Economic
INSIGHT

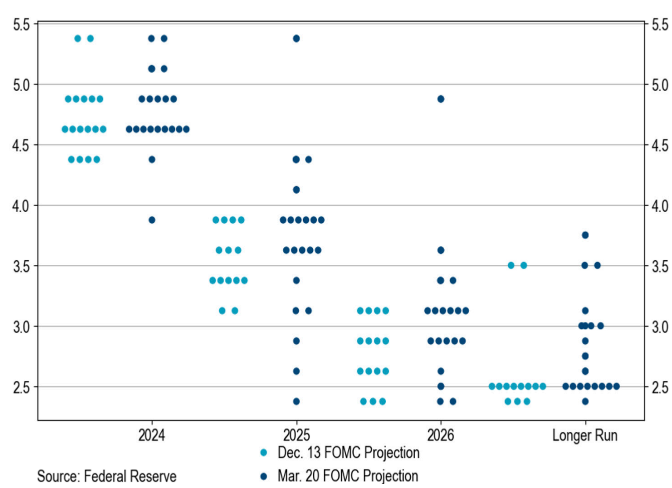
April 29, 2024

A Scenario-Based Federal Reserve: What if Inflation Does Not Retreat as Expected?

The latest March Federal Open Market Committee (FOMC) forecast showed the majority of Federal Reserve (Fed) officials anticipate three rate cuts by year-end. Of course, such an outlook was accompanied by the prospect of a further retreat in price pressures with the headline Personal Consumption Expenditures (PCE) expectedly falling to 2.4% by December. However, with inflation reversing its downward trajectory since the start of the year, Fed officials have dialed back expectations for rate cuts both in number and timing. Furthermore, they have adjusted the official message to one of *"patience"* amid a prolonged pause on the sidelines awaiting further evidence of improving inflationary conditions. But what if such improvement fails to materialize? What if inflation continues to rise? What then will be the policy course?

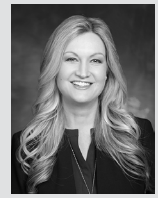
The Fed typically communicates a baseline forecast, but it does not offer an alternative outlook if economic and/or market conditions do not evolve as expected. An alternative approach, such as scenario analysis, would allow the Fed to propose varying outcomes and settings, and better prepare the market for a potential pivot in policy direction. Such an allowance would seemingly prove particularly welcome given the latest unexpected bout of stubbornly elevated inflation.

A STEADY BUT OUTDATED FORECAST?



Source: Federal Reserve

In March, the Fed left its previous December forecast in place, showing most Committee members anticipated three rate reductions in the remaining eight months of 2024. However, with growth accelerating beyond expectations at the end of last year and inflation reversing course, such an outlook already appears to be outdated. After all, such optimism was based on the premise that inflation would continue to retreat back towards the Fed's 2% target. In fact, according to the March FOMC meeting minutes, while the majority of officials anticipated that rate cuts would prove appropriate at some point this year, *"participants generally noted their uncertainty about the persistence of high inflation and expressed the view that recent data had not increased their confidence that inflation was moving sustainably down to 2 percent."*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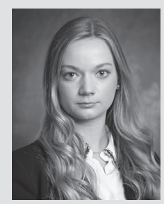
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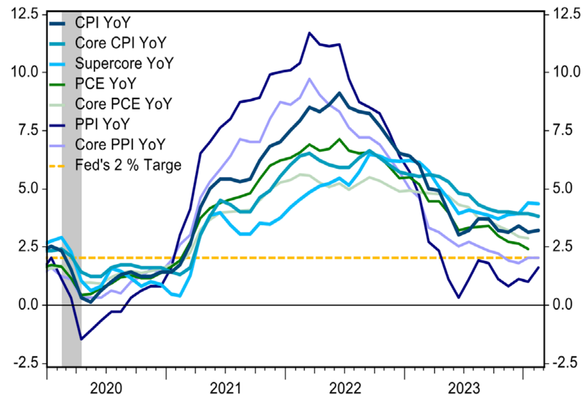
Since January, inflation has failed to improve as expected. Inflation's downward progress has not only stalled, but by many measures is also pushing higher. Following three consecutive months of hotter-than-expected consumer and producer prices data, the latest read on the PCE, for example, showed both the headline and core accelerating beyond the prior month's pace and moving nearer 3%.



Sources: BLS, BLS/H, BEA/Haver

In other words, inflation appears to be moving further away from the Fed's desired 2% target at a time when policy makers expected it to be doing the opposite.

According to Federal Reserve Chairman Jerome Powell and other Fed members, given the lack of improvement in the latest data, the Fed is willing to remain on the sidelines and maintain the current level of policy restriction for *"as long as needed."* Separately, acknowledging that previous disinflationary progress has stalled, several Fed members have reiterated this message of *"patience,"* noting there is *"no rush"* to cut rates given *"remarkable"* U.S. growth. Other policy makers, furthermore, have directly called into question the extent to which the current level of policy has played in restraining the economy, resulting in some seeing a reduced possibility for *any* near-term policy easing.

Of course, while the Fed has clearly articulated that there is no limit to the Committee's willingness to wait for further improvement in inflation before implementing a rate reduction, Fed officials have stopped short of addressing the threshold for increasing rates if inflation fails to improve, or worse, continues to reverse course in a meaningful and sustained manner. In other words, at what point is the Committee willing to not just delay rate cuts, but also reengage in additional rate *hikes*? At what point will the Committee concede it likely stopped short of the needed level of rates to meaningfully slow the consumer and the broader economy in order to quell price pressures?

A CONDITIONAL OUTLOOK

Given the rapid pace of change in the underlying data, as well as the uncertainty surrounding the outlook for growth and inflation, there is emerging pressure for the central bank to shift towards a *"scenario analysis."* Rather than providing a singular baseline outlook, under scenario analysis, the Fed would communicate a range of possible outcomes based on varying market conditions, including rising inflation.

While acknowledging alternative pathways will not provide investors clarity, nor imply a certainty of action, advocates argue it would give the market a better understanding of the potential bandwidth for policy, given varying degrees of improvement in key measures of economic health and activity. At the very least, outlining the possibility of different pathways both for the economy and the corresponding policy response could potentially reduce volatility as officials adjust the rate pathway in changing and unexpected economic scenarios.

On the international stage, Sweden's Riksbank already uses scenario analysis to consider alternative policy reactions to potential changed economic conditions. Additionally, former Fed Chair Ben Bernanke is currently making a push for the

GLOSSARY

CPI – Consumer Price Index

FOMC – Federal Open Market Committee

PCE – Personal Consumption Expenditures

PPI – Producer Price Index

YoY – Year over Year

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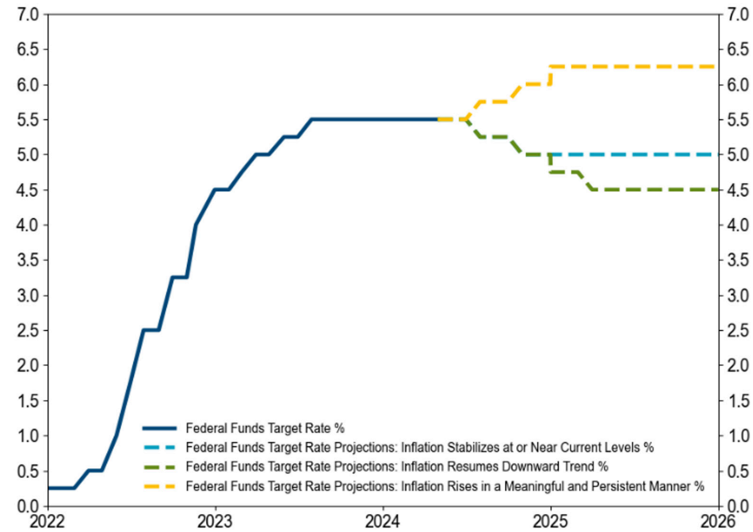
Bank of England (BOE) to adopt a similar approach. Publishing both central and alternative scenarios, Bernanke said, means the public will be better equipped to *“draw sharper inferences about the reaction function and thus better anticipate future policy actions.”* Of course, while the Fed staff does run varying economic scenarios for the Committee members to consider, some criticize their value given they are not associated with an agreed-upon course of action should such conditions materialize.

At this point, several Fed members have voiced support for scenario analysis, including Minneapolis Fed President Neel Kashkari, who last year outlined the hypothetical policy implications for two competing outlooks in an essay entitled *“Policy Has Tightened a Lot. Is It Enough? (A Second Update).”*[1] Nevertheless, even under growing or unanimous support for a change to the current process, the Fed does not adjust communication practices easily as each comes with its own inherent risks. As the Fed struggles to remind the market each quarter that the famed dot plot, for example, is not a commitment to a particular policy pathway, scenario analysis could also complicate the Fed’s ability to pivot in an alternative direction outside of the finite pathways proposed.



Source: Bureau of Economic Analysis/Federal Reserve Board/Stifel

PROPOSED SCENARIOS

While the Fed’s analysis cannot entirely account for the limitless scenarios in today’s ever-changing and globally integrated environment, given inflation’s disorderly behavior as of late, the most telling action at this point would be the expected policy response if inflation fails to recede near term. While the Fed’s next move is still likely a rate cut should a near-term improvement in prices become evident, the conversation of further rate *hikes* appears to be back on the table. At the very least, with already three months of upward momentum, the Committee would be well advised to consider and prepare for multiple scenarios.

That doesn’t mean the Fed isn’t or won’t be willing to cut rates at some point in 2024, as this is clearly a Committee desperate to provide relief and continue to perpetuate positive economic conditions. However, if inflation remains at current levels – or even pushes slightly higher still – after one or two reductions, there is likely little more the Fed could offer. Meaning, at most, 50 basis points of relief followed by a second-round extended pause on the sidelines. In fact, even if inflation reversed course and continued its previous – painfully slow – pace back nearer the 2% target, the pace of rate reductions would expectedly be slow and tempered, keeping the federal funds rate well above neutral out beyond 2025.

[2] Link to Essay: https://www.minneapolisfed.org/article/2023/policy-has-tightened-a-lot-is-it-enough-a-second-update

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The biggest risk for policy is a sustained and meaningful rise in inflation, forcing the Fed to reengage in additional rate *hikes*. While unfavorable for policy makers given this would presumably confirm the Fed stopped short of a sufficiently restrictive level of rates to tame inflation, with at least half of the Fed's dual mandate – stable prices – not yet met, there would seemingly be no other alternative. The longer the Fed tolerates above target – and rising – inflation, the more engrained price pressures will become and the more difficult they will be to tame, potentially forcing the Fed to raise rates even higher than they arguably would have if inflation had been tackled the first time around. Furthermore, with topline activity still growing but losing momentum, the window to tackle inflation against the backdrop of a *"solid"* economy is far from indefinite.

CONCLUSION

Pivoting from an earlier forecast of numerous rate cuts by year-end, the Committee has adopted a new message of *"patience."* Reiterating a firm stance on the sidelines, the Fed has indicated a need for further evidence of declining inflation before engaging in rate cuts. However, what if such improvement fails to materialize? What is the proposed pathway under the scenario of rising prices? Rapidly rising prices?

The Fed's forecast communication is limited to the Committee's more optimistic base case of an improving environment. While far from a catchall, some argue scenario analysis would better allow the Fed to communicate varying potential pathways under a variety of conditions, including both a favorable and an increasingly unfavorable inflationary environment.

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