August 2021

Fed Thoughts:
The Potomac River Delta Gambler

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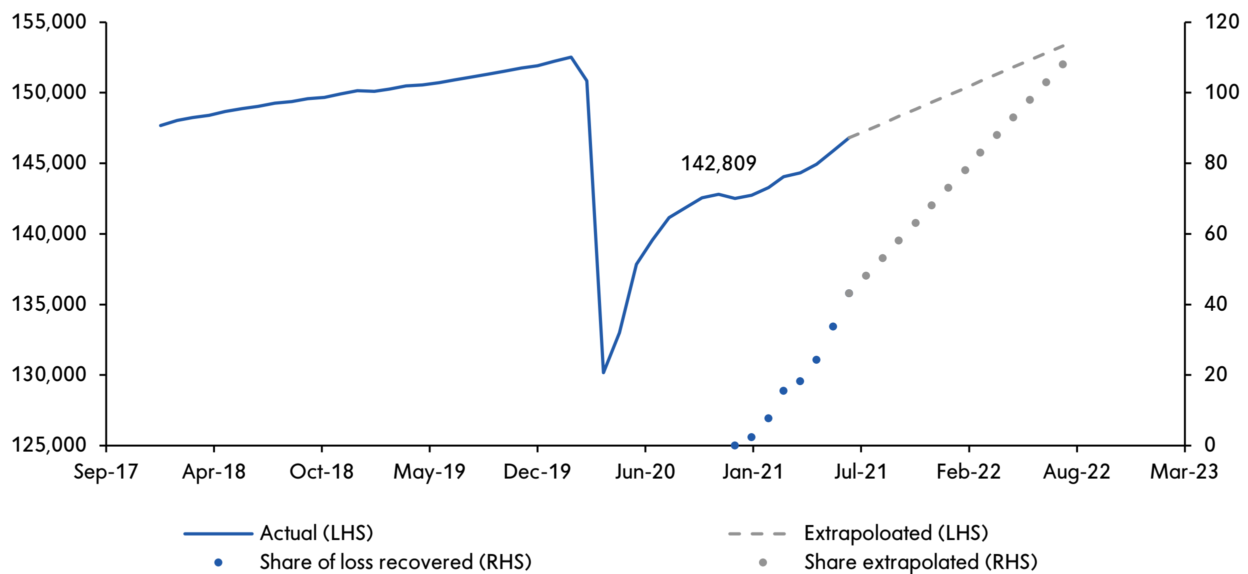
The high-stakes contest of wills attending most major decisions of the Federal Reserve's (Fed's) policy-setting group, the Federal Open Market Committee (FOMC), is center stage. Up for consideration is when to slow asset purchases from their current pace of $120 billion per month—that is, the timing of tapering bond buying. The house dealer (Fed Chair Jay Powell) has been pressed to the wall as a succession of his colleagues up the ante on an early exit.

Their macroeconomic justification appears clear cut. Inflation is well above the Fed's target of 2 percent. There are more job openings than unemployed, evidencing meaningful repair of the labor market. Taken together, this pulls closer the marker that the FOMC put down in December that it needed to see "substantial further progress" in meeting its goals before entering the exit ramp. On the conservative assumption that one-half million jobs are created on net each month over the near term, as in the chart below, by October the economy will have made up one-half the shortfall of employment in December from its February peak. If the economy keeps that pace up, it will be three-quarters of the way home by February. That sounds like mission accomplished for the goals of generating inflation and recovering jobs. Moreover, significant further fiscal impetus, while not assured, is certainly possible. Is this not time to slow the increase in monetary policy accommodation?

Nonfarm payroll employment: actual and extrapolated

Thousands of workers and share of loss recovered, percent



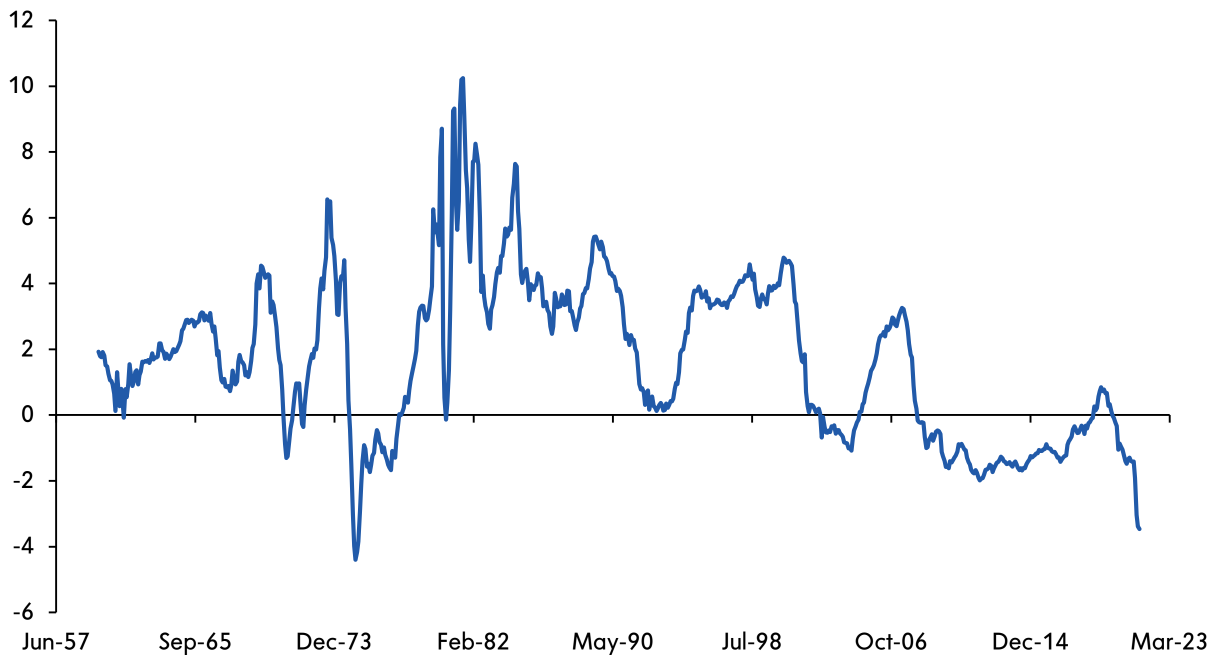
Source: Bureau of Labor Statistics , accessed via FRED on 8/18/21.

We will first document the views expressed in the press and ultimately made plain in the minutes of the July FOMC meeting of early exit advocates. Next, we will explain why this is a perspective not likely shared at the top of the house by Chair Powell. And then we offer potential responses of the chair, including how he can keep his colleagues at bay—if he wants. The first test will be Powell's Jackson-Hole address, to be delivered virtually once again. But the issue will play out repeatedly thereafter because of policymakers' penchant to litigate everything fully in public.

Truth be told, unless officials fumble the delivery of their chosen message, the exact timing of the taper does not matter much in terms of overall Fed accommodation. After all, the pace of asset purchasing paring can be calibrated somewhat to the timing of its start. Meanwhile, the throttle on the conventional instrument of monetary policy will remain fully open. With the nominal federal funds rate pinned at zero, increased inflation has pulled the ex-post real interest rate to its lowest level since 1975, indicated in the chart below. We believe accommodation is not going away any time soon.

Real fedral 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 8/18/21.

The Chattering Classes

The bidding war on the timing of the exit was started by the president of the Federal Reserve Bank (FRB) of St. Louis, James Bullard, who held that, “My preference would be to get to a decision in September and start sometime after that.” Robert Kaplan, FRB Dallas president, offered, “It would be my view that if the economy unfolds between now and our September meeting ... if it unfolds the way I expect, I would be in favor of announcing a plan at the September meeting and beginning tapering in October.” This calendar arithmetic was echoed by President Raphael Bostic of the FRB Atlanta and brought home by the dean of the Reserve Bank college of cardinals, Eric Rosengren of the FRB Boston, who did not mince words, “I think it is appropriate to start in the fall. That would be October or November. I certainly would not want to wait any longer than December.”

As is their wont, these speakers were front-running publication of the FOMC minutes, this time for the July meeting, to make sure that their message resonates. After an apparently lengthy discussion of asset purchases, the voted-upon characterization of the sense of the committee was:

> "... most participants noted that, provided that the economy were to evolve broadly as they anticipated, they judged that it could be appropriate to start reducing the pace of asset purchases this year because they saw the Committee's "substantial further progress" criterion as satisfied with respect to the price-stability goal and as close to being satisfied with respect to the maximum-employment goal. Various participants commented that economic and financial conditions would likely warrant a reduction in coming months."

The key points are the symmetric consideration of the Fed's two goals, maximum employment and stable prices, and the characterization that the former is close at hand and the latter may have already been breeched. Until now, most Fed-speak has made the twin goals sound hierarchical, ranking running the labor market hot first and letting inflation fend for itself, even if that involved some overshooting of price stability and reframing the goal as some backward-looking average. A committee concerned about inflation around 5 percent is a committee concentrating on exiting policy accommodation.

The Top of the House

All this appears to point to a committee lumbering toward announcing the beginning of the end of asset purchases sometime soon, probably at its upcoming meeting in September. Why do we suspect this view is not shared by Chair Powell?

For one, as a Fed governor, Powell was a cheerleader for an early exit from the prior round of quantitative easing in 2013, and that this episode is known as the "taper tantrum" explains how poorly it went. The risk of repeating this experience at the front, not the middle, of the pack, may likely raise angst.

For another, the Fed summarizes the discussion at an FOMC meeting two times each session. The formal version, the minutes, is released three weeks after the fact, but there is now a rough draft of history provided in the chair's press conference just after the conclusion of each meeting. The former passes through multiple drafts with comments from all participants. The latter is what the chair believes he heard a few hours earlier.

When it came to the timing of the taper, Chair Powell did not apparently hear as distinct a message as conveyed in the formal document. When asked about tapering, his answer (on page 20) was:

> "I'm not meaning to suggest anything about a particular time at which we might taper, because we really have not made that decision. All I'm saying is, is, we're not at substantial further progress. There's a range of views on, on what timing will be appropriate. And those views ultimately track, track back to people's views about the economy and, and what will happen as we make progress towards, towards our—towards our goal."

This is neither a ringing endorsement of action sometime soon, nor an accurate depiction of the mood of the majority of his colleagues.

Some Advice from an Unlikely Source

When the chair of a policy committee does not share the view of the bulk of his or her committee, the best strategic advice comes from the late Kenny Rogers: know when to hold 'em, know when to fold 'em, know when to walk away, and know when to run.

Run. Going a bit back in time, Fed chairs did not feel compelled to provide a transparent discourse on the current state of monetary policy deliberations at every public occasion. Indeed, some prior chairs revelled in blowing smoke about the current situation or introducing some off-topic theme, say on the solvency of social security or the weight of GDP.[1] In principle, this chair could similarly try to change the subject, but, given the expectations allowed to build around the event, this would come across as transparently running away from the issue. Indeed, it would have a whiff of panic. To appreciate how unappealing that look is to the Fed chair, just consider Powell's testy response when asked at the most recent press conference if the Fed was panicking about inflation.

Fold 'em. This is the path of least resistance. Powell can embrace his colleagues' position that the marker of "substantial further progress" is within sight. To be specific, he could outline the tapering calendar, with all the appropriate caveats, of course. Supporting his embrace of the exit plan, he could sound less hierarchical in his weighing of those goals by expressing more concern about inflation. Such handwringing would resonate at a time when the increases in headline price indexes are around 5 percent, and public discontent is on the rise. The chair could wrap this core macroeconomic message in a technical discussion of slowing asset purchases, emphasizing the contingent nature of the plan, and reassuring that it is about slowing additional, not removing, policy accommodation.

Hold 'em. The Powell beaming into the virtual Jackson Hole could be the same one who was broadcast at the last press conference. Rather than channel the sense of his committee, he could express his own reservations about early action. This seems more in sync with the risk aversion of the person in charge and the scar tissue Powell has remaining from the taper trantrum of 2013. True, market participants seem to expect him to follow the script of his committee. But, giving market participants what they want often is followed by them wanting (or fearing) more. Overshooting is not uncommon when policy turns in a material way, whether expected or not.

In framing such a challenge to prevailing opinion, the chair already pulled an ace from his hand (or from up his sleeve). In speaking to students and teachers recently, Powell explained that, "It's not clear whether the Delta strain has important effects on the economy; we'll have to see about that." Translated. Yes, the economy is roaring. The labor market is hot. Inflation is overshooting the Fed's goal. But, bad things happen to good people. Indeed, the major lesson any serious observer of the past eighteen months should take is that outsized events, outside of the realm of economics, can quickly reshape the outlook.

The clearest course for Chair Powell, if he wants to slow-walk his colleagues along the path to tapering, is to discuss the risk management of monetary policy in the presence of potential rare disasters and to express concern that the probability of the adverse event may have risen. Consumer confidence has been set back. Private forecasters are marking down their projections. And business people seem a little warier as the return to office for many slips into the future. Is it appropriate for the Fed to now lean into a program of slowing incremental policy accommodation when a little patience will be rewarded with more information about the efficacy of vaccines and the virulence of the Delta strain? If the baseline is correct, a faster pace of paring purchases started a little later could get them to about the balance-position by about the same point in 2022.

Walk away. Chair Powell can be transparent about policy deliberation, but he does not have to be in front of the wagon train. He does not have to endorse the majority view, only relay that there is one, but expand at length that it is a contingent plan explicit in its consideration of rare-disaster risk. That is, he could combine less assertive versions of "fold-em" and "hold-em" remarks. In fact, they fit together, as follows.

As this point, the FOMC sees an orderly path toward the start of incremental slowing of asset purchases sometime soon. This is an expectation, not a contract, that depends on events, including hard-to-predict health outcomes. He and his colleagues are especially sensitive to the possibility of adverse shocks to the economic outlook, but they are also cognizant of medium-term threats to the dual objectives. They will do their best to manage these risks going forward and are especially attuned to the need to provide ample advanced notice to the public. It is a shame not to meet in person, and he looks forward to doing this in the mountains next year, not stuck at home near the Potomac.

A Final Note

While Chair Powell speaks for his institution, it would be natural if he also took into consideration his own circumstances. There is always an unfair dynamic in a policy committee. The Fed chair explains what the committee decides and disproportionately earns the plaudits or bears the criticism of the public for the results.

On the one hand, an announcement of an early exit opens up the possibility of untoward market events and frames the Fed as less accommodative than some in Washington, DC, want. On the other hand, being tone death on inflation will rattle a different subset of the political class. Walking away from an outright decision by encompassing both views will not satisfy either group. However, it will also not completely alienate them. This might be a consideration in the window during which they are considering a second term as Fed chair for Jay Powell.

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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] With miniaturization and increased intellectual content to GDP, more of it can fit into a smaller box.

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