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Q&A-Fed taper could begin by December, rate hikes in early 2023; Delta variant, U.S. stimulus complicate Fed's outlook: Vincent Reinhart, Dreyfus and Mellon



The U.S. Federal Reserve may begin tapering asset purchases in December and is likely to hike rates in early 2023, **Vincent Reinhart, chief economist at Dreyfus and Mellon**, told the Reuters Global Markets Forum on Tuesday, September 14.

The COVID-19 Delta variant could crimp aggregate demand which may impact the Fed's policy table, while the U.S. Capitol is poised to deliver trillions of dollars of fiscal stimulus that could see inflation uncomfortably overshoot the central bank's target, Reinhart said.

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Following are edited excerpts from the conversation:

Q: What do you make of the latest U.S. inflation data, and whether we're seeing "transitory inflation" or not?

A: Today's (September 14) print makes Federal Reserve Chair Jerome Powell's life a little easier, in that he can put off his more aggressive colleagues at the upcoming meeting. Inflation will be above the Fed's goal of 2% for some time, and the U.S. will not be alone as similar dynamics play out around the world. In the U.S., the Fed bet that the initial faster increases in prices were transitory because they reflected calendar effects and temporary bottlenecks. They did, but they were larger in size, more widespread in scope, and more persistent. Moreover, those price gains hit goods and services especially salient to households, who then raised their inflation expectations. Emerging-market economies, with a more checkered inflation history and no safe-haven demands to buffer their currencies, will have a particularly rocky time. In this environment, investors will increasingly need higher inflation compensation in nominal debt securities and come to expect significant Fed tightening in the fullness of time. Avoiding longer duration instruments and being suspicious of equity valuations seems appropriate.

Q: What does this mean for the Fed's tapering timeline? Do you expect an announcement at the September meeting?

A: September seems a little rushed to me. Chair Powell is a little behind his colleagues, in part because this is the window for the consideration of his renomination. Adjusting monetary policy is sometimes like landing a jet on the deck of an aircraft carrier. The runway may be lurching at a variable speed, moving up and down, and rocking from side to side. Monetary policy makers might have a plan to raise interest rates just as employment regains its pre-pandemic heights and inflation settles at goal, but the reality of the pandemic and the vicissitudes of politics intrude. The Mellon forecast is that asset purchases are begun to be trimmed back this December to clear the deck of unconventional policy by mid-2022. This allows Fed officials to begin hiking rates in early 2023, with the option of beginning a bit earlier, if necessary.

But the deck of the carrier is rolling. On the one hand, U.S. politicians have delivered and are likely to deliver more fiscal stimulus, in at least two tranches, this year, speeding the recovery in aggregate demand even as aggregate production struggles to keep up because of supply-chain obstructions. As a result, the Fed faces a more significant overshoot of its inflation goal than it can comfortably tolerate. This should incline officials there, at a minimum, to sound more forceful about the coming removal of accommodation or even speed up the process.

On the other hand, the spread of the Delta strain has set back the growth of aggregate demand, as households worried about health outcomes are reluctant to spend. This raises the still-small chance of a truly adverse turn to the economy that would reset the policy table. At the same time, the near-term range of outcomes from Capitol Hill span complete gridlock with a government shutdown and debt-ceiling confrontation to encompassing entitlement redesign and significant tax-law restructuring. Risk management raises the option value of waiting to change the direction of policy.

Welcome to the danger zone. Monetary policy gets hard when it is time to change direction. And the Fed is setting itself up to be late to start.

Q: How much do you see other central banks influenced by the Fed's timeline?

A: The Fed sets the policy rate at the financial center. Other central banks were able to be accommodative -- unusually so for EMEs (emerging market economies) -- in 2020 because the bar was set so low. As the withdrawal of accommodation by the Fed enters the frame, other central banks will have to react. After all, they do not want their exchange rates to change much.

Q: What impact do you see from President Joe Biden's anticipated infrastructure spending combined with higher tax rates?

A: President Biden's two fiscal packages (are) the American Jobs and Families Plans -- AJP and AFP... The passage of both the AJP and AFP would restructure and expand entitlements, raise marginal tax rates, and layer in infrastructure spending over time. They would also ramp up the time profile of the already large government debt over time. While there would be more fiscal impetus, this probably implies that the Fed would dial back its accommodation more quickly. The case for a multiplied boost from infrastructure spending is unpersuasive in the historical record, nor are there likely to be large benefits to productivity, and higher tax rates on households and businesses are a negative. The net effect is likely a small boost to activity this year and the next, but some of that stronger demand will push up prices faster.

Q: Do you anticipate another government shutdown, or will we get an 11th-hour raising/suspension of the debt ceiling?

A: History repeats. The two parties lock horns, threatening calamity, until one of them appreciates that they'll get blamed when things go wrong. A shutdown is possible, a default is too consequential for politicians to brook. But they will threaten on the cliff, for sure.

Q: Do the increasingly widening deficits and a buildup of debt pose a long-term threat to the U.S. economy?

A: Politicians should remember that mistakes matter. As for the longer-term consequences of debt, they matter. I looked at the long-term experience of debt and growth for 26 countries since the Napoleonic War in an academic paper with my wife Carmen and Ken Rogoff. Countries grow more slowly when government debt is high relative to income compared to their own experience when debt is low. We are not seeing the consequences now because the Fed is keeping interest rates so low. The real Federal Funds Rate is at its lowest level in 50 years! When Fed policy renormalizes, the results might be dramatic for federal finances.

Q: Could we see similar effects globally?

A: Yes. There was unprecedented discretionary fiscal stimulus around the world last year. Poorly performing economies cut tax collection and raised benefits. The result was an enormous increase in government budget deficits everywhere, piling on debt. The rising tide of Fed renormalization will lift all boats in markets. Other central banks are already raising rates. More will move with the Fed. As a result, interest costs will rise. Meanwhile, for the least well off, the window for forbearance will close.

Q: How do you see the labor market recovery progressing now that extra unemployment benefits are expiring?

A: We are into the hard part of job matching. Early on, people were returning to their existing places of employment. Now, they need to find new places to work. That takes time. It also is made easier by more generous unemployment benefits. As they roll off, the incentive to settle for a new place of work is a little more forceful. That said, there isn't a lot of evidence at the state level that benefits mattered much. However, that may be because states with well performing economies cut benefits sooner. More people will be pulled into the labor market, that process trails the business cycle. But one way people get pulled into the labor market is higher wages. Costs are increasing faster.

Fed Chair Powell's bet is that running the labor market hot for some time will produce (some) benefits. It worked in 2018-19 and could work again. The problem is that costs are not as well behaved this time.

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