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FOMC: Stakes Growing

by Pierre Ellis

As expected, the FOMC changed no policy settings on May1. Surprisingly, however, there was less explicit note taken than expected of the sudden March growth-arrest and of the recent slowdown in core-PCE inflation.

But, the Committee did add a totally new indication that all policy options are on the table—explicitly noting that it is "prepared to increase or reduce the pace of its purchases." The "increase" possibility was implicit in the March 20 statement, but the Fed clearly feels that serious new emphasis is appropriate.

The FOMC's new economic assessment arrived at the same broad conclusion as was reached at the last meeting: that growth is "moderate." Last time, the economy was seen as "returning" to that state, while now it is described as "having been" in it.

However, and perhaps strangely to most observers, the new description of labor market conditions might even be mildly more favorable than the one at the March meeting. Conditions are now said to "have shown some improvement in recent months, on balance,..." which seems a notch more definitive than the previous judgment that they "have shown signs of improvement in recent months,..." In both texts, the sentence finishes identically: "but the unemployment rate remains elevated."

Also a bit surprisingly, the inflation assessment was left absolutely unaltered—still noting just that price increases have "been running somewhat below the Committee's longer run objective." Actually, they have been running substantially further below than at the earlier meeting, with the latest data showing the core PCE price index up only 1.1% year on year in March, down from +1.4% year on year in January (At the last meeting the latest data available were for January, then showing a 1.3% year-on-year increase).

Meanwhile, the demand-side assessment of the economy was left absolutely unchanged from March, and restrainedly upbeat, for the private-sector components, but the fiscal policy comment was made a notch more negative, going from "fiscal policy has become somewhat more restrictive" to "fiscal policy is restraining growth." The latter judgment may not have been uncontroversial—Minutes will tell.

All of this shows the FOMC in its normal posture of being very careful not to leap to conclusions about sudden turns in the data—too many whipsaws have occurred in the past. But, the non-notice of new inflation developments—which do not tend to swing quickly—is a bit surprising. Perhaps it reflects the longstanding, and still true, assessment that "inflation expectations have remained stable."

It may also be that FOMC doves see themselves as putting arguments for easing in a back pocket—to be brought out with full force if the current economic slowdown worsens, or just proves to be too lasting.

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Restrictive fiscal policy is ready to go as such an argument—with any new private-sector demand weakness likely to be portrayed as an induced effect of the policy, above and beyond the visible decline in government purchases that budget cuts can cause.

And, inflation is now so far below target that it would complete an open-and-shut case for new easing, if the outlook for the demand side of the economy became weak, or stagnant, enough.

Odds are, the FOMC is choosing not to leap to conclusions about economic growth or inflation, but—by hammering home the fact that stepped-up asset purchases are just as possible as tapered-back ones—it is also making clear that the Committee is not at all conflicted about adding more stimulus, should that be judged necessary.

Decision Economics thinking is that the economy will emerge from the current soft patch over the course of the next few months—probably avoiding the necessity for any new Fed action. But, the stakes are growing for the FOMC, and not too much more explicit weakness in the numbers will be necessary to prompt a change in course.