Federal Reserve Policy Outlook: Time for a Strategy Reboot?

By Steven Friedman, Senior Investment Strategist - FOR PROFESSIONAL INVESTORS - June 13, 2016

Summary

- Downside risks to global growth, the fragility of inflation expectations and the proximity of the zero interest rate lower bound all point to challenges ahead for the Federal Open Market Committee (FOMC) in reaching and sustaining inflation at the two percent objective.
- Indeed, there are already signs that the long period of undershooting the inflation objective is damping inflation expectations.
- Given the aforementioned risks, the Committee should consider a strategy shift, delaying further rate increases until inflation hits two percent and looks set to remain at or above that level.

Introduction

The FOMC has embarked on a strategy of gradually tightening policy to bring inflation slowly back to the two percent objective, despite a number of factors that present challenges to this approach. These include downside risks to global growth, declining inflation expectations and limited policy options should the outlook deteriorate. Faced with these headwinds to achieving the inflation objective, this note considers an alternative strategy under which the Committee would forestall additional rate increases until inflation hits two percent. The strategy would also make clear a tolerance for above-objective inflation in the years ahead, with the goal of more rapidly returning average inflation to two percent over the medium term.

A Sensible Strategy for Policy Tightening, in Theory….

Well ahead of raising the target range for the federal funds rate last December, the FOMC went out of its way to communicate the rationale for beginning policy normalization before inflation reached the two percent objective. Two features of the strategy, the level of the real equilibrium policy rate and avoiding significant inflation overshoots, are worth reviewing since they may explain some of the challenges that the Committee has faced in achieving sufficiently strong growth to boost inflation. On the first of these strategy elements, the Committee has long articulated that the real policy rate consistent with full employment and the two percent inflation objective, also known as cyclical r*, was expected to rise gradually as headwinds from the financial crisis faded. As a result, the Committee would need to raise the target range for the federal funds rate to at least keep track with the estimated increase in r*; absent such an adjustment in the actual policy rate, a rise in cyclical r* would lead to a looser stance of policy. And if inflation was returning to objective as the labor market strengthened, the real policy rate would need to rise by even more than the estimated increase in r* in order to tighten policy over time.

The Committee also highlighted that avoiding a significant inflation overshoot required raising rates before achieving the inflation objective. Given the typical lags with which monetary policy affects economic outcomes, the FOMC judged that waiting too long to raise rates could risk more significant policy increases later. The Chair herself stressed this point in her press conference in December, noting that, “Were the FOMC to delay…we would likely end up having to tighten policy relatively abruptly at some point to keep the economy from overheating… Such an abrupt tightening could increase the risk of pushing the economy into recession”. Thus “reasonable confidence” that inflation was moving back to objective, as opposed to “full confidence” supported by more meaningful progress on the inflation front, became a precondition for lift-off.

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...But Strategy Proves Problematic in Practice

While sensible in theory, in practice these strategy elements may have made it more difficult for the Committee to achieve its objectives. Even though Committee participants consistently stress that the FOMC seeks to avoid significant inflation overshoots, this has been a challenging message for the public, in part because the Committee has never defined a significant overshoot. For example, in the prior tightening cycle, the Committee tolerated an inflation overshoot of around fifty basis points for a number of years. It has been unclear if this is the sort of inflation overshoot that the Committee now seeks to avoid.

There is not only a lack of clarity about tolerable levels of above-objective inflation, but Committee communications unwittingly give the impression that there is little tolerance for *any* inflation overshoot. For example, at the time of liftoff in December, the Committee's Summary of Economic Projections (SEP) indicated that the vast majority of Committee participants did not envision core PCE inflation rising above two percent at any point over the projection horizon[1]. Specifically, the top of the central tendency range for inflation projections was at no point above two percent through 2018[2]. Using this data point for each projection year implies that the vast majority of Committee members are comfortable with core inflation averaging no higher than 1.6 percent over the five-year period ending in 2018. In the context of a persistent failure to sustain two percent inflation since the financial crisis, there is a risk that the public will perceive that the two percent inflation mandate is a ceiling, not an average to be achieved over the medium term, or that many FOMC members do not treat the inflation goal symmetrically. To counter this misperception, a number of Committee members have recently stressed that the two percent inflation mandate is indeed an average to be achieved over time, and this January the Committee revised its Statement on Longer-Run Goals and Monetary Policy Strategy "to highlight the symmetry of its inflation goal". Still, the public may be interpreting the projections and recent history as indicating that the Committee is comfortable with inflation remaining below two percent for long periods of time.

In many circumstances it can be a sensible strategy for a central bank to set policy so that inflation gradually rises to, but does not exceed, the inflation objective. However, currently there are a number of factors that are a constraint on this strategy. First, a loss of global growth momentum and a generally poor outlook for global growth will serve as ongoing headwinds to the US economy. In addition, as the policy rate remains near the zero interest rate lower bound, the FOMC has a limited set of tools with which to respond to any loss of domestic growth momentum. And finally, increasingly fragile inflation expectations amplify the challenges the Committee will face in boosting inflation. As we have noted previously, long-term inflation expectations have declined over the past year, and in fact are now at the lowest level ever in the history of the University of Michigan survey. Meanwhile, the Federal Reserve's measure of forward inflation compensation embedded in Treasury Inflation-Protected Securities remains near historical lows. These movements suggest market scepticism that inflation will rise to mandate-consistent levels over the longer run if the Committee continues to raise rates even as global growth momentum wanes and recession risks at home remain somewhat elevated.

The argument for raising the effective federal funds rate based on expectations for a rising equilibrium policy rate have also proven problematic, largely because there is little evidence to date that cyclical r* has begun to firm in a meaningful way[3]. In addition, growth has shown signs of slowing towards the Committee's estimate of potential amidst expectations for only limited policy rate increases. This suggests that r* may be lower than the Committee believes (though still above the current level of the effective federal funds rate). If this is the case, even small adjustments to the policy rate may jeopardize the Committee's ability to sustain above-trend growth and push inflation up to the two percent objective.

Communications Errors Compound the Issue

As the FOMC turned its attention to policy tightening, it committed to avoiding the communications pitfalls of the 2004-06 tightening cycle. At that time, the Committee used forward guidance to signal a "measured" pace of rate increases, which the public eventually interpreted as a relatively firm commitment to raise rates at each meeting by 25 basis points. FOMC meeting minutes from that period indicate that Committee participants were aware of this consequence of their communications, and while uncomfortable with it, were hesitant to deviate so as not to compromise the credibility of future communications. The commitment nature of the forward guidance, however, led to criticism that the FOMC's strategy suppressed market volatility and led to overly easy financial conditions that contributed to the formation of asset bubbles. Whether a fair criticism or not, the Committee is attempting to rely on a more data-dependent communications strategy this time around in order to avoid some of the potential costs associated with forward guidance.

In practice, though, the data-dependent approach to tightening has run into two roadblocks of the Committee's own creation. First, Committee members have frequently engaged in deliberate attempts to influence market expectations for the timing of policy rate increases. In January, for example, Stanley Fischer commented that the expected path of policy rates discounted in markets was "too low", and that investors were "underestimating" the Committee's intent to raise rates this year. More recently, since the last FOMC meeting a number of FOMC participants noted their expectations for 2-3 rate increases this year, sending a clear signal that the Committee viewed a June rate increase as a distinct possibility. The meeting minutes suggest this may have been a coordinated effort to influence market expectations. There is the obvious problem that such communications over the past year have consistently dented the Committee's credibility, as these projections for rate increases have proven overly optimistic. But there is the larger issue that market expectations reflect an assessment that the risks to the economic outlook are decidedly more skewed to the downside than the Committee's own assessment. Relative to the market assessment, Committee members' policy projections are viewed, on the whole, as unduly restrictive[4].

The "dot chart" in the SEP compounds the Committee's communications challenges. The dots place the emphasis on modal policy rate projections over distinct time horizons with no indication of the significant uncertainty attached to these forecasts, and thus gives the impression of date-dependent forward guidance (this is a theme we will explore more fully in a forthcoming Central Bank

[1] By contrast, the inflation projections of the Bank of England are more consistent with a symmetric inflation goal, as the Bank's projections often indicate the Monetary Policy Committee's expectation that inflation will rise above their two percent target during the forecast horizon.
[2] The top of the central tendency range will capture all but the three highest inflation projections of Committee participants.
[3] See for example Laubach and Williams, Measuring the Natural Rate of Interest Redux and their current estimates of r*.
[4] For example, the Federal Reserve Bank of New York's April survey of market participants revealed that respondents assigned close to one-third odds to either no change in the target federal funds rate this year, or to a decrease. These are notably higher odds assigned to downside growth and inflation risks than those implied by recent Federal Reserve communications.

Watch). In addition, the projections for the federal funds rate are not sufficiently tied to macroeconomic forecasts to reinforce the data-dependent nature of these projections. This is because there is no reason to expect that the median interest rate projections match up with the median projections for the unemployment rate and inflation – they have likely been submitted by different FOMC participants who can have quite different policy reaction functions. Absent a sufficiently strong link to economic projections and through their emphasis on modal outcomes over distinct horizons, the Committee's policy rate projections are viewed as containing an element of date-dependent guidance that does place sufficient weight on downside risks. As such, the current construct of the SEP contributes to concerns that the Committee is not treating its inflation goal symmetrically.

Time For a Strategy Reboot?

At the end of the day, the Committee is attempting to normalize policy at a time when investors remain concerned about downside risks to growth and inflation, and about the ability of the FOMC to respond to a recession given the proximity of the lower interest rate bound. In addition, a slowdown in jobs growth in recent months and some weakening in the ISM activity surveys have contributed to perceptions that the economy will struggle to sustain above-trend growth and, ultimately, full employment and mandate-consistent inflation. Indicators that global growth is losing momentum serve to compound these concerns. As a result, the Committee will continue to face significant market scepticism if it continues to signal a steady diet of interest rate increases. This scepticism would not be problematic were it not for the fact that it results in tighter financial conditions and lower inflation expectations, which will make it more difficult for the Committee to achieve its objectives.

Faced with these risks to achieving its objectives, the Committee could consider shifting its strategy for policy normalization in a number of ways. First, it could abstain from additional rate increases until it has attained its two percent inflation objective and is confident that inflation will remain at or above this level over the next 1-2 years. This approach would serve to bolster confidence that the inflation goal is indeed symmetric, and lead to an immediate easing of financial conditions that would serve to limit downside risks to the outlook.

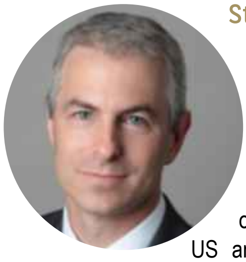
Second, with this shift in strategy, Committee members should stop discussing their own near-term projections for policy rates, and instead allow the evolution of economic conditions to shape market expectations. Chair Yellen's more recent communications approach, evident in her last speech before this week's FOMC meeting, indicates progress in this direction. Specifically, she discussed her expectation for gradually increasing the policy rate but without any reference to the timing of rate adjustments, and also placed considerable emphasis on the uncertainties surrounding her projections. It is unclear, however, if the shift in her discussion on the policy outlook reflects a pivot in communications strategy, or simply less certainty in the outlook.

This proposed shift in policy strategy and communications tactics could be reflected in the SEP in two important ways – as inflation firms, the Committee's projections would begin to indicate expectations within the central tendency for inflation to rise above two percent, reinforcing the symmetry of the Committee's inflation objective. And second, from a presentational perspective, the Committee should move forward implementing "fan charts" that highlight the uncertainty that meeting participants attach to their economic and policy rate projections (and ideally their balance sheet projections too). These changes to the presentation of projections would deemphasize time-dependent elements of monetary policy communications that play into concerns that the Committee is not treating its inflation objective as symmetric, and would instead reinforce a data-dependent approach.

Limited Scope for Change at the June Meeting

Unfortunately, at this point in time there is little reason to expect a significant shift in policy strategy aimed at bolstering realized and expected inflation. On the whole, the Committee still appears comfortable reducing the level of accommodation in the months ahead despite perceptions that the Committee does not treat its inflation goal in a symmetric manner. Indeed, looking at surveys and market-based measures, it is hard to avoid the uncomfortable conclusion that investors as well as the broader public are marking down their expectations for inflation over the longer term given the Committee's willingness to tighten policy despite the economy persistently undershooting the inflation objective. Unfortunately, with growth likely slowing to trend this year and the public continuing to view risks to the outlook as decidedly tilted to the downside, we see little scope for a significant recovery in inflation expectations any time soon.

Biography



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Steven is a Senior Investment Strategist at BNP Paribas Investment Partners. In this role, he is responsible for developing thematic views on the market, economic and policy outlook in the US and other major economies. Steven joined our company in 2013 and is based in New York.

Prior to his current role, Steven was a Director for the Central Banks and Official Institutions team at FFTW, a subsidiary of BNP Paribas Investment Partners. Steven also held various positions at the Federal Reserve Bank of New York, most recently as Director of Market Analysis, where he worked on both market and policy analysis and relationship management for the Bank's Investment Advisory Committee on financial markets. Prior to that, Steven worked in other roles within the Markets Group, including, Director of Foreign Exchange and Investments, where he had oversight for the Fed's and Treasury's foreign exchange portfolios. During the financial crisis, he worked on the design and implementation of a number of liquidity facilities, such as swap lines with other central banks. Steven also spent two years at the Bank for International Settlements as a member of the Basel Committee Secretariat.

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