The Daily Dish

The Fed Gets Tough(er) on Inflation

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The minutes of the Federal Open Market Committee (FOMC) – the policy-setting arm of the Federal Reserve – on December 14-15 were released yesterday and it is clear that the FOMC is trying to send a message that it will get inflation under control. A key part of a summary paragraph reads: “Participants generally noted that, given their individual outlooks for the economy, the labor market, and inflation, it may become warranted to increase the federal funds rate sooner or at a faster pace than participants had earlier anticipated. Some participants also noted that it could be appropriate to begin to reduce the size of the Federal Reserve’s balance sheet relatively soon after beginning to raise the federal funds rate. Some participants judged that a less accommodative future stance of policy would likely be warranted and that the Committee should convey a strong commitment to address elevated inflation pressures.”

There are two key aspects of this passage. The first is the overall more hawkish tone. The FOMC needs to “convey a strong commitment to address elevated inflation pressures” through a “less accommodative future stance of policy” that would involve increasing “the federal funds rate sooner or at a faster pace” and also “reduce the size of the Federal Reserve’s balance sheet” relatively quickly after beginning to raise rates. The urgent focus on inflation stands in sharp contrast to years of policy statements supporting accommodative monetary policy and the desirability of letting the economy run hot.

The second key aspect is the mechanics of the less accommodative stance. First, the Fed will hike rates sooner and more frequently than had been previously anticipated. In the not-too-distant past, market participants had expected rates to remain at zero through 2022. No more. In the aftermath of the release of the minutes, the bond market priced in three rate hikes during 2022, with a chance (roughly 40 percent probability) of a fourth. Now, it is important to note that this means the federal funds rate may get to 1 percent in 2022, but with inflation surely at 3 percent or higher, real interest rates will remain solidly in negative territory. The Fed is tougher, yes, but Scrooge? No!

The more interesting part is the notion that the Fed would quickly begin to shrink its balance sheet. After the Great Recession, the Fed waited two years to begin a comparable exercise. Recall that the balance sheet expands when the Fed buys Treasuries or mortgage-backed securities (MBS). The flip side to those purchases is cash injected into financial markets, so the increased size of the balance sheet is a measure of the monetary stimulus floating around in markets. Reducing the size of the balance sheet is reducing stimulus; doing so while simultaneously raising rates conveys a much greater urgency on the inflation front.

One can expect a bit of financial market volatility as participants digest the new message. Markets respond to news quickly. But inflation itself will not disappear quickly, and the real question is whether an impatient public will be mollified by a greater commitment to fight inflation.