Q&A-Fed likely to announce taper in November; May want SEP "out of the way" before setting taper schedule: Dennis Lockhart, former Atlanta Fed President

The U.S. Federal Reserve is likely to announce a taper of its asset purchases in November and begin the process a month later, **Dennis Lockhart, former president of the Atlanta Fed,** told the Reuters Global Markets Forum on Thursday, September 2, 2021.

Waiting until November will give policymakers more data on the labor market's recovery and economic growth, he said.

But Lockhart, who headed the Atlanta Fed from 2007 to 2017 and is currently Senior Fellow at the Harvard Kennedy School, warned "a particularly bad next two months" could postpone this timeline.

The summary of economic projections, due to be released at the September Fed meeting "could present a picture not entirely consistent with the tapering decision in some respects," he said.

Lockhart was "agnostic" on the route the central bank might take to unwind its $120 billion worth of monthly bond purchases -- whether by following the post-Great Recession playbook and first cutting back Treasury purchases, or leading with mortgage-backed securities to calm a red-hot housing market.

Following are edited excerpts from the conversation:

Q: What is your view on the ongoing debate on whether current inflation is transitory or persistent, and why?

A: I still buy the inflation hypothesis. I think the price pressures that we're experiencing are greater and possibly more persistent than was expected by the Federal Reserve. But as I said, I buy the transitory hypothesis for now. That said, the play out of the inflation story appears to be less clear-cut than the Fed had hoped or expected. Some of the signals are mixed. There are elements that are not going to retreat soon. There's lots of chatter and noise, with some alarmist messaging, that could be affecting public sentiment on inflation. So, it's possible, that price pressures will be sticky and last well into 2022. That's an uncomfortable situation, for the Federal Reserve, and their hypothesis that the inflation that we saw in the spring and early summer is actually transitory. We have to watch expectations closely, because it's one source of fuel for persistent inflation. The attitudes of the public and the business community can have an influence on actual inflation. The persistent tight labor market can drive wage growth – a wage price spiral is a legitimate concern, and this would be driven, if it were to develop, by the past through wage increases into prices. I think the questions that have to be considered at this time are whether the short-term transitory theory that the Fed has been espousing will be proved wrong and will a self-feeding cycle, that somewhat impervious to at least initially to tightening, actually develop. I think it is still quite plausible that we're looking at a transitory phenomenon.

Q: What do you expect on the Fed's timeline and method of tapering?

A: I think at the September meeting, they could disclose a bit more, but I doubt the final decision will be announced at the September meeting. I put a bit more probability on an announcement coming out of the November meeting, with the start of the actual tapering maybe a month or so later -- so starting in the month of December. By the November meeting, the committee will have one more jobs report -- it will be the October jobs report on the September employment situation. They'll clearly have more inflation information, and they'll have some preliminary third quarter growth numbers to look at. Since the September meeting is a forecast meeting with the summary of economic projections (SEP) being published, it could conceivably be a little bit of a distraction, and also could present a picture that is not entirely consistent with the tapering decision in some respects. So, they may wish to have the SEP out of the way before they actually announce the tapering decision.

As regards the details they have to work out are the start date, the end date, the step-down plan -- if that's what they plan to do, and very importantly, the mix of Treasuries and mortgage-backed securities. I'm a little bit agnostic on that last question, which is important to the markets. The reason is because I think there is a bias to use the playbook that was used when tapering occurred after the Great Recession, and that's the easy thing to do because it's been proven to work well. At the same time, I do think there are strong arguments for leading more with mortgage-backed securities in order to remove whatever support that provides for a very robust housing market and the house price trajectory that we have been watching. So, I'm not sure where they'll come out, but probably they will just go proportional to purchases. So, they'll just keep that ratio in place, probably, but I'm not so sure.

Q: Do you see risks given the conflicting jobs data, a situation where labor market recovery isn't where the Fed wants it and inflation is hotter than where they're comfortable with?

A: I think that's possible. We have a job report tomorrow. I have no reason to believe that the employment situation will reverse, and the job gains will fall off a cliff. I expect a number that is north of 600,000, and conceivably in the 800,000 range, which is the average we've seen for the last three months. Having said that, the downside risk to the outlook is the Delta variant and how it plays out. We're in a very odd situation at the moment, where there are certainly signs of a new wave or a surge of infections. At the same time, the vaccinated part of society is pretty much behaving normally. It's a very uncertain period in terms of how that Delta variant factor actually plays through… the committee will be trying to gather as much data as they can to come up with a conclusion on that. If we have a particularly bad next two months, it wouldn't totally surprise me that they delayed the tapering decision. But as of now, it does not look like the base case.

Q: What reaction do you expect from financial markets once tapering begins? And how much should the Fed consider this in its decision-making?

A: Short term volatility -- the tendency of the committee will be to look through that, to take note of it but not react to short-term volatility. And if the volatility were more persistent, then the important question would be is this market volatility playing through to the real economy? One thing that I have repeatedly emphasized is (that) the committee and the Federal Reserve are not in service of financial markets. They're more in service of Main Street, America, the real economy, so to speak. So, they don't formulate policy with the first thought in their mind being let's avoid market turbulence. They formulate policy to try to do the best they can to shape conditions for the real economy and live with, to some degree, financial market reaction. I don't think the tapering decision will be a surprise. I think it's been well-signaled -- the pretty strong statement in the Jackson Hole speech, that in all likelihood we will see tapering began in this calendar year. That's a little bit firmer statement than we've seen in the past coming from (Fed Chair) Jerome Powell on policy. So, (it'll be) no surprise when it comes and how it's performed. If tapering is completed by mid-year next year, I don't think that takes the market by surprise -- it's very hard to predict market reaction. But there won't be a lot of new news in this announcement. In that respect, my guess would be the market will absorb it without a whole lot of volatility.

Q: Do you think strong fiscal spending and loose monetary policy, together with a buildup of leverage in the financial system pose systemic risks? And could this result in a 2008-style spillover into the real economy?

A: The low interest rate conditions and the search for yield encourages leverage. So yes, there is a lot of leverage in the system, we've been living with a lot of leverage in the system for several years. I haven't seen recent numbers, but let's argue for the sake of discussion that leverage has actually been building or creating in the system. To some extent the Federal Reserve clearly is going to be monitoring systemic indications of systemic risk. The predictability of an event, particularly an event that has profound impact, I believe is extremely low. Something could happen tomorrow that triggers something some kind of a systemic meltdown, or something could happen in 20 years. I don't think there is any predictability of when and how that would occur. Having said that, as you pointed out in your question, there are conditions extant today that deserve close monitoring, because they tend to bring more danger of a systemic event. But I have no idea if or when that would happen.

Q: How should Fed respond to calls, especially from progressives, for them to do more on climate and inequality, and how that should fit into the central bank's mandate?

A: If I were advising Congress, I would not change the mandate. I think the mandate has served the country well on balance, and it's appropriate for a central bank. Now, let's talk about the climate question. My understanding is that factoring in climate concerns is more a question of bank regulation and financial market oversight, than it is a question for the FOMC table which is about monetary policy.

I think it's perfectly legitimate for bank supervisors to observe and, to some extent, express concern about climate risk in the portfolios of financial institutions. Yesterday, I was reading an article about the climate hit expected from (Hurricane) Ida on insurance companies. If insurance companies are in the direct line of fire from climate, an indirect line would be other risk takers in the financial sector including banks -- indirect in the sense that they're lending to a borrower and the borrower may or may not be affected by apparently climate-related events. I think it's hard to be a complete denier of the climate effect on the economy.

As regards inclusion and inequality, that's a very interesting question, because the new strategic framework that was presented last year and is clearly being implemented and biases the committee to be patient seems to signal an important change in the mentality of the central bank, particularly as regards the employment side of the dual mandate. I think the conditions that existed, pre COVID-19, 3.5% unemployment, and about almost 64% participation, and very importantly, very high participation and high employment, therefore low unemployment of minority cohorts and women -- that is in the minds of policymakers as approaching an ideal set of conditions, that if they're patient and stay the course, (it) can be achieved again.

I think the "inclusion" word that was in the status strategy statement is meaningful, it's important and marks a somewhat of a change of approach to policy. Because I think (if) Federal Reserve officials believe that they can do anything at all about inequality, it's to create the conditions in which people are employed and have jobs and job opportunities.

Q: Is the rising level of inequality something to be concerned about, especially from a central bank perspective? And how much of this blame should be laid at the feet of easy monetary policy and its impact on asset prices?

A: This is a very complex subject… I see three dimensions of inequality. There is income inequality, wealth inequality and opportunity inequality. As regards wealth inequality, I think you can argue that over the last decade or more in conditions of very low interest rates, which have tended to spur asset prices inflation, those who owned assets, whether they be securities or real estate, tended to gain wealth and those who were living paycheck to paycheck, and basically didn't have much in the way of personal wealth were left behind in that process. That, to me, seems to be apparent. On the wealth dimension, I think monetary policy has had an effect of exacerbating wealth inequality, as a byproduct of a policy that was in the best interest of the average American. Many people have lower income, and that is to support the economy such that it produces jobs and gives to people incomes. Income inequality and inequality related to opportunity are, in some respects, (are) less clear cut the in terms of causal factors. The education system -- unequal access to high quality education -- is a major causal factor in terms of opportunity and ultimately in terms of income. My thinking that the relevance of the question to monetary policy falls substantially in the inequality of wealth part of the picture.

Q: What do you view as the Fed's top three challenges in the next four or five years, and what kind of leader does the Fed need to navigate them?

A: I'll tell you an anecdote that makes an important point. When I was part of the committee, for every meeting we would have to judge whether current uncertainty was greater or lesser than uncertainty in the past, and that was reported in the quarterly summary of economic projections. At one meeting, one of the Presidents said, "have we ever believed that current uncertainty was actually less than an uncertainty in the past?"-- there is a kind of recency bias to believe that you live in very uncertain times, and you forget how uncertain the times were in the past. But clearly the uncertainty factor and how the economy will evolve, and what conditions will prevail in the United States and around the world, continues to be very challenging for the Federal Reserve.

For example, I think the 2021 growth numbers will be very high. But I doubt that those growth numbers will continue in 2022 and 2023. There will be much more of a reversion to the mean, and in this case it's probably around 2%. That was the trend rate of growth prior to the COVID-19 crisis. So, we'll be seeing a moderation in growth and a slowdown, and with that will come conceivably slower progress in the labor markets. That clearly is going to be a challenge. It is quite possible that inflation is a challenge, particularly if expectations are reset well above 2%, if expectations fall in the 2%-3% range, I think the Federal Reserve will view that as tolerable, and for that matter desirable. But it's possible that this inflation experience will raise expectations to a more dangerous level.

Then there could be a change of leadership. Whenever there's a change of leadership, there's internal challenges in adapting to the thought process and the style and committee management process of a new leader. Powell actually embodies much, if not all, of the characteristics that I think are important. Someone who's calm and steady, a good communicator, and very importantly someone respected by the committee and who runs the committee process in a way that includes everyone, at the same time gets to the necessary decisions in a timely fashion. I think he's earned renomination, particularly the actions that took place in March and early April of 2020. Very quick reaction in the staving off of what could have been a much worse situation in Treasury markets, and financial markets in general had it lasted. That was, I'm sure, Powell's leadership at work. So, I am a strong supporter of Powell.

Q: Who are the most appropriate candidates to fill other open roles?

A: I think all the focus is on the Chair position because of what a prominent position it is in the world. The Vice Chair for supervision position is in play, and the expectation is there could be turnover there. I think you can expect that there is, at least from part of the Democratic Party, a very strong push for someone who will be for lack of a better term tough on banks, a tough regulator. And then it could very well be where the political decision-making comes into play in the filling of that position.

Q: What do you make of current spending plans working their way through Congress? Is President Biden on the right track with his infrastructure plans, or is the price tag too high?

A: Infrastructure spending, which realistically would be spread over several years, is contributing to deficit spending and therefore the national debt -- at least under current law -- but isn't an alarming decision or amount of money. I think we have to think through practically how long infrastructure projects take and for that matter, the availability of a workforce to do some of the work. So, I expect that spending to be spread over a multi-year period and it will contribute to deficits, but it's not the same as changing the structure of entitlements so that you have an immediate surge in spending in certain areas.

The $3.5 trillion proposal is a different matter, because it relates to current spending more than infrastructure. That, I think, is a bit more debatable. It can be worrisome, or cause for worry that national debt to GDP (gross domestic product) is now in excess of 100%. We're getting into a completely different territory than we were a decade ago.

How that will play out remains to be seen. I am sympathetic to some of the spending targets that are in the $3.5 trillion package, for example, pre-kindergarten education, more than two years of college, help with child and elderly care – how we get to pay for them is a terribly important question. In some of the data related to student debt, I think our economy will be better off if we have a solid childcare and elder care system in place, because realistically, it allows more women to be in the workforce.

Q: Global markets have been benevolent to the increase in debt levels. However, the 'lost decade' for emerging markets (EMs) coincided with the U.S. credit downgrade in 2011, EU debt crisis in 2012 and taper tantrum in 2013, as literally every country was thrown into fiscal austerity. How do you see this playing out this time around?

A: The COVID-19 crisis has hit emerging markets extremely hard, and many of them have still do not have access to vaccination. It's been a very bad decade for EMs, the stars have not aligned well for poor countries or countries that are facing all of these issues. A question I used to get is, to what extent is the fate of emerging markets factored into monetary policy making at the table of the FOMC? The answer is committee members are not unsympathetic to what's going on around the world and the influence of their policies on other countries. But by law, the central bank of the United States looks after the affairs of the United States.

Therefore, there's rather little factoring into the ultimate decision of what influence that decision will have on other countries, whether they're advanced or emerging market countries. And that is really left to those countries try to deal with. There is no question that the dollar and U.S. monetary policy create conditions that these countries have to adapt to, and this has been very challenging for over a decade.