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A Close VIEW

The Powell Doctrine: Speak Loudly and Carry a Small Stick

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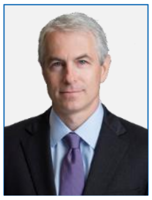


Authored by Steven Friedman
Senior Macro Economist

There remains a wide gap between Chair Powell's tough words on inflation and the Committee's latest projections, which still show a leisurely rise in the policy rate despite high inflation. This apparent disconnect can be explained in large part by the Committee's view that long-run inflation expectations remain well-anchored. Should expectations move higher, the Committee will be compelled to convert its tough words into a much tougher policy response, raising rates more aggressively than indicated in their projections.

In his post-meeting press briefing and a speech early this week, Chair Powell engaged in an extraordinary game of expectations management. He emphasized the Committee's focus on high inflation, making clear that ultimately, policymakers would focus on price stability, even if doing so would jeopardize the expansion. He went so far as to note in his speech that, "no one expects that bringing about a soft landing will be straightforward."[1]

Clearly, Powell is attempting to burnish policymakers' inflation-fighting credibility while the policy rate still remains in very accomodative territory. The Committee's most recent economic projections make the disconnect between words and action even more evident. As seen in the table, the median projection from FOMC participants has inflation ending this year at 4.3 percent and then falling to a still-high 2.7 percent next year. Despite these high inflation projections, participants' median policy rate projection for the end of this year is just 1.9 percent, below the 2.25 to 2.50 percent range that most Committee participants view as neutral; the policy rate only goes into restrictive territory over the course of 2023.

Given that policy is still projected to remain accommodative this year, and the lags with which policy works, growth is projected to remain comfortably above its longer-run trend through next year, and the labor market is expected to remain very tight for the foreseeable future. All this suggests the Committee is not yet willing to push aggressively against inflation. Rather than take active steps to slow economic growth and quickly bring inflation down to the two percent objective, the Committee appears content to let inflation remain above target at least through 2024.

FIGURE 1: MEDIAN FOMC PARTICIPANT'S ECONOMIC PROJECTIONS

	2022	2023	2024	Longer Run
PCE INFLATION	4.3	2.7	2.3	2.0
POLICY RATE	1.9	2.8	2.8	2.4
REAL GDP GROWTH	2.8	2.2	2.0	1.8
UNEMPLOYMENT RATE	3.5	3.5	3.6	4.0

Source: Board of Governors of the Federal Reserve System, March 16, 2022

What explains the Committee's gradualist policy response to high inflation? First, the Committee still appears to believe that the pandemic-related factors that boosted inflation last year will fade over the course of this year. These factors include strong fiscal support for households, the shift in household consumption towards goods and away from services, supply-chain issues, and weak labor supply. While these influences may fade more slowly than initially thought, the Committee still sees this outcome as its base case. Powell stated as much in

1. Jerome Powell, "Policy Options for Sustainable and Inclusive Growth," speech delivered to the 38th Annual Economic Policy Conference, National Association for Business Economics, Washington, D.C., March 21, 2022.

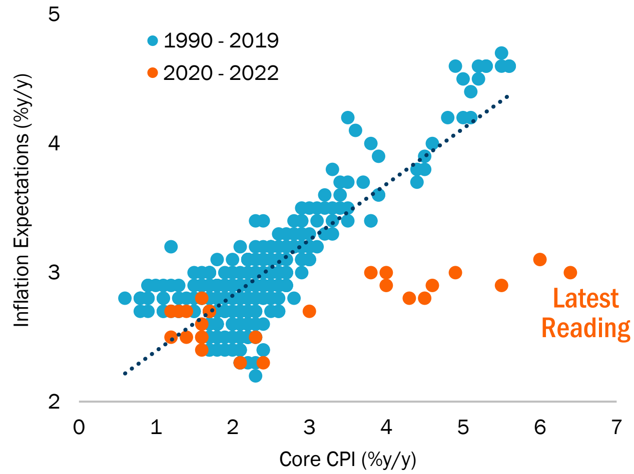
his press briefing, when he acknowledged that the expected decline in inflation this year was largely due to base effects and pandemic-related factors, rather than policy tightening.[2]

Second, the Committee hopes that long-run inflation expectations will stay well-anchored. This outcome is much less assured than it was several months ago. The winter Omicron wave of the pandemic and the impact of the Russia-Ukraine conflict on commodity prices and supply chains will delay the hoped-for moderation of inflation, with the Russia-Ukraine conflict likely to push inflation even higher in the near term. And the longer inflation remains elevated, the greater the odds that upward price pressure becomes embedded in longer-run expectations. If it does, the Committee would have to adopt a more forceful policy response, which would risk a recession. The Committee can't be pleased that the yield spread between 5-year nominal and inflation-indexed Treasury securities reveals higher inflation compensation than at any time in the measure's 20-year history.

The Committee now faces the risk that its preferred measures of longer-run inflation expectations, including from the University of Michigan's consumer survey, will begin to edge higher. The most recent readings indicate that inflation expectations remain relatively well-anchored at long horizons, but the strong historical correlation between the Michigan measure of expectations and realized inflation is reason for concern. In the past, when CPI inflation was at or above five percent, inflation expectations rose north of four percent, well above current levels (Figure 2).

At the end of the day, the Committee's current strategy still leans more heavily on communications than action. We should expect Powell and other core members of the Committee to continue to talk tough on inflation, including by expressing a willingness to increase the policy rate in 50 basis point increments. If long-run inflation expectations remain well-anchored and inflation begins to moderate in the months ahead, the Committee may stick to its leisurely path of projected rate increases, accepting inflation somewhat above its two percent objective in the years ahead if it means the expansion can be extended. Such an outcome would be consistent with their flexible average inflation targeting strategy. But if instead inflation expectations drift higher in the coming months, or inflation remains at current high levels, the Committee will have no choice but to tighten more aggressively. At some point, strong words will need to be backed up by even stronger action.

FIGURE 2: CORE CPI AND LONG-TERM CONSUMER INFLATION EXPECTATIONS



Source: Bureau of Labor Statistics, University of Michigan

2. In discussing the factors expected to bring down inflation this year, at his press briefing on March 16, Powell noted, "So part of -- part of inflation coming down at the very beginning is clearly to do with factors other than our policy, and those would include potentially the supply chain is getting a little bit better, certainly base effects... And so it's really -- it's all the things we've been talking about, you know, that really haven't helped much, including the shift away from goods and back to services; including supply chains getting better; including work, labor force participation; all those things that have been sticky and not happening. But a big part of it is, though, is the base effects I mentioned as well. You know, I think monetary policy starts to bite on inflation and on growth, with a lag, of course. And so you would see that more in '23 and '24."