The Daily Dish

Hawkish Fed Talk

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The lay of the monetary landscape is quite clear. Inflation has sprung up rapidly to nearly 8 percent as measured by the Consumer Price Index, and several multiples of the 2 percent Federal Reserve target by any of the popular measures of inflation. The Fed is behind the curve in addressing the inflation problem. It kept its foot on the monetary accelerator through 2021, when it should have been moving to neutral and preparing to tighten as needed. As a result, the gap between the inflation rate (the problem) and real interest rates (the mechanism for addressing inflation) is as large as it has been since the mid-1970s, when it took nearly a decade to get inflation under control.

The Fed turned the corner in the March meeting by raising the policy rate by 25 basis points, but that is a mere drop in the sea of needed policy response. As a collective, it is spending the time leading up to the May meeting on a public relations blitz intended to send the message that it understands the magnitude of the problem, can calibrate accordingly the magnitude of the policy response, and is willing to take the tough measures that are required.

The messaging began with Chairman Pro Tempore (his title until re-confirmed) Powell's remarks to the National Association for Business Economics. He was quite clear and unvarnished: "We will take the necessary steps to ensure a return to price stability. In particular, if we conclude that it is appropriate to move more aggressively by raising the federal funds rate by more than 25 basis points at a meeting or meetings, we will do so. And if we determine that we need to tighten beyond common measures of neutral and into a more restrictive stance, we will do that as well."

That got people's attention, especially when he added that the Fed needed to get to "neutral" as expeditiously as possible and that, even having done so, it might take 3 years for inflation to return to the 2 percent target. The idea of multiple 50 basis point moves got put on the table. This past Wednesday the Fed released the minutes of the March meeting. "Many participants noted that one or more 50 basis point increases in the target range could be appropriate at future meetings …. Participants judged that it would be appropriate to move the stance of monetary policy toward a neutral posture expeditiously. They also noted that, depending on economic and financial developments, a move to a tighter policy stance could be warranted."

Powell had warned everyone: Get ready for higher rates.

In addition, the minutes gave some details on the process of reducing the balance sheet: "Participants generally agreed that monthly caps of about $60 billion for Treasury securities and about $35 billion for agency MBS [mortgage-backed securities] would likely be appropriate. Participants also generally agreed that the caps could be phased in over a period of three months or modestly longer if market conditions warrant." This is bigger (nearly twice as big) and faster than the last time the Fed started reducing its balance sheet.

That point was hammered home by Vice Chair Lael Brainard in a speech on Wednesday: "The [FOMC] will continue tightening monetary policy methodically through a series of interest rate increases and by starting to reduce the balance sheet at a rapid pace as soon as our May meeting," she said. "Given that the recovery has been considerably stronger and faster than in the previous cycle, I expect the balance sheet to shrink considerably more rapidly than in the previous recovery, with significantly larger caps and a much shorter period to phase in the maximum caps compared with 2017-19."

Get ready for Fed action and look for signs that demand is diminishing and price pressures lessening. It certainly has not happened yet. As was recorded in the minutes: "Many participants indicated that their business contacts continued to report substantial increases in wages and input prices that were being passed through into higher prices to their customers without any significant decrease in demand."