Fed Policy Outlook: Clarification Needed

- The Fed is on track to begin reducing the pace of asset purchases during the summer quarter. The labor market outlook has improved since the program’s inception in September, downside risks in the economic outlook have diminished, and a revival in consumer credit card footings is among reasons to have greater confidence in forecasts of a gradually improving growth profile.

- Policy makers have hinted strongly that a “tapering” move is approaching, but are likely to signal more explicitly before acting. The FOMC policy statement and economic projections due next Wednesday at 2:00 p.m., and Chairman Bernanke’s 2:30 press conference could clarify the likely course of the asset purchases.

- An update of the Fed’s June, 2011 Exit Strategy Principles (in the works, though not necessarily for release next week), could further reduce uncertainty in the policy outlook: FOMC members have recently suggested that the Fed might forgo sales of agency mortgage-backed securities (currently slated to begin sometime after the first rate increase) and revisit the stated intention to cease reinvestment of principal as the first step in the process of policy normalization.

The shape of tapering to come

It has been the FOMC’s consensus view since December that the wind-down of open-ended asset purchases would commence in the second half of this year, either because the objective of “substantial” improvement in the labor market outlook had been achieved or due to concerns about financial stability or the size of the balance sheet. Officials indicated subsequently the Fed’s intention to calibrate the purchase “flow rate” incrementally in response to progress toward its objective. The labor market outlook has improved substantively (if not “substantially”) since the initiation of open-ended asset purchases in September: an upward shift in voluntary employment separations reflects workers’ perception that job opportunities are expanding (Figure 1), while downward revisions to the FOMC’s FOMC Labor Market Outlook Has Improved Since Inception of Open-Ended Asset Purchases

Source: Bureau of Labor Statistics, Haver Analytics, T. Rowe Price

Source: Federal Reserve, T. Rowe Price
unemployment rate forecasts reflect a more upbeat official view (Figure 2, page 1).

**Tapering hints already in the air**

“[A] number of participants [at the April 30-May 1 FOMC meeting] expressed willingness to adjust the flow of purchases downward as early as the June meeting,” and “[M]ost observed that the outlook for the labor market has shown progress since the program was started in September, but many of these participants indicated that continued progress, more confidence in the outlook, or diminished downside risks would be required before slowing the pace of purchases would become appropriate.”

Since the last FOMC meeting, several voting members of the Committee have indicated that the first tapering step could take place by the September 17-18 meeting if the economy evolves as they expect. Against this backdrop, the greatest potential source of new information coming out of next week’s meeting and press conference is additional guidance about the likely course of asset purchases: the conditions under which a first “tapering” step would take place, the likely size of that step, and the subsequent pace of the wind-down (assuming the economy evolves as the FOMC expects).

**Stronger signals to precede action**

In regard to these hints of a coming tapering, we believe that, “a word to the wise is sufficient.” Nonetheless, we expect the Committee to follow the general protocol established in the run-up to the first rate hike of the 2004-2006 tightening cycle, providing more explicit notice that an adjustment is imminent before taking the step, and emphasizing that the wind-down of asset purchases is expected to be gradual and linked to further progress toward “substantial” improvement in the labor market outlook.

If the Committee decides next week that it wants the option to taper asset purchases at the July 30-31 meeting, it could signal its intention by adjusting its tapering-related guidance to reflect the greater likelihood that such an adjustment would be downward. More likely, in our view, would be less explicit signals, such as clearer acknowledgement in the policy statement of recent improvement in the labor market outlook and of reduced downside risk in the outlook. On the latter score, the recent upturn in consumer revolving credit balances should underscore policy makers’ confidence in their expectation that the underlying moderate growth trend will persist through the current headwind of fiscal tightening and gain momentum through year-end and over the longer forecast horizon (Figure 3). In addition, Chairman Bernanke’s press conference could shed light on the envisaged contours of the tapering process.

**No “push back” on market rate expectations**

We disagree with the view expressed in some quarters that the Fed may push back against the recent increase in interest rates, which has brought the first rate hike as expressed in fed funds futures to June 2015 from September 2015 on March 20. This expectation is not significantly misaligned relative to the FOMC’s stated threshold for raising rates. More generally, a central virtue of state-dependent rate guidance is that once the Fed has set its economic conditions and issued its economic forecasts, it is for market participants to express their own views as to when those conditions will be met.

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1 “...if the economic information received by that time showed evidence of sufficiently strong and sustained growth,” Minutes of the Federal Open Market Committee, April 30-May 1, 2013, released May 21, 2013.
2 ibid.
4 “The Committee is prepared to increase or reduce the pace of its purchases to maintain appropriate policy accommodation as the outlook for the labor market or inflation changes.” (Statement of the FOMC, May 1, 2013).
5 The characterization in the May 1 policy statement: “Labor market conditions have shown some improvement in recent months, on balance, but the unemployment rate remains elevated.”
6 We assume a ¼ point increase to 0.50%.
7 The average of the mid-points of the “central tendency” ranges of FOMC unemployment rate forecasts for 2014Q4 and 2015Q4 is 6.55%, roughly equal to the 6.50% threshold.
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