditions and lower demand.[1]

- That movement into the cone isn't all up to central banks. A modest further firming of the nominal policy rate would produce even firmer financial conditions, as inflation falls and market participants anticipate policy will be kept firm until the mission is achieved.

Regions of risk intrude in this picture, shown in the next graph as three scary shaded areas, and relate to three fundamental questions about the outlook.

What about Economic Recession?

Economic responses to tighter financial conditions and changes in resource use are uneven across sectors and unpredictably depend on confidence. Pushing outcomes into the northeast quadrant raises the odds of a downturn (the region shaded in orange). A recession is not inevitable along the last mile, only more likely as the unintended consequence of the policy imperative. The precedent is not encouraging, in that recessions have accompanied all but one Fed firming cycle of the modern era. Economists have been concerned about a downturn for some time, but robust activity has pushed forward the date quarter after quarter. Perhaps they'll eventually be right.



Were the Bank Runs in March a Harbinger of Financial Crisis?

A poorly performing economy and a high rate of discount will weigh heavily on asset valuations and the balance sheets of intermediaries. This is an even more uncertain call than recession but presumably lies in a region especially dependent on the restrictiveness of financial conditions (shaded in pink) overlapping considerably with recession.

- This is a longstanding concern of the BIS, which adopted the wishful thinking in its annual report that macroprudential policy could shrink the region of crisis risk and safely walk the last mile to price stability.

- Gita Gopinath, the second-ranking official at the International Monetary Fund (IMF) who also participated at the ECB conference, took the crisis-risk region as a hard constraint, counseling that central banks may have to stop short of returning inflation to goal. That is "...central banks may need to adjust their monetary policy reaction function to account for financial stress."

- The prevailing view at the Fed, in contrast, is the separation principle. Monetary policymakers can pursue their goals in the confidence that their supervisory colleagues have hemmed in the financial stress zone. The separation doctrine is an extreme view of the BIS's wish about macroprudential policy—we're already there. The view is prevailing, not predominant, and we expect increasing divisions within the FOMC about the consequences of additional hikes on financial strains.

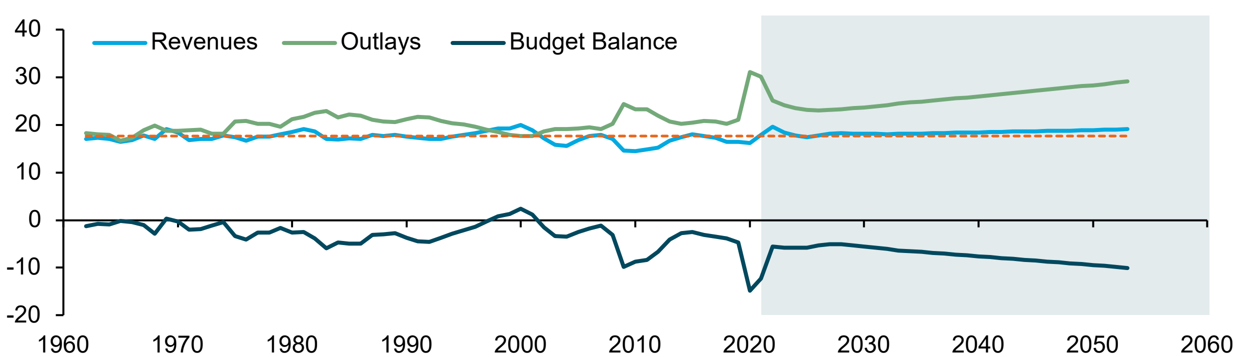
Who will Buy Government Debt?

For many economies, a dark region hovers above the recession and financial crisis zones, one of government debt unsustainability (shaded in purple). Starting from a high level of government debt relative to income, if financial conditions are extremely tight and the economy weak, debt service may consume a sufficiently large share of the budget as to require unsustainably high future issuance. The update of the Congressional Budget Office (CBO) on debt trends was grim, but we are not near that unstable region, yet, thanks to our reserve-currency status.

There is, however, a significant concern in the starting point of the CBO debt forecast. When Fed Chair Paul Volcker famously started tightening in 1979, government debt had one-quarter the footprint on nominal economic activity than today and still interest service ballooned. Chair Powell and his colleagues are shrinking the available federal budget space, which is sure to make the political class increasingly restive.

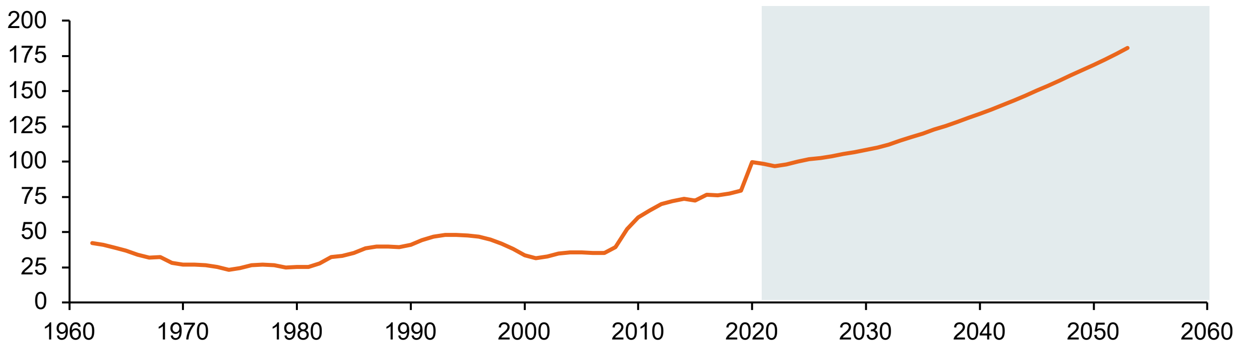
Federal Budget

Relative to nominal GDP, percent



Source: CBO, "The Budget and Economic Outlook" (February 2023) and "The 2023 Long-Term Budget Outlook" (June 2023). Accessed 7/1/2023.

Net Government Debt
Relative to nominal GDP, percent



Source: CBO, "The Budget and Economic Outlook" (February 2023) and "The 2023 Long-Term Budget Outlook" (June 2023). Accessed 7/1/2023.

Summary

Our view is that good intentions about the last long, hard mile will prompt another quarter point or so of Fed firming, but the dark regions in the map of risks will induce enough trepidation for the Fed travelers to stop. Despite Chair Powell's resolute tone, we think he believes modest additional policy firming will produce sufficient market restraint because credit will tighten more than commonly expected in light of the strains on bank balance sheets. In any event, the reality of recession, the threat of further financial strains, external pressure about the budgetary toll, and internal differences about the goals and strategy of monetary policy will likely stop the Fed in its tracks soon in the yellow cone, as illustrated in the chart on page 3. We believe the result will be a poorly performing economy with somewhat above-goal inflation next year, which is when the Fed will pivot to accommodation.

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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 path to price stability lies somewhere in a cone because the missing dimensions in the diagram are time and uncertainty. A modestly restrictive stance held for a long time can match the results of a very restrictive policy held more briefly. As for uncertainty, the green aggregate demand relationship isn't really a line but a wider zone of possibilities.

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