Powell's Fed Debut Shows Shift Away From Theory, Models

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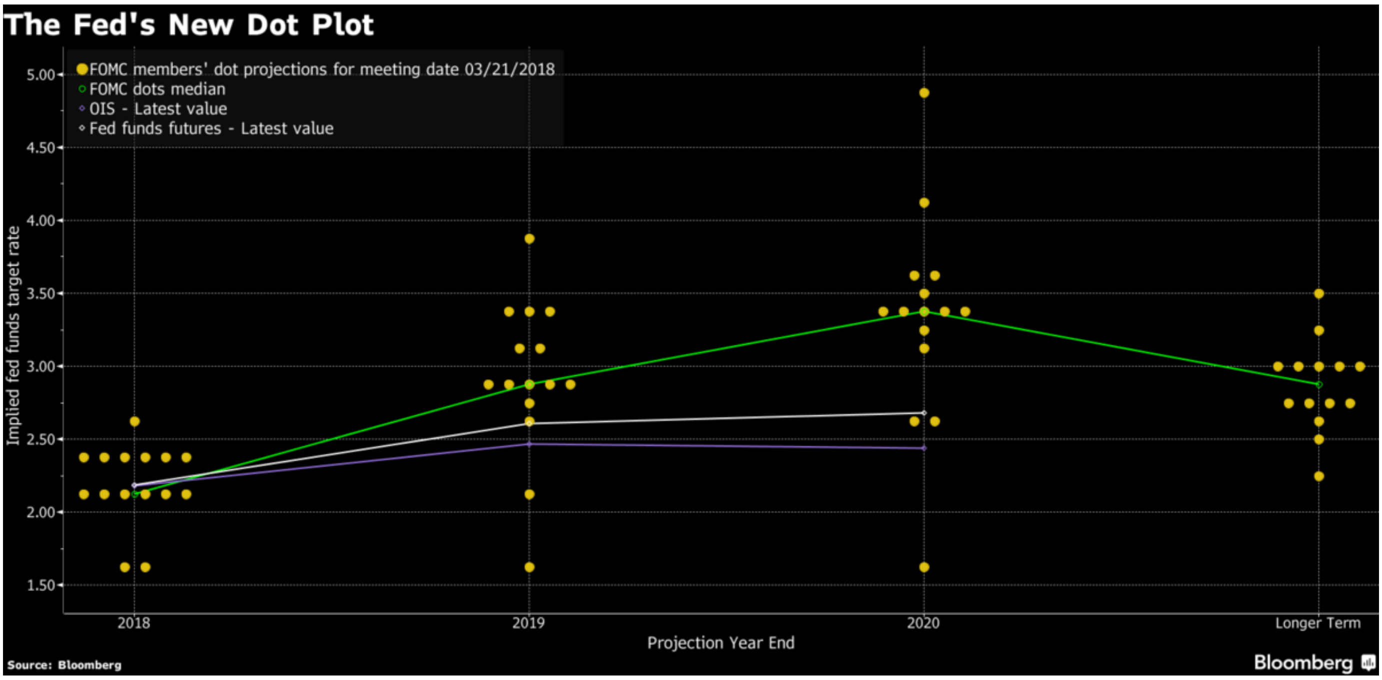
- Fed forecasts show mild response to labor market overshoot
- Powell willing to let labor market show him when slack is gone

Federal Reserve Chairman Jerome Powell showed he will be guided by the U.S. economy's performance rather than the theories and models relied upon by his predecessors to set monetary policy for the past three decades.

Fresh from overseeing his first policy-setting meeting and its first interest rate hike of 2018, Powell signaled he won't try to guess the limits of the labor market or the growth-boosting effects of Republican tax cuts.

His message: He'll know the economy is changing when he sees it. For now, his Fed is on track to raise rates at least twice more this year and possibly three times.

"There is no sense in the data that we are on the cusp of an acceleration of inflation," Powell told reporters on Wednesday in Washington. "We have seen moderate increases in wages and price inflation, and we seem to be seeing more of that."



Shortly before Powell spoke, the Federal Open Market Committee raised interest rates for the sixth time since December 2015. Financial markets largely took the move in stride. The target range for the federal funds rate was increased by a quarter percentage point to 1.5 percent to 1.75 percent, the highest since the 2008 collapse of Lehman Brothers Holdings Inc. froze credit markets worldwide.

“This decision marks another step in the ongoing process of gradually scaling back monetary policy accommodation -- a process that has been under way for several years now,” Powell said in opening remarks to reporters that signaled policy continuity with his predecessor, Janet Yellen.

What Our Economists Say

“The Powell Fed is proceeding with a similar sense of gradual deliberation, at least for now. The dot plot revealed policy makers shifting toward a faster pace of tightening in outlying years, consistent with Bloomberg Economics’ expectation for them to “backfill” rate hikes into 2019-2020.”

-- Carl Riccadonna and Yelena Shulyatyeva, Bloomberg Economics

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Policy similarities aside, there were stylistic differences. In addition to keeping his remarks short -- the press conference was a scant 43 minutes compared to Yellen’s somewhat longer performances -- he also declined to be drawn deeply into professorial discussions about the economy.

Powell, 65, is a former private-equity executive -- experience the Trump administration appointee brought up to describe how businesses consider tax policy when making investment decisions. Asked whether tax cuts will deliver supply-side benefits, he concluded, “the whole thing is very uncertain.”

His lack of economic formalism came through again as he backed away from being specific about the changing relationship between labor market slack and inflation -- a critical issue now for the pace of Fed tightening.

“He may be even less constrained than Chair Janet Yellen in his thinking,” said Julia Coronado, president of Macropolicy Perspectives LLC in New York. “He is not as tied to models or theory and may be more inclined to take signals from incoming data.”

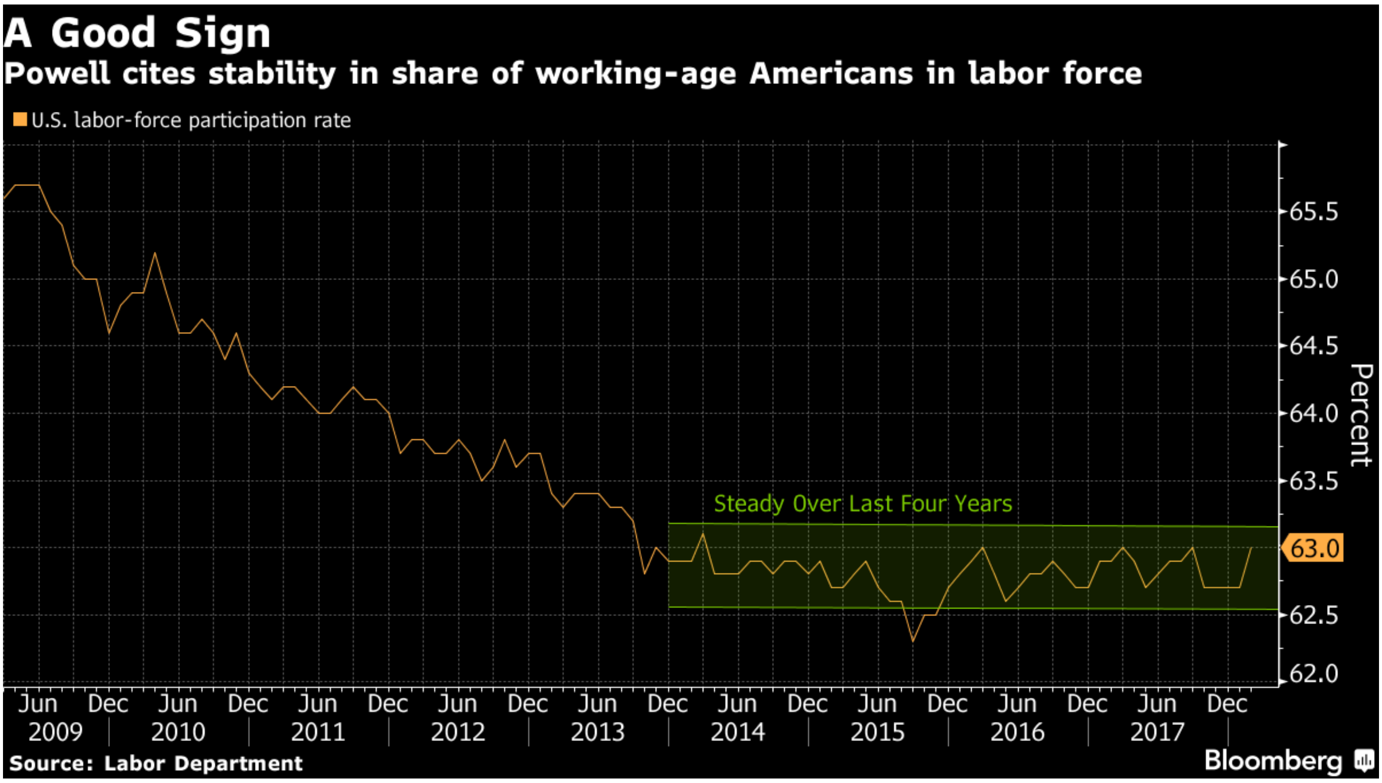
The economic data are improving in several areas, including the job market. The median FOMC estimate in the March forecasts for the unemployment rate show it averaging 3.8 percent in the final quarter of 2018 and 3.6 percent in 2019 and 2020 -- below the 4.1 percent rate reported in February.

Overshooting Full Employment

That would represent a three-year overshoot of the Fed’s 4.5 percent estimate for the unemployment rate that keeps labor supply and demand in balance. Still, the committee’s response was not to shift to a faster pace of rate increases this year. Officials continued to project two more rate hikes in 2018, followed by three moves in 2019 and two further increases in 2020.

The moderate path is partly a result of the heavy inertia holding back inflation Fed officials see in the economy. They forecast headline inflation of 1.9 percent for this year, 2 percent in 2019, and 2.1 percent in 2020. They have been under their 2 percent target for almost every month since April 2012.

A median forecast above the Fed's 2 percent target is a "dovish development," Roberto Perli, a partner at Cornerstone Macro LLC in Washington, wrote in a research note. "The FOMC is telling us that PCE inflation will not hit 2 percent any time soon, and when it does the Fed won't get too excited," he said.



"The theory would be if you get below the sustainable rate of unemployment for a sustained period, you would see an acceleration of inflation," Powell said in response to a question. "We are very alert to it. But it's not something we observe at the present."

Powell noted that labor market supply was responding to job market strength. He said the amount of people participating in the labor force moved higher in February and has remained roughly unchanged for the past four years despite a demographic pull downward.

"That is a sign of improvement, given that the aging of our population is putting downward pressure on the participation rate," said Powell, who indicated he's willing to consider more than the four press conferences that the Fed currently schedules after its eight policy meetings a year. "We expect that the job market will remain strong."

Perli said Powell's "tone was very balanced, and he delivered the message as clearly as anyone could have hoped. He seems definitely ready for having a press conference after every meeting."