A Close VIEW

FAIT Accompli? Fiscal Policy and Inflation Are Reshaping the Monetary Policy Outlook

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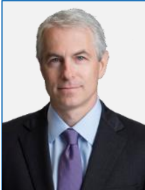

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Prospects for sustained fiscal stimulus, combined with moderate inflation, set the stage for a higher policy rate than financial markets currently discount for the years ahead. The FOMC's intentions should be clear by year-end, with the release of the Committee's December projections after passage of Democrats' "human infrastructure" fiscal package. Meanwhile the signaling has already begun, as evidenced by Federal Reserve Vice Chair Clarida's surprisingly hawkish comments earlier this month.

Federal Reserve Vice Chair Richard Clarida made headlines with his August 4 speech at the Peterson Institute by strongly suggesting that he now anticipates a first policy rate increase in the first quarter of 2023. Clarida's comments also hinted at a hawkish reinterpretation of "maximum employment", one of the Committee's stated requirements for liftoff. He also asserted that fiscal policy can offset the constraint on monetary policy effectiveness when the policy rate is stuck at the lower bound. This constraint was the main rationale for the shift last year to Flexible Average Inflation Targeting (FAIT). Taken together, the comments imply less commitment to achieving a "broad-based and inclusive" labor market given upside inflation risks, and less need to keep monetary policy accommodative for an extended period after liftoff.

Maximum Employment

With its shift to FAIT last year, the FOMC set three conditions for liftoff: (i) labor market conditions consistent with the Committee's assessment of maximum employment, and inflation (ii) at 2 percent and (iii) projected to moderately exceed that level for some time. In his speech, Clarida laid out why he believes all three conditions will be met by year-end 2022. As for labor market conditions, here is the key quote from the speech that suggests a redefinition of maximum employment:

> "Finally, while my assessment of maximum employment incorporates a wide range of indicators to assess the state of the labor market—including indicators of labor compensation, productivity, and price-cost markups—the employment data I look at, such as the Kansas City Fed's Labor Market Conditions Indicators, are historically highly correlated with the unemployment rate. My expectation today is that the labor market by the end of 2022 will have reached my assessment of maximum employment if the unemployment rate has declined by then to the SEP median of modal projections of 3.8 percent."[1]

This is quite a departure from Clarida's previous comments on maximum employment. In his speeches since the new policy framework was introduced last August, Clarida had frequently noted that the Committee defines maximum employment as, "the highest level of employment that does not generate sustained pressures that put the price-stability mandate at risk."[2] That phrasing suggested that the Committee would probe to determine just how tight a labor market could be achieved before inflation and inflation expectations would rise beyond their comfort zone.[3] Yet this language is absent from his August 4 speech, and Clarida instead points to an unemployment rate of 3.8 percent as consistent with maximum employment. A weaker commitment to maximum employment was also evident in the Q&A, where Clarida

1. Richard Clarida,"Outlooks, Outcomes, and Prospects for U.S. Monetary Policy," August 4, 2021.
2. See, for example, Richard Clarida, "The Federal Reserve's New Framework: Context and Consequences," January 13, 2021.
3. See Maximum Employment and the Risks of a Policy Error for more information on Clarida's prior comments.

commented that liftoff would not occur until the labor market was "at least in the zip code of maximum employment."[4]

If the unemployment rate is an adequate indicator of progress towards maximum employment, Clarida also appears to have redefined the threshold. Powell, for example, has previously inferred that the labor market may still have been shy of maximum employment conditions just prior to the pandemic, when the unemployment rate was 3.5 percent.[5]

It's unlikely that Clarida is marching to the beat of his own drum. As Vice Chair of the Board of Governors, we can expect that his comments have been coordinated with the Chair. In fact, Clarida's new formulation of maximum employment brings to mind a previous set of communications. In October 2018, Powell set markets on edge when he noted that the policy rate was "a long way from neutral."[6] Later that fall, Clarida indicated that at 2.25 percent, the policy rate was already close to the *range* of Committee estimates of neutral. This was the first indication that core Committee members were no longer wedded to getting the policy rate up to at least 3 percent, the median Committee participant's estimate of a neutral policy setting at that time. In fact, after one final rate hike that December to 2.50 percent, the FOMC began to signal possible rate cuts, which were delivered in the second half of 2019. In short, Clarida has played the role of bellwether for Powell before. He is likely doing the same now.

Fiscal Policy

Clarida's comments on fiscal policy are worth quoting in full, given their significance:

> "In the context of our new framework, it is important to note that while the ELB [effective lower bound] can be a constraint on monetary policy, the ELB is not a constraint on fiscal policy, and appropriate monetary policy under our new framework, to me, must—and certainly can—incorporate this reality. Indeed, under present circumstances, I judge that the support to aggregate demand from fiscal policy—including the more than $2 trillion in accumulated excess savings accruing from (as yet) unspent transfer payments—in tandem with appropriate monetary policy, can fully offset the constraint, highlighted in our Statement on Longer-Run Goals and Monetary Policy Strategy, that the ELB imposes on the ability of an inflation-targeting monetary policy, acting on its own and in the absence of sufficient fiscal support, to restore, following a recession, maximum employment and price stability while keeping inflation expectations well anchored at the 2 percent longer-run goal."[7]

Distilled to its essence, Clarida was saying that while policy rates at the effective lower bound constrain monetary policy's ability to achieve the central bank's employment and inflation objectives, fiscal policy can offset this constraint. He thus implied that if fiscal policy is persistently loose, the rationale for flexible average inflation targeting is much weaker. In such a scenario, the risk that inflation will persistently undershoot the two percent objective largely goes away, and with it so does the need to keep monetary policy ultra-loose for an extended period.

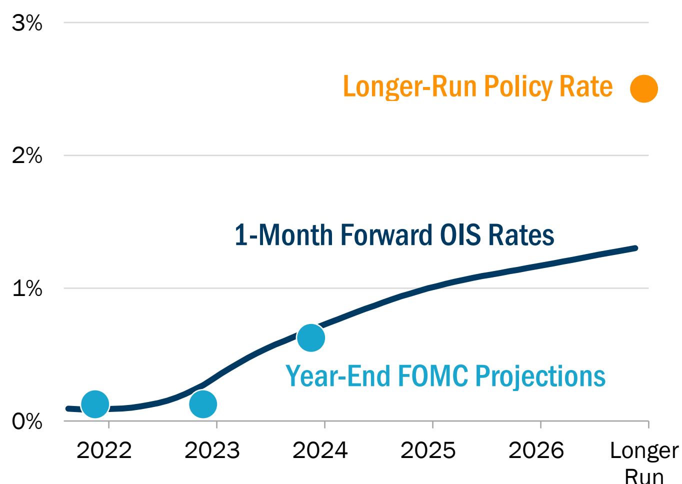
In one sense, none of this is surprising. It is perfectly logical that monetary policy can be less accommodative if fiscal policy is supporting the economy. Nonetheless, Clarida's remarks are the first acknowledgement that policy may eventually need to be tightened more rapidly because fiscal policy is doing its part to ensure inflation and inflation expectations remain anchored over the longer term at two percent.

Policy Implications

If Powell shares Clarida's views, as I suspect he does, there are significant implications:

First, the median FOMC participant's projection for policy rates will likely shift to show lift-off next year if Democrats enact a large-scale "human infrastructure" program. Progress on this legislation will take time, so the FOMC's projections might not shift until the December meeting.

FIGURE 1: FOMC PROJECTIONS WILL SHIFT HIGHER ONCE DEMOCRATS ENACT THEIR POLICY PRIORITIES



Year-End and Longer-Run Projections are based on median FOMC participant's projection. The FOMC's longer-run projection represents the value to which the policy rate would be expected to converge under appropriate monetary policy and in the absence of further shocks to the economy.

Source: Bloomberg, Board of Governors of the Federal Reserve System.

4. "Fed Vice Chair Richard H. Clarida on US economic outlook and monetary policy," Peterson Institute for International Economics, August 4, 2021.
5. On labor market conditions before the pandemic, Powell stated in a February speech, "There was every reason to expect that the labor market could have strengthened even further without causing a worrisome increase in inflation were it not for the onset of the pandemic." See "Getting Back to a Strong Labor Market," February 10, 2021.
6. Jerome Powell, Q&A session at the Atlantic Festival, Washington, DC, October 3, 2018.
7. Richard Clarida, "Outlooks, Outcomes, and Prospects for U.S. Monetary Policy," August 4, 2021.

Second, if this additional fiscal stimulus is enacted, the median projected policy rate will likely rise more steeply after lift-off. Note that starting at the September meeting, the projections will extend out to 2024. The year-end policy rate projection for 2024 could well be in the 2.0 to 2.5 percent range by the time of the December projections.

One important caveat: It is not clear that Powell and Clarida will be around long enough to bring about these policy outcomes. President Biden may seek to put his own stamp on the Federal Reserve, as Powell's and Clarida's terms in leadership positions expire next year. Still, one leading candidate to replace Powell, current Governor Lael Brainard, has largely been aligned with Powell and Clarida on monetary policy. Thus we should still expect monetary policy to lean against the next big spending package, even under new Fed leadership. FAIT may have fully accommodated the springtime American Rescue Plan, but policy makers will not sit on their hands indefinitely.

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