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Fed Thoughts: The Body Politic

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Not surprisingly in a year divisible by four, attention has turned to the general election in the US in November. For the Federal Reserve (Fed), this is unwanted attention. For that reason, we expect Fed Chair Jay Powell to repeat, as he said at the January 31 press conference, that “We’re focused on doing our jobs” whenever given the chance. But is part of the job about politics?

How could it not be? The Fed was created by elected officials in 1913. Elected officials altered its structure and revised its instructions over the years and can do so again. And elected officials oversee the Fed through hearings usually featuring more heat than light and requests and advice by way of correspondence typically framed for headlines. This year, elected officials face, well, election, and in their existential struggle will shift blame where they can. In the sphere of economics, this is often historically to the independent central bank.[1]

The Fed, however, is not politically partisan but rather politic. To be politic is to be sensitive to the surroundings and cautious in drawing criticism, especially in circumstances when criticism is likely to be heated. Because the election landscape is dotted with landmines that could bring serious harm if the Fed missteps, we believe the Fed will try to keep as low a profile as possible. We think this will influence the timing, but not the general direction, of policy this year.

It certainly influences our call that the Fed commences easing with a quarter-point move on June 12th and ambles along thereafter at that pace at every other meeting until the funds rate settles at 4 percent in mid-2025. To many, this may come across as a late start and a slow descent of the policy rate, but we think it’s about risk management given the political calendar.

The Federal Open Market Committee (FOMC) must balance the risks on either side of being wrong, either by tarrying too long before easing and seeing economic activity soften unacceptably or by moving too soon before inflation is assuredly on a path to its 2-percent goal. As of now,

- Aggregate economic activity retains momentum, and resources are already stretched.

- We believe the easy wins in disinflation may be behind us given the healing of pandemic dislocations. Strains on global trade networks are re-emerging in light of global tensions, implying goods deflation will soon no longer be dragging down the headline. And, as evident in the past few price prints, inflation in the service sector is likely to sluggishly extend the journey along the last mile to the Fed’s goal.

- Financial conditions, which are easier than when firming commenced, in our view, continue to support spending as investors front run the eventual pivot in policy.

In these circumstances, slow-walking accommodation probably seems manageable to Fed officials, as in our view it appears that there are few evident threats to economic activity. If they were to emerge suddenly, markets could potentially price aggressive easing with each weak data point in the same manner as expectations of firming lessened the harm done by the Fed’s sluggishness at the start of the policy cycle in 2022. In contrast, we feel a premature turn in policy before inflation settled assuredly on its path to goal would feed an abrupt swing in financial markets, further ease financial conditions, extend the tortured last mile of disinflation and ultimately sow doubts about the Fed’s commitment to its price-stability goal.

Indeed, this risk balance is such that a case can be made for an even later start than June. A few more FOMC statements talking about the need to be confident about the attainment of price stability could potentially wring out lingering excessive optimism of financial market participants. Chair Powell could set the stage for a pivot in his remarks at the Jackson Hole economic symposium in late August, and his committee could deliver action in September, framed by the publication of the Summary of Economic Projections (SEP) that detailed the recalibration of the level of the nominal funds rate given sustainably lower inflation. Like-sized action in the funds rate at the two remaining meetings of the year gets the funds rate where they probably want, lower but still somewhat restrictive in real terms. Three more moves at the first three meetings of 2025 could potentially put the nominal funds rate at 4 percent, near enough to the neutral real rate to support sustainable economic expansion.

Except, this is a year divisible by four. There was a quaint time in American politics when the campaign season started in earnest on Labor Day. Now, the firing pistol for an election sounds the evening of the prior one. Still, the first Monday in September is when matters come to a boil, with the national conventions out of the way and debates near on the horizon. Dropping the policy-pivot bombshell amidst peak electioneering makes the Fed a focal point for criticism and invites partisan discussion of its future, both personnel and structure.

A politic Fed will prefer a calmer corner of the calendar to announce a headline-grabbing change in the direction of policy (in the same manner that it reserves other awkward announcements for press releases at four o'clock on Fridays). We think the FOMC meeting on June 11-12 is their least-worst option to slip action into the political current. The challenge for monetary policymakers will be to rein in the optimism of investors, who are conditioned to expect a succession of aggressive cuts once the easing cycle starts. We think the FOMC will opt for a package with three elements:

- **Start small.** A quarter-point reduction, from 5¼ percent to 5 percent in the lower bound of the target, signals that this is about realigning the nominal funds rate to lower inflation, not the defensive reaction to a changed view of the outlook for aggregate demand.

- **Remain equivocal.** This is a situation where "mights," "mays" and "woulds" matter in conveying future intent. The statement could follow the language from last year that "In determining the extent to which additional policy firming may be appropriate…" with no contractual element.

- **Guide about the future path.** If the year-end funds rate in the unloved dot plot in the SEP still showed a net ¾ percentage point cut in the policy rate in 2024, we believe market participants would see (but probably not fully believe) the plan of quarter-point moves at every other meeting.

Repeating this sequence could get the nominal funds rate to 4 percent by the middle of next year, an appropriate level given their outlook of sustained expansion of aggregate demand.

Starting sooner but going slower could make no material difference on the economic outlook, provided that the FOMC pulls off the communications challenge of managing the financial market's tendency to exaggerate future moves. We believe the rationale for timing action this way will never be discussed by a politic Fed, only arrived at by an assertion that its subjective assessment of confidence in the path of inflation changed. That is, as part of the Fed's job.

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Vincent is the firm's Chief Economist and Macro Strategist. In this role, he is responsible for developing views on the global economy and making relative value recommendations across global bond markets, currencies and sectors.

Previously, Vincent served as the Chief US Economist and a managing director at Morgan Stanley. For the prior four years, he was a resident scholar at the American Enterprise Institute (AEI). Vincent also spent 24 years at the Federal Reserve, holding several roles including Director of the Division of Monetary Affairs and Secretary and Economist of the Federal Open Market Committee (FOMC). His responsibilities at the Federal Reserve included directing research and analysis of monetary policy strategies and the conduct of policy through open market operations, discount window lending and reserve requirements. Prior to these roles, he was the principal liaison with the domestic desk at the Federal Reserve Bank of New York and was responsible for preparing a document outlining policy alternatives for each FOMC meeting. He was Deputy Director in the Division of International Finance and Associate Economist of the FOMC and spent five years at the Federal Reserve Bank of New York in both the domestic and international research departments.

His academic publications primarily concern the conduct of policy and issues related to the monetary transmission mechanism as well as an analysis of alternative auction techniques and Treasury debt management. After an undergraduate training at Fordham University, he received graduate degrees in economics at Columbia University.

Endnotes

1. There are many elegant theories on why governments make central banks independent, mostly related to the potentially different time horizons of politicians and central bankers. The most compelling one, however, is that it provides politicians someone else to blame for the performance of the economy, as in Avinash Dixit, *The Making of Economic Policy: A Transaction-Cost Politics Perspective.* MIT Press, 1998.

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