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# Early Warning Signal in a Noisy Environment

## FOMC Preview

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#### Contents

Introduction	1	Early warning signal in a noisy environment	3
Projecting transient inflation	1	Conclusion	3
Substantial progress before tapering	3		

## Summary

- Given recent data the economic projections of FOMC participants are likely to see an upward revision for PCE inflation in 2021 and the dot plot may be getting closer to a rate hike before the end of 2023. The Fed is pushing back verbally against fears that high inflation is permanent and should underline this in its inflation projections for 2022 and 2023. Today's University of Michigan consumer survey suggests that the Fed has been successful in talking down consumer inflation expectations somewhat.
- The discussion about tapering the asset purchase program is likely to start at this meeting, so it will be interesting to hear what Powell has to say about this topic at the post-meeting press conference. The practical problem for the FOMC is to assess whether "substantial progress" has been made regarding unemployment and inflation while the data remain heavily distorted at least until early September. The unemployment forecast for 2021 may give us a clue about the Fed's numerical threshold for tapering. An early warning signal for tapering will inevitably be given in a situation with data clouded by the temporary labor shortage.

## Introduction

The next meeting of the FOMC is on June 15-16. In addition to a formal statement and a press conference, we also have an update of the economic projections to look forward to. In its formal statement the FOMC is likely to repeat that the path of the economy will depend significantly on the course of the virus, but that indicators of economic activity and employment have strengthened, and that inflation has risen, largely reflecting transitory factors. The discussion about tapering the asset purchase program is likely to start at this meeting, so it will be interesting to hear what Powell has to say about this topic at the post-meeting press conference.

## Projecting transient inflation

This month's meeting of the FOMC will include an update of the economic projections of the March meeting (see Table 1). We are likely to see an upward revision of the PCE inflation forecasts for 2021 given recent data. However, the inflation projections should fall back toward 2.0% in 2022 and 2023 if the FOMC participants still believe the current inflation bump is transitory. Meanwhile, the Fed's inflation view and FAIT strategy are ruling out any increase in the target range for the federal funds rate in the next couple of years. The March dot plot implied not a single rate hike before 2024. However, an increasing number of FOMC participants is thinking about a first hike before the end of 2023. As we noted after the March meeting, it takes only two more participants to shift toward a hike in 2023, to make it a split 9-9 committee on whether to hike or not in 2023. The recent inflation data have raised the probability of an upward shift in the median rate projection.

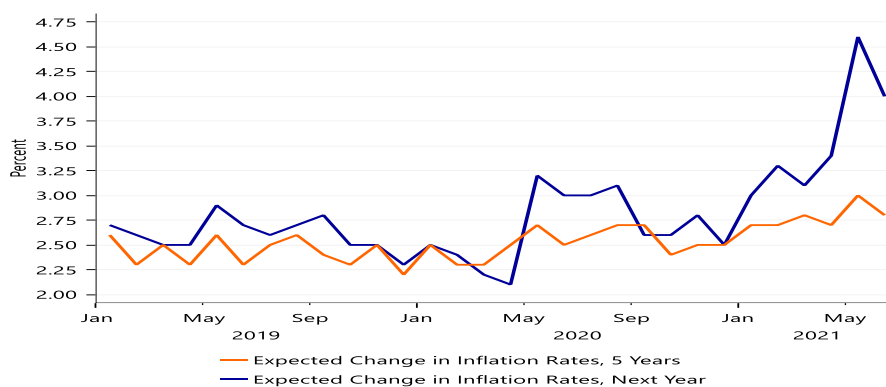
**Table 1: Median projections of FOMC participants**

<i>Variable</i>	<i>2021</i>	<i>2022</i>	<i>2023</i>	<i>Longer run</i>
GDP growth	6.5 (4.2)	3.3 (3.2)	2.2 (2.4)	1.8 (1.8)
Unemployment	4.5 (5.0)	3.9 (4.2)	3.5 (3.7)	4.0 (4.1)
PCE inflation	2.4 (1.8)	2.0 (1.9)	2.1 (2.0)	2.0 (2.0)
Core PCE inflation	2.2 (1.8)	2.0 (1.9)	2.1 (2.0)	
Federal funds rate	0.1 (0.1)	0.1 (0.1)	0.1 (0.1)	2.5 (2.5)

Source: FOMC, March 17, 2021 (December 16, 2020)

For inflation to be transitory the Fed believes it is crucial that inflation expectations remain anchored. If not, a positive feedback between inflation expectations and inflation could arise. The usual example is the wage-price spiral. The Fed is pushing back verbally against fears that high inflation is permanent and is underlining this in its inflation projections for 2022 and 2023. Today, the University of Michigan's consumer survey (Figure 1) suggests that the Fed has been successful in talking down consumer inflation expectations somewhat. The median inflation expectation 1 year ahead fell back to 4.0% in June from 4.6% May and the expectation 5-10 years ahead took a step back to 2.8% from 3.0%.

**Figure 1: Consumer inflation expectations**



Source: Macrobond, University of Michigan

As we explained in [Is the Fed going to be blindsided by inflation?](#) the FOMC has taken an extreme monetary policy position by adopting flexible average inflation targeting, holding policy rates at the zero bound through the end of 2023. This should not pose any problem if higher inflation is indeed transitory, but if it turns out to be longer lasting or even permanent the Fed will be very far behind the curve.

## Substantial progress before tapering

While the first rate hike is still far away, the first taper is getting closer. The minutes of the FOMC meeting on April 27-28 revealed that a number of participants suggested that if the economy continued to make rapid progress toward the Committee's goals, it might be appropriate at some point in upcoming meetings to begin discussing a plan for adjusting the pace of asset purchases. With inflation going through the roof (CPI 5.0% year-on-year in May and Core CPI 3.8%) and a reacceleration in employment growth and a decline in the unemployment rate to 5.8% in May tapering is likely to be on the agenda of the FOMC deliberations in June.

In its formal statement the FOMC has said that it will continue to increase its holdings of Treasury securities by at least \$80 billion per month and of agency MBS by at least \$40 billion per month until *substantial further progress* has been made toward the Committee's maximum employment and price stability goals. So before a decision on tapering can be made, the FOMC will have to determine what constitutes "substantial further progress." While it may be difficult to summarize this in a numerical target for a specific variable, the projections of FOMC participants include the forecast for the unemployment rate in 2021, which is the average unemployment rate in the fourth quarter of 2021. If the Committee is thinking about tapering at the turn of the year, this forecast could give us a numerical indication of what "substantial progress" means. In the March projections, the 2021 unemployment forecast was 4.5%.

## Early warning signal in a noisy environment

According to the April minutes many participants highlighted the importance of the Committee clearly communicating its assessment of progress toward its longer-run goals well in advance of the time when it could be judged substantial enough to warrant a change in the pace of asset purchases. This is about the early warning that Powell promised us earlier.

However, the problem with the early warning signal for tapering is that a temporary labor shortage is distorting the data. The participation remains depressed, which is slowing down employment growth and may be artificially reducing the unemployment rate. The three main reasons that are mentioned most often are fear of COVID-19, child care and enhanced federal unemployment benefits. While the first factor should be receding now that vaccination rates across the US are rising, schools are yet to reopen fully hampering parents to go back to work. For example, in May 61% of public school students in NYC were still receiving only remote learning. Meanwhile, recent empirical evidence suggests that 1/7 job offers are refused because of the \$300 per week extra unemployment benefits. All in all, the labor supply distortions could last until early September when the enhanced federal unemployment benefits are scheduled to end and schools<sup>1</sup> are expected to start reopening fully.

This means that the fog over the data will not dissipate until the November meeting of the FOMC. However, a statement in November about a tapering decision in December or January may not be very much of an early warning signal. This implies that an early warning signal for tapering will inevitably be given in a situation with data clouded by the temporary labor shortage. This brings us back to August (Jackson Hole) or September (FOMC meeting, with new projections).

## Conclusion

With a hike in the target range for the federal funds rate still far away, the only rate action we are going to see from the Fed this year is in administered rates, in particular the IOER and ON RRP rates. If we see a rapid decline in the effective federal funds rate we should expect the Fed to hike the IOER and the ON RRP rates. The [minutes of the March meeting](#) showed that Powell does not

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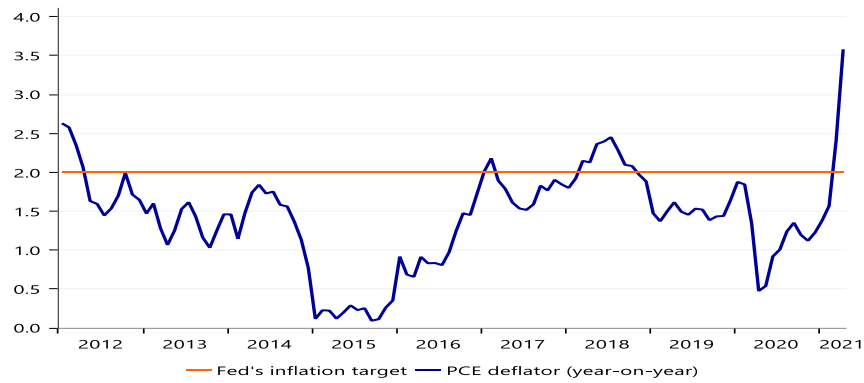
<sup>1</sup> In the US the start of the school year varies greatly, but generally somewhere from August through October.

see the need to wait until a scheduled FOMC meeting before taking action. This also reduces the need to do it pre-emptively at a scheduled meeting. Anyway, this would be a technical adjustment rather than a change in the stance of monetary policy.

Meanwhile, the Fed is slowly moving toward tapering its asset purchase program. In order to avoid another taper tantrum Powell has promised us to give early warning. However, the distortions in the current data does not make it easy for the Fed to give clear guidance.

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**Figure 2: PCE inflation and Fed target**



Source: Macrobond

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