The dove in the dots: how the FOMC is paving the way for an inflation overshoot

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Steven Friedman
Senior Economist
steven.friedman@bnpparibas.com

Key points

- FOMC communications and projections suggest that policymakers are largely accommodating fiscal expansion and possibly encouraging an inflation overshoot.
- The approach implies a dovish shift in the FOMC's reaction function that is not adequately reflected in the Committee's statement on Longer-Run Goals and Monetary Policy Strategy.
- Still, quarterly policy rate increases through end-2019 remain likely as the unemployment rate will continue to fall below the Committee's projections.
- Longer-term, there is little clarity about how the Committee will cool off the labor market. Redefining full employment by continuing to revise NAIRU lower will become less tenable if inflation continues to firm.

Introduction

At the June Federal Open Market Committee meeting, policymakers raised the target range for the federal funds rate by 25 basis points and in the Summary of Economic Projections (SEP) signaled a slightly steeper path for the federal funds rate through year-end 2019. The shift in interest rate projections has generally been described by Fed watchers as a hawkish tilt by the FOMC, with the Committee gradually tightening policy in response to above-trend growth, a tight labor market and slightly above-objective inflation. However, this narrative misses the more important evolution in the Committee's thinking about the optimal path for the economy in the face of fiscal expansion. Specifically, relative to the significant change in macroeconomic projections since last fall, the change in interest rate projections over the same period has been quite limited. This growing contrast between the economic and policy rate projections suggests that the Committee is largely accommodating fiscal stimulus rather than pushing against it to prevent the output gap from moving further into positive territory and the unemployment rate from falling further below the Committee's estimate of NAIRU. As a result, the shift in interest rate projections in the SEP relative to the shift in macro projections should most appropriately be considered dovish. This dovish stance in turn suggests that the risks of the economy overheating over the medium term are rising.

Dovish projections: a fiscal policy case study

One useful approach to understanding the Committee's policy stance relative to the economic outlook involves applying a Taylor Rule to the Committee's own economic projections, and comparing the resulting rule-prescribed path for the policy rate with the Committee's own policy rate projections. The September 2017 Summary of Economic Projections (SEP) can be used as the point of departure for considering changes in economic projections, as this was the final SEP before Committee members broadly began to expect fiscal expansion. This can be seen in the table below. Between September 2016 and September 2017, median GDP projections in the SEP did not change significantly even as Trump took office and his administration and Congress pushed forward, however haltingly, with corporate and household tax cuts. But beginning with the December 2017 SEP, growth projections began a substantial shift as meeting participants increasingly discounted a strong fiscal impulse that also included the two-year budget agreement to lift discretionary spending. Between September of last year and the most recent SEP, the median FOMC participant's growth projection rose by 70 basis points for this year and 40 basis point for 2019.

Table 1: FOMC Median Projections for GDP

SEP Date	2018	2019	2020
Sept '16	2.0	1.8	N/A
Sept '17	2.1	2.0	1.8
Dec '17	2.5	2.1	2.0
June '18	2.8	2.4	2
Change, Sept '16 - Sept '17	0.1	0.2	N/A
Change, Sept '17 - June '18	0.7	0.4	0.2

Source: Board of Governors of the Federal Reserve System

A review of FOMC meeting minutes confirms this timing in the shift of fiscal policy expectations. For example, the September 2017 meeting minutes note that, "most participants had not assumed enactment of a fiscal stimulus package in their economic projections or had marked down the expected magnitude of any stimulus." By the December meeting, however, "participants saw the outlook for economic activity and the labor market as having remained strong or having strengthened since their previous meeting, in part reflecting a modest boost from the expected passage of the tax legislation under consideration." Further positive revisions to the growth outlook have occurred this year. By the March meeting, "Tax changes enacted late last year and the recent federal budget agreement, taken together, were expected to provide a significant boost to output over the next few years." With the fiscal thrust leading to persistently above-trend growth, Committee participants continued to revise down their projections for the unemployment rate, and policymakers' speeches reflected greater confidence in the inflation outlook.

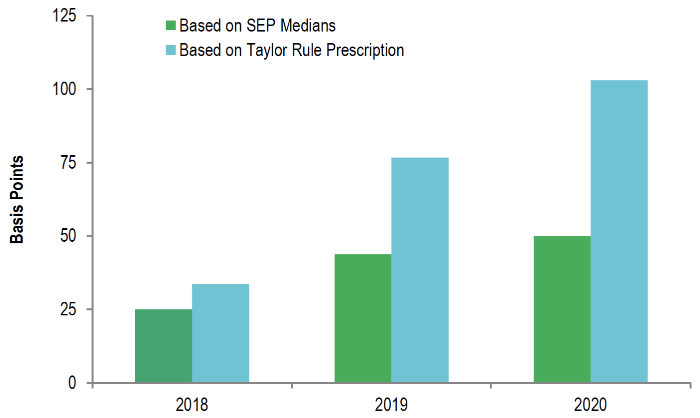
Table 2: FOMC median projections for the unemployment rate and core inflation

SEP Date	Unemployment Rate				Core PCE Inflation		
	'18	'19	'20	Longer run	'18	'19	'20
Sept '16	4.5	4.6	N/A	4.8	1.8	2.0	N/A
Sept '17	4.1	4.1	4.2	4.6	1.9	2.0	2.0
Dec '17	3.9	3.9	4.0	4.6	1.9	2.0	2.0
June '18	3.6	3.5	3.5	4.5	2.0	2.1	2.1

Source: Board of Governors of the Federal Reserve System

An inertial Taylor Rule suggests that these changes to the median unemployment rate and inflation projections should have steepened the policy rate path by 100 basis points through 2020[1]. However as seen in the chart below, the actual change to the median projection was just half this amount. This suggests that the Committee has largely chosen to accommodate fiscal expansion instead of leaning against it to keep the unemployment rate around NAIRU and the output gap from rising further into positive territory. Indeed, by 2020, the latest SEP reveals no projected closing of the gap between the projected unemployment rate (3.5 percent) and the Committee median NAIRU projection (4.5 percent). Even if the Committee's projections for inflation prove accurate, maintaining this policy path with the unemployment rate persisting well below NAIRU implies rising upside inflation risks beyond the projection horizon.

Chart 1: Change in policy rate projections, September 2017 to June 2018



Sources: Board of Governors of the Federal Reserve System, BNP Paribas Asset Management

Exploring the dovish tilt

Significant fiscal expansion at a time when the economy is largely operating at or beyond full employment represents a challenge that the FOMC could not have anticipated when it embarked on its strategy of gradual policy normalization in 2015. Furthermore, even as the administration prioritized tax cuts, it would have been challenging for the Committee to speed up its pace of policy normalization while passage of the tax package remained uncertain. In addition, the first half of 2017 brought an unanticipated decline in inflation that precluded a quickening of the pace of policy tightening. As a consequence of these considerations, at the time that the Tax Cuts and Jobs Act (TCJA) finally became law, policy remained highly accommodative for an economy with a closed output gap and very low unemployment that was also on the verge of a significant fiscal expansion.

Once the TCJA was enacted, the Committee could have pivoted to offset fiscal stimulus more forcefully and limit risks of the economy overheating over the medium term. As such, the decision to stick to a gradual pace of normalization despite a very different economic outlook should be viewed as a policy *choice*. This begs the question of why the Committee is pursuing a strategy of a significant NAIRU undershoot for the unemployment rate and above-objective inflation. There are several explanations. One rationale that Committee participants have cited in recent months is the need to reinforce the notion of symmetric treatment of the two percent inflation objective. As the FOMC began raising the policy rate at a time when inflation was still running below two percent, it is possible that the public began to view a two percent rate of inflation as the maximum amount that the Committee would tolerate. If so, inflation expectations may have become somewhat unanchored to the downside in recent years, creating a headwind to achieving the inflation objective. Seen in this context, tolerating or even encouraging an inflation overshoot could reinforce the notion of a symmetric objective and re-anchor inflation expectations at two percent.

Another rationale for accommodating fiscal expansion and a very tight labor market stems from the likely contour of growth over coming years. The growth impulse from fiscal policy will begin to fade starting in 2020. Aware of this, the Committee may not want an overly restrictive policy stance by that time, as growth will be decelerating back towards trend. Under this strategy, the Committee may expect that a slightly restrictive policy stance from 2020 onward will be sufficient, over time, to cool the labor market and ensure inflation stabilizes around the objective. Above-trend inflation in the meantime may be seen as an acceptable cost for returning the unemployment rate gradually to NAIRU while limiting the risk of a recession.

Uncertainty regarding NAIRU is another factor behind the Committee's decision to stick to a gradual path of rate increases even as the unemployment rate is expected to fall to, if not below, levels last seen in the 1960s. As inflation has failed to sustain a two percent rate of increase in recent years, the Committee gradually revised down their NAIRU estimate. The fact that the rate of core inflation is no higher now than it was 18 months ago, when the unemployment rate first declined below the Committee's estimate of its longer-run level, suggests that uncertainty over the true level of NAIRU likely remains high. Further downward revisions to policymakers' NAIRU estimates may still occur, although the case for doing so will not be as strong if the recent firming in inflation continues.

Finally, for a number of years now, the Committee has been examining the policy implications of a natural rate of interest, or r-star, that appears to have declined over the past decade and is likely to remain depressed for the foreseeable future. One implication is that the current tightening cycle is likely to end with a relatively low level of the policy rate compared to prior cycles, and hence the ability to cut rates in the next recession could be limited. This longer-term risk, combined with uncertainty about the true level of r-star, suggests that the Committee may be particularly careful in raising rates. In addition, a low level of r-star implies that all else equal, the Committee might prefer to enter the next recession with a somewhat elevated level of inflation in order to create additional space for cutting the real policy rate below zero.

The fact that many FOMC participants are highlighting reasons for an inflation overshoot, and that the economic projections suggest as much, imply that the Committee's reaction function has shifted somewhat in a dovish direction. At the very least, the likely evolution of inflation and policy is at odds with the "symmetric" language in the FOMC's Longer-Run Goals and Monetary Policy Strategy document, which states that that the Committee "would be concerned if inflation were running persistently above or below this objective." This language implies that the Committee should always work to return inflation to the objective[2], without consideration of the past level of inflation, uncertainty over NAIRU, or challenges in a future recession associated with a low natural rate of interest. In fact, a number of Committee participants have stated that low prior readings of inflation are sufficient grounds for encouraging higher inflation over the next several years. The minutes from the May FOMC meeting also reflect this view, if somewhat elliptically:

"In discussing the outlook for inflation, many participants emphasized that, after an extended period of low inflation, the Committee's longer-run policy objective was to return inflation to its symmetric 2 percent goal on a sustained basis." [3]

This suggests that at least for some Committee participants, the inflation objective does indeed have a backward-looking consideration that is independent of the state of inflation expectations.

The way forward

Communications from policymakers as well as the evolution of the SEP all paint a picture of a Committee that is largely accommodating fiscal expansion and possibly encouraging above-objective inflation. This suggests a modest dovish shift in the reaction function that is not accurately captured in the "symmetry" language in the Committee's statement on Longer-Run Goals and Monetary Policy Strategy. As such, the statement could very well undergo further refinement, perhaps even before the typical annual review at the first Committee meeting of each year. A few options[4] likely to be under discussion include:

- Specifying an acceptable range for inflation around a central two percent objective
- Defining circumstances in which the Committee would encourage deviations from the two percent objective, such as when inflation expectations have moved away from the objective for a significant period of time
- Targeting average inflation of two percent over the medium term.

Even as the Committee is comfortable with an inflation overshoot, there are limits to its tolerance for above-objective inflation. It is highly unlikely that the Committee will tolerate persistent inflation above 2.25 percent. At a certain point, the Committee will become concerned about inflation expectations becoming unanchored to the upside, and would also grow more concerned about potentially non-linear inflation effects associated with extremely low unemployment – the so-called kink in the Phillips curve. In addition, inflation above 2.25 percent would likely come about as a result of shelter inflation rising significantly above two percent, and it could be challenging for the Committee to slow meaningfully the pace of housing costs without causing a recession.

With this 2.25 percent threshold on above-objective inflation in mind, it is worth considering how policy will evolve in the near term. The Committee is likely still underestimating just how low the unemployment rate will fall. This is somewhat surprising given that most Committee members seem to appreciate that the labor force participation rate is unlikely to rise in the years ahead. With few also assuming a pickup in productivity, persistent above-trend growth suggests that the unemployment rate could meaningfully undershoot the median Committee participant's projection of 3.5 percent for end-2019. As this becomes apparent, the projections will reflect additional policy tightening. The next 18 months are therefore likely to see an additional 150 basis points of cumulative tightening: two more 25-basis point rate increases this year, and four next year. Thus even with a dovish shift in the reaction function, the SEP rate path is likely to show additional steepening in future projection rounds as the unemployment rate shows sustained downward momentum.

Even with a steeper eventual rate path, there is still no clear indication of how the Committee will eventually shrink the positive output gap and cool off the labor market over the medium term. The 2020 median projection suggests that the unemployment rate will still be far below all Committee members' NAIRU estimates, but with the projected policy rate just marginally in restrictive territory. This suggests that either the Committee will continue to tighten policy in 2021 or that inflation could rise more meaningfully above two percent. At the June press briefing, Chairman Powell was asked about plans for returning the unemployment rate to NAIRU over the medium term, and he did not provide a clear answer.[5] His response instead focused on uncertainty over the level of NAIRU and the possibility that NAIRU could be revised lower. However this will be an unconvincing approach for addressing the issue of a persistently low (and still-falling) unemployment rate if indeed inflation rises above two percent. In the meantime, the September SEP may provide important clues as to how the Committee plans on avoiding an overheating in the years ahead. In September, the SEP projections will roll forward another year, to 2021. If the median projections for that year show no additional rate increases but a higher unemployment rate projection than for 2020, it would confirm that the Committee hopes that with only moderate tightening it can eventually succeed in returning inflation to objective after an overshoot that will likely extend beyond the projection horizon.

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1. The median projections for the longer-run unemployment rate and federal funds rate from the September 2017 and June 2018 SEP were also used as Taylor Rule inputs.

2. The "symmetry" language was added to the longer-run goals and strategy statement at the January 2016 meeting, and the minutes of that meeting make clear that the language was meant to convey discomfort with deviations from the objective: "inflation moderately above the Committee's 2 percent goal and inflation the same amount below that level were equally costly." Benefits or justification of temporary over- or undershoots are not mentioned.

3. In a change from prior meeting minutes, almost every reference to the inflation objective in the May minutes referred to the objective as symmetric. Against a backdrop of rising inflation, this change was intended to signal comfort with an overshoot.

4. The Committee will also at some point debate longer-run changes to its strategy framework in response to a persistently low level of r-star. However in the most recent post-meeting press briefing, Chair Powell indicated that such a reconsideration is not an immediate priority: "It's not something that the Committee has looked at seriously. I imagine we will be having discussions about it, but—not something that we have on the calendar right now." Powell and other Committee members may see encouraging an inflation overshoot in the years ahead as a tactical substitute for a more fundamental change to the framework.

5. The press briefing exchange on cooling off the labor market over the medium term is worth highlighting as it points to a fundamental and ongoing unknown about the FOMC's approach:

Question: "You guys moved the median unemployment forecast for 2020 down to 3.5 percent but left the longer-run at 4.5 percent today. But you're only forecasting a moderate overshoot on the fed funds rate beyond your longer-run value. How are you going to get unemployment from 3.5 percent up to that 4.5 percent rate?"

Powell: "I would just—would—I would just emphasize, emphasize that—a couple things. First, we're learning about the real location of the natural rate of unemployment as we go. So it's moved down by more than a full percentage point since 2012. So it's not so simple as thinking, oh boy, we've just got to go ahead and get that rate up. If you—if you look at the forecast, two years from now, end of 2020, you're still seeing inflation very close to target. So there's no sense that inflation will—no sense in our models, or in our projections, or forecasts—that inflation will take off or move unexpectedly quickly from these levels, even if unemployment does remain low…So if we thought that inflation were going to take off, obviously, we'd be showing higher rates, but that's not what we think will happen."

Question: "If I could just follow up really quickly. Then why, I guess, would the longer-run unemployment rate not be a little bit lower and closer to that 2020 number?"

Powell: "Yeah, it may be. It may be. We may find that out. You know, the best estimate that we have, over the longer run, is that. Although, you know, there's a range of views, you know. Some people are in the low 4s, and, again, I said the uncertainty bands are, you know, not quite a full percentage point on either side, but ¾ of a percent, that kind of thing, so it's very possible. We have to be, you know—we can't do—we can't be too attached to these unobservable variables. You know, we—I think we have to be practical about the way we think about these things and we do that by being grounded in the data and what we see happening in the real economy."

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