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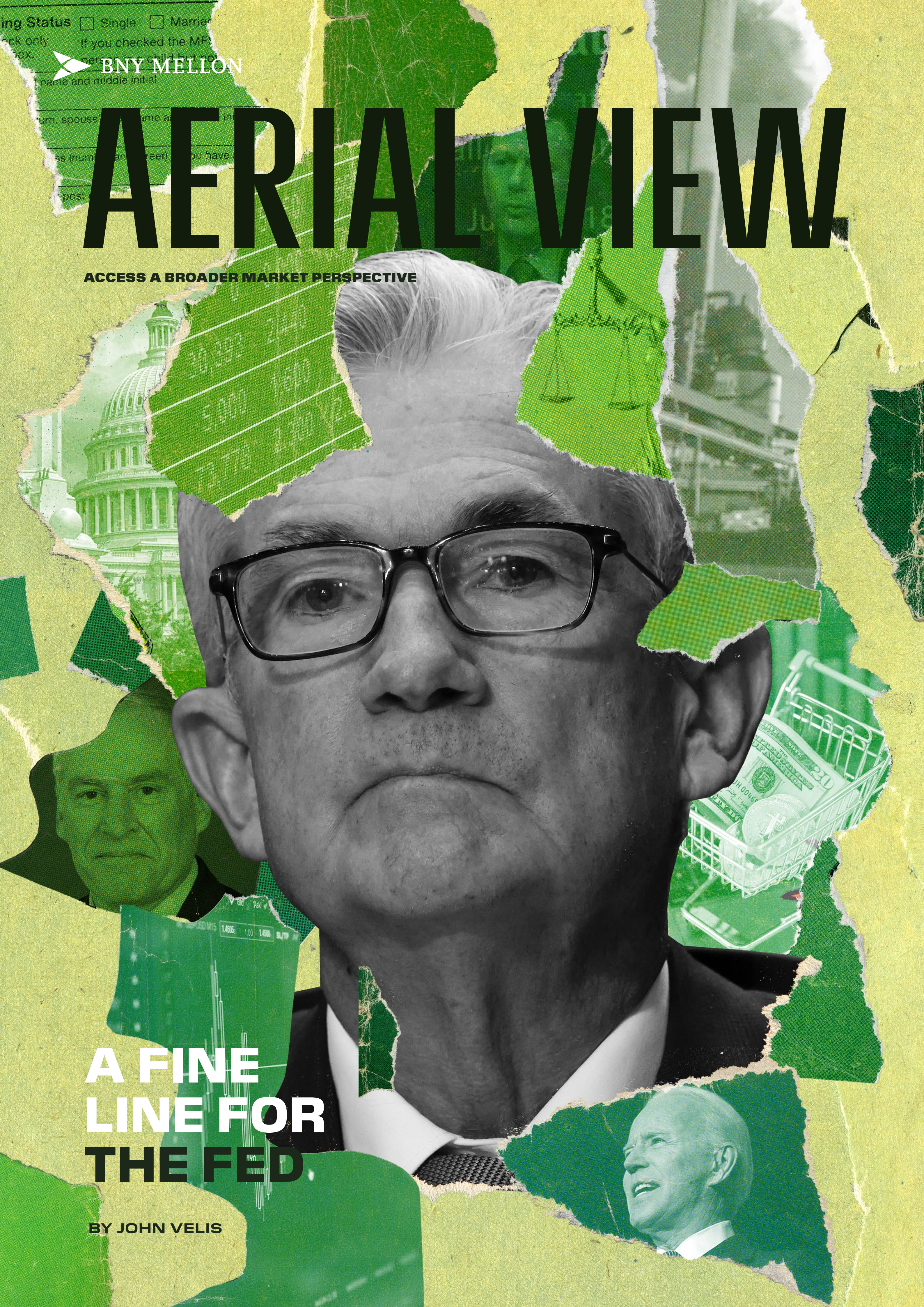
AERIAL VIEW

ACCESS A BROADER MARKET PERSPECTIVE



A FINE LINE FOR THE FED

BY JOHN VELIS

BY THE NUMBERS

2%

The Fed's target inflation rate over the medium term[*]

2.2%

The Fed's projection of inflation in both 2022 and 2023, as of September 2021[*]

4

Seats on the Board of Governors for which President Biden will need to nominate candidates[*]

4.3%

Current inflation based on Personal Consumption Expenditure[**]

5.2%

Unemployment rate as of September 2021, well above the pre-pandemic low of 3.5% [***]

4.7%

Consumer expectations of inflation in one year, according the University of Michigan Survey of Consumer Confidence

58.5%

Current percentage of persons in the U.S. employed, well below recent historical norms[**]

$120 BILLION

Current rate of monthly asset purchases by the Fed as part of its quantitative easing program[*]

SOURCES:

*Federal Reserve Board of Governors

**Bureau of Economic Analysis

***Bureau of Labor Statistics

THE U.S. FEDERAL RESERVE FINDS ITSELF IN A DIFFICULT POSITION ON MULTIPLE FRONTS, FROM RISING INFLATION AND WEAK EMPLOYMENT GROWTH TO UNCERTAINTY OVER ITS LEADERSHIP, ETHICS CONCERNS AND BANK SUPERVISION QUESTIONS.

BY JOHN VELIS

The U.S. Federal Reserve's job in steering the economy and the health of the financial system is often fraught with unforeseen challenges. But as we approach the second year of the pandemic, it faces an unusually complicated set of issues even by central bank standards, without the bipartisan political support it needs to address them.

The traditional remit of the Fed is to run monetary policy in a manner such that the economy achieves low and stable prices with maximum growth and employment. While the Fed has wound down a series of special credit and liquidity facilities it used to quell market disturbance in early 2020, it has kept in place an ultra-loose monetary policy of large-scale asset purchases that it is only now signaling the intention to wind down. As we write, policy decision makers at its Federal Open Market Committee are discussing whether to initiate that taper as soon as November this year.

At the same time, on the macroeconomic front, the U.S. economy is emerging from a deep recession that started with the COVID-19 pandemic. The job market is healing slowly and remains well short of the levels of employment seen before COVID hit. Fed Chair Jerome "Jay" Powell wants more than a job market at pre-pandemic levels; he has stated that he wants to see broad-based gains across demographic groups, particularly those which have suffered disproportionately from the pandemic.

In the background, inflation is creeping up to levels that have not been seen since mid-2008, when core measures of inflation rose in a short-lived burst. The Fed and many others have argued that current inflation levels are, in the central bank's language, "transitory" and likely to fade on their own. We are more of the view that, after decades of low and stable inflation, the pandemic and its aftermath have created the conditions for a sustained bout of inflation above the Fed's target of 2%, which could last longer than the central bank is bargaining for.

The combination of inflationary pressures picking up, and a labor market still well below its pre-pandemic norms, could prompt the Fed to tighten monetary policy to keep prices in check.

“Even Powell himself is beginning to acknowledge the stubbornness of supply-side inflation...and the labor market is not fully healed.”

How long can the Fed tolerate higher-than-target inflation, with the economy below full employment?

The tradeoff between inflation and under-employment takes place while the Fed comes under increasing scrutiny on other fronts. A number of Federal Reserve Board of Governor seats are up for nomination and confirmation by the Senate; congressional members have criticized the Fed’s record on a number of issues ranging from financial system regulation to global warming and ethics concerns involving senior Fed officials.

Chair Powell is having to navigate these pressures while at the same time striving to achieve an appropriate monetary policy setting for the unprecedented economic conditions present in a post-COVID world.

NO PLAYBOOK

Since 1913, the Fed’s number one job is to conduct monetary policy utilizing a limited set of tools to optimize the tradeoff between low inflation and full employment.

Keeping money supply tight is often the policy prescription for getting and keeping inflation under control, but it often comes at the price of a slower economy and weak employment growth. Conversely, a central bank might be tempted to run a looser monetary policy with the objective of allowing economic growth to run hotter and create more jobs, while risking higher inflation.

Currently, U.S. inflation is running well above the Fed’s stated goal of 2% per year. The most recent data indicated that personal consumption expenses - through August - are 4.2% higher than they were a year ago. We know that households have also registered a dramatic increase in their perceptions of inflation over the next 12 months. For example, the University of Michigan Consumer Sentiment Survey of inflation one year from now is currently 4.7%, its highest reading since a brief period in mid-2008 (when oil prices were at a record high). Before that, one must look back to the early 1980s - the end of the postwar, high-inflation era in the U.S. - to find such pricing data.

Chair Powell and the Fed do not seem too spooked by this. They have continuously declared that these supply-side bottlenecks would eventually clear up, the “base effects” from the post-lockdown reopening would fade, and inflation would return to sustainably low levels in a matter of time.

Nevertheless, as the current episode of strong inflation now stretches out longer and longer, (core inflation as measured by the Consumer Price Index (CPI) has been over 4% every month since April), the Fed has acknowledged that these supply chain bottlenecks are persisting longer than it had initially expected, and that inflation may stay higher for longer than anticipated.

Even Powell himself is beginning to acknowledge the stubbornness of supply-side inflation, saying recently during a central banking forum: “It's ...frustrating to see the bottlenecks and supply chain problems not getting better, in fact at the margin apparently getting a little bit worse.”

The Fed’s own Summary of Economic Projections, most recently updated in late September, see inflation ending this year at 4.2%, and 2.2% in both 2022 and 2023. These levels would be above the Fed’s stated goal of 2% inflation. However, under

LABOR PAINS

Employment dropped precipitously during the onset of the COVID-19 pandemic

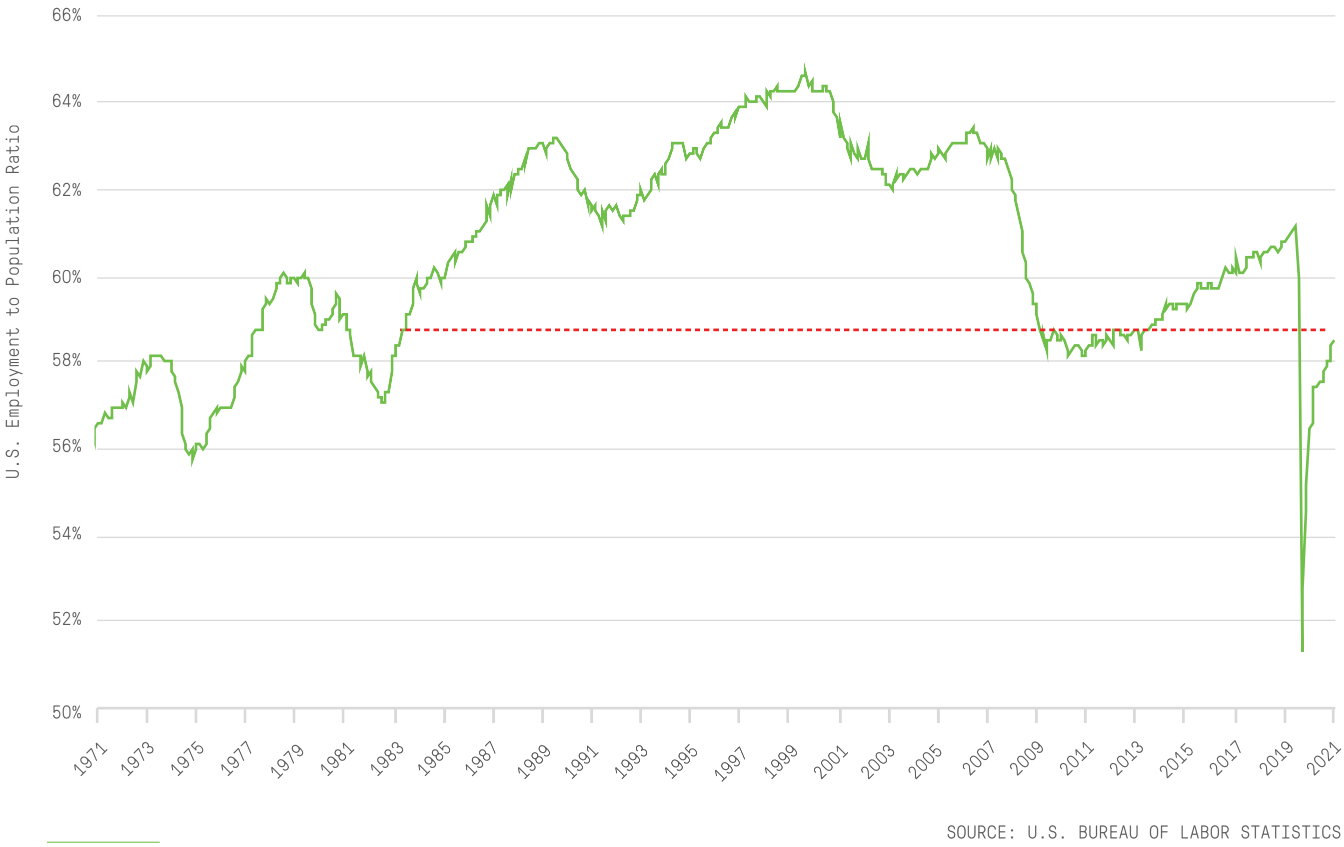


FIGURE 1

the Fed's new policy framework of "average inflation targeting," the central bank will allow inflation to run above 2% for some time to help offset those earlier periods we have witnessed during which inflation had been under its target.

At BNY Mellon, we have been arguing for quite a while that inflation was going to be higher and longer lasting than the Fed's sanguine view had asserted. COVID-19 represents a global shock impacting everything from shipping and materials prices to the availability of semiconductors and natural gas. In addition, multi-decade-long forces of global disinflation, including the internationalization of production and supply chains, off-shore manufacturing, and just-in-time logistics, are beginning to retreat.

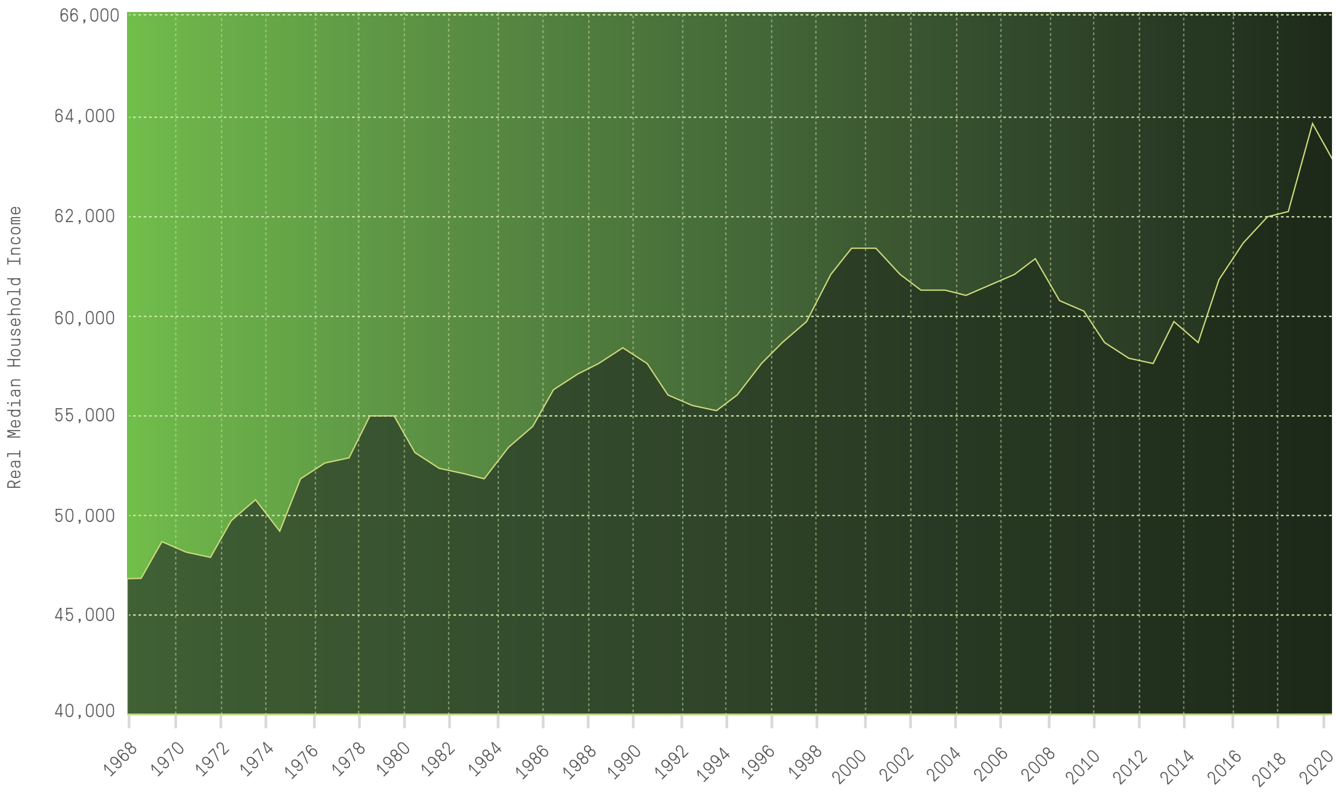
Normally, the Fed's response would be to raise interest rates, tightening monetary policy and slowing the economy to get inflation under control. However, that model relies on the idea that excess demand is causing inflation - more goods and services being consumed than the economy can produce when it is at full employment of its resources, labor force, and technological capabilities. As we have described above, current inflation is primarily supply-side driven. What the recipe is to rein in price increases in such an environment, is still up for debate, but it certainly doesn't include the loose monetary policy setting on which the economy is currently running.

On the other side is, of course, the labor market. Total employment in the economy remains far below levels seen pre-pandemic. The economy is indeed reopening and of the more than 22 million jobs lost in the immediate aftermath of the great lockdown, 17 million have been regained. Yet that still leaves the economy 5 million jobs shy of where it had been. The unemployment rate, at 5.2%, remains well above the pre-pandemic low of 3.5%.

Furthermore, the employment-to-population ratio, a measure of how many people in the country are working, is at 58.5% (see Figure 1), a level last seen in the aftermath of the Global Financial Crisis and before that, in the early 1980s. Not coincidentally, the latter period corresponded to a recession engineered at the end the 1970s, when the Fed raised interest rates to extraordinarily high levels to combat high and persistent inflation. By 1982,

PURSE STRINGS

Median household income was rising steadily, until the pandemic



SOURCE: U.S. CENSUS BUREAU

FIGURE 2

unemployment had reached 10.7%.

Powell has placed a great deal of importance not just on getting the labor market back to full employment, which he says is "a long way off," but also making sure that future employment gains are well distributed across demographic, gender, and income groups. This requires keeping monetary policy loose, possibly at the expense of higher inflation. The pandemic has disrupted the labor market and it may take years to match unemployed workers with jobs. We wrote about this "reallocation shock" during the pandemic.

Long-running economic forces have kept a lid on real earnings for decades now. Only around five years ago did median real household income in the U.S. begin to rise (see Figure 2). Higher inflation now comes as America is only slowly getting back to work.

This is the essence of the Fed's policy dilemma: Inflation is above its target and the labor market is not fully healed (see Figure 3). Powell himself recently bemoaned this situation: "This is not the situation that we have faced for a very long time and it is one in which there is a tension between our two objectives."

Congress, the Fed's overseer, is now involving itself in the policy debate. For example, Senator Joe Manchin (D-WV) has circulated a memo in which he requires the Fed to "end quantitative easing" as one of the conditions for him to vote for President Biden's "soft infrastructure" package. This is a challenge to the Fed's statutory independence in conducting monetary policy.

"A DANGEROUS MAN"

In addition to the economic tradeoffs between inflation and employment, the Fed is navigating politically fraught waters. How to craft policy to address the inflation-employment tradeoff, with the composition of the Fed's leadership likely to change, both on the Board of Governors as well as the wider Federal Open Market Committee (FOMC), is an open question.

Powell's term as chair expires on February 5, 2022. His renomination by President Biden and confirmation by the Senate is not a foregone conclusion. And the terms of two other key members of the Board of Governors are set to expire. Vice Chair Richard Clarida's term expires in September of next year, while Vice Chair for Supervision Randy

“Dramatic changes in personnel at the top of the central bank–as well as among the Board of Governors–could upset markets, especially if continuity in monetary policy looks likely to be threatened.”

Quarles's term expires this year on October 13. In addition, there is a still-vacant governor's position that needs to be filled.

This is a high degree of potential turnover and an opportunity for President Biden to reshape the Board's makeup. The politics of nominating and confirming each of these positions are daunting, and in the current environment, quite delicate.

Key members of Congress and others have pushed for more gender and racial diversity, both on the Board itself and within the broader Federal Reserve System, including the leadership of the regional Federal Reserve banks. Furthermore, five of the six current governors are registered Republicans, four of whom were appointed by former President Donald Trump. Powell, a Republican, was first appointed to the Board in 2012 by then-President Barack Obama and elevated to Chair in 2017 by Trump.

In addition to the diversity issue, banking supervision is a major source of concern. Progressives in Congress regard the current Fed, and in particular Vice Chair Quarles (whose portfolio includes supervision) as too lax in its approach and overly solicitous of large banks' preferences, particularly in relation to crafting stress tests, supervising and implementing capital requirements, and supervising commercial lending.

If Biden were to renominate Powell, he would likely have bipartisan support for confirmation on both sides of the aisle in the Senate, although several key senators are thought likely to oppose him. In particular, at a recent hearing of the Senate Banking Committee, Senator Elizabeth Warren (D-MA), called him a “dangerous man” and declared her opposition to a potential second Powell term. Committee Chair Sherrod Brown (D-OH) has not made his views on a Powell renomination known, nor used such incendiary language, but has explicitly voiced his objection to Quarles, going as far as to say that “he should not be there after October.”

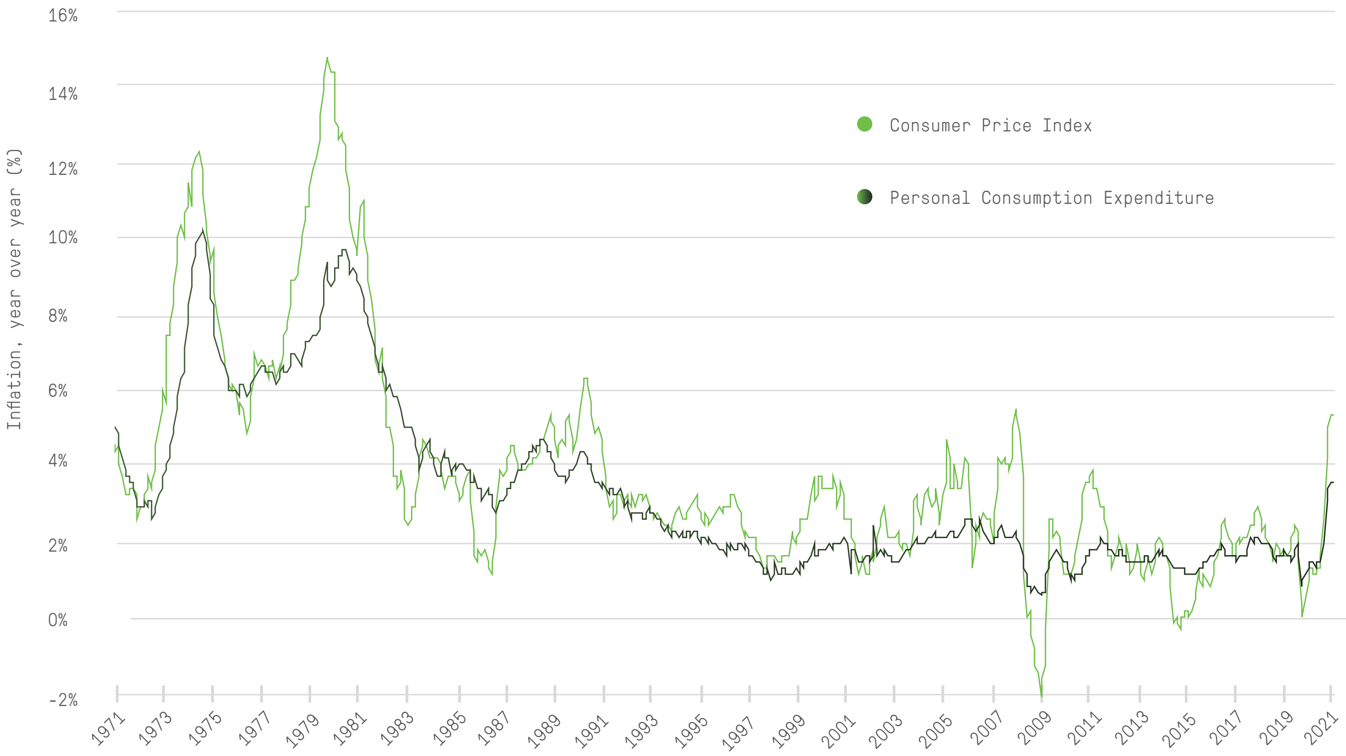
By many accounts, it is thought that President Biden would like to renominate Powell, striving for continuity in such a key economic policy position at a delicate point in the economic cycle. Powell's broad bipartisan support - despite key progressive opposition like Warren's - is another attraction. Bloomberg has reported that Treasury Secretary Janet Yellen, the Fed Chair preceding Powell, is supportive of his renomination. Does Biden heed the powerful Senator Warren, or his top economic policymaker Yellen?

Other potential nominees who could wind up being nominated if Powell were not to go forward include current Governor Lael Brainard, the only Democrat on the Board. She was considered by Biden for the Treasury Secretary role, which ultimately went to Yellen. She has served on the Board since 2014, was nominated by Obama, and previously worked in key posts in the executive branch under Obama (Under Secretary for International Affairs), as well as under President Clinton in various advisory roles in the White House. A potential Brainard nomination could be a very close vote in the full Senate, with most Republicans likely to oppose.

Raphael Bostic, the current president of the Atlanta Fed, is another potential nominee to the Board. He is widely respected for his leadership of

COST CENTER

Prices are creeping higher, but we are not reaching an inflation scare



SOURCES: U.S. BUREAU OF LABOR STATISTICS, U.S. CENSUS BUREAU

FIGURE 3

the regional Fed bank and his views on monetary policy are well-regarded among mainstream economists. He is also the only African American and openly gay member of the Federal Open Market Committee. Another potential pick if Biden were to go in another direction would be Roger Ferguson, a former vice chair of the Fed, who is most recently on the Board of Directors of Alphabet, the parent company of Google.

In addition to the Chair and three other Board of Governors' positions (see Figure 4), two vacancies in the regional Fed banks have suddenly become open. Eric Rosengren (former president of the Boston Fed) and Robert Kaplan (former president of the Dallas Fed) have come under criticism for personal securities transactions they made during the pandemic, which although compliant with ethics rules in each bank, have come to be seen as black marks on the Federal Reserve System's public standing.

Regional Fed presidents are appointed by the Board of Directors of each bank, subject to the approval of the Board of Governors in Washington, D.C. There is no presidential or congressional involvement in the appointments, but with the scrutiny that Rosengren and Kaplan have come under, as well as the Fed's recent congressional and public perception issues, these appointments will be equally delicate - key members of Congress have extolled the need for diverse leadership at the regional Feds as well.

A DELICATE TENSION

With the Fed caught in a monetary policy dilemma, as well as confronting wide-ranging leadership changes - even if Powell gets renominated and confirmed - markets will have a lot to contemplate. For example, the president of the Boston Fed, whenever the person is placed in that position, will be replacing a fairly hawkish member in Rosengren.

The FOMC rotates voting members every year among the regional Fed presidents, and Boston becomes a voting bank in 2022. Will the new president stay true to Rosengren's hawkish leanings or bring a much more dovish perspective to the committee? If Powell is replaced by Brainard, we think the FOMC could take an overall dovish

FOLLOW THE LEADER

The current makeup of the Fed's board of governors has several officials' terms expiring around the same time

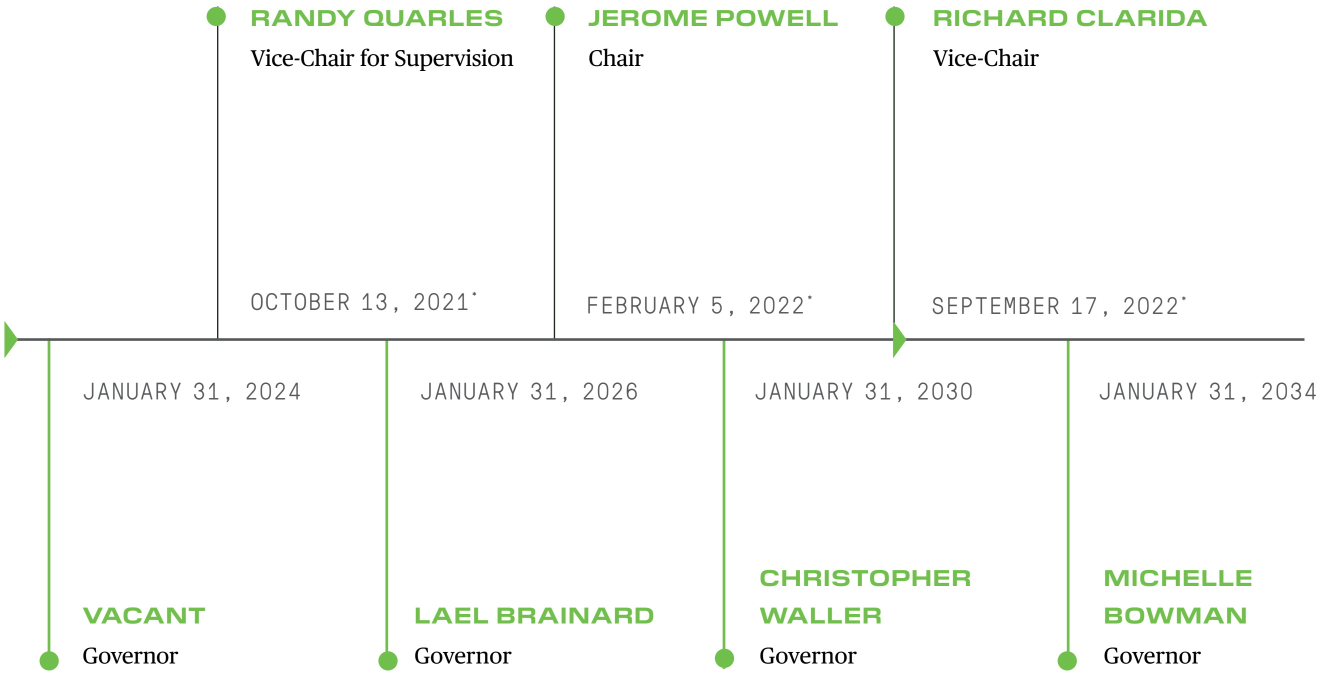


FIGURE 4

*Clarida's term as Governor ends on January 31, 2022
Powell's term as Governor ends on January 31, 2028
Quarles's term as Governor ends on January 31, 2032

turn, meaning it could be less inclined to tighten monetary policy in favor of letting the economy run "hot" to address the labor market slack.

Overall, the Fed risks becoming much more politicized, caught between competing interests in Congress, and President Biden's ability to reshape the board, all subject to senatorial confirmation. We have written about the threats to central banks' independence around the world and remind readers that former President Trump put enormous public pressure on Chair Powell before the pandemic to maintain easy money policies.

The Fed's independence has been granted by Congress, and throughout the years, it has had to navigate congressional scrutiny to not run afoul of its overseers. Independence enshrined by Congress can be eroded by Congress, and the Fed as an institution has been strategic in staying on the right side of the legislature.

On monetary policy, however, the realities of the post-pandemic economy have crystalized the inflation-employment tradeoff to a high degree. How the Fed tries to run an optimal policy in the face of high inflation and a weak labor market will be a challenge to financial markets as well as the real economy and the citizenry that forms the Fed's constituency.

Dramatic changes in personnel at the top of the central bank - as well as among the Board of Governors - could upset markets, especially if continuity in monetary policy looks likely to be threatened. Higher inflation that persists could usher in a world of higher borrowing costs, while a slowing economy could menace the economy.

Either outcome would probably subject the Fed to even more scrutiny from Congress and/or the executive branch. This too would roil the markets as the Fed's credibility and independence could be further weakened.

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