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Fed Thoughts: A Central Bank Switchback

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Central bankers gathered recently at the economic symposium in Jackson Hole, WY, many occupying their free time hiking in the Tetons. One lesson of the trail: going back is sometimes the only way to move forward. Apparently, the lesson sunk in with Federal Reserve (Fed) officials in their latest “framework” review, which is done every five years and evaluates the monetary policy strategy, tools and communication practices of the Federal Open Market Committee (FOMC). In his remarks at the symposium, Chair Jerome Powell effectively announced that they abandoned the monetary policy strategy designed five years ago to go back to basics.

The prior framework, which Powell also unveiled at Jackson Hole in 2020, was permissive of inflation overshooting, interpreted achievement of the 2% inflation goal as a backward average of prior inflation and assessed resource slack in an encompassing manner. The Fed adopted a “make-up” strategy (in which inflation above the 2% goal was appropriate after a period when it was below) that was one-sided toward accommodation (by emphasizing the avoidance of employment “shortfalls”). The design fit the prior twenty years, when secular goods-price deflation offset above-goal service-price inflation, allowing them to test the upper limit of maximum employment and often hug the zero lower bound of the nominal policy rate.

The result of the policy strategy announced in 2020 was what usually happens when the disclaimer “past performance does not necessarily indicate future behavior” goes unheeded. The pandemic pushed up goods prices, the Fed initially tolerated overshooting and high inflation did not prove transitory.

In the new framework, the Fed: (1) downplayed the threat of the lower bound in favor of conducting policy “across a broad range of economic conditions;” (2) eliminated tolerance of inflation overshooting; and (3) returned to a balance approach weighing deviations from both maximum employment and stable prices rather than “shortfalls” in the former.

The switchback follows a well-trodden path — treating the mandates symmetrically, relying on the survey the Summary of Economic Projections (SEP) and communicating in simple terms. Some prominent analysts, notably including former chair Ben Bernanke, argued for an enhanced description of the economic outlook in line with some other central banks that publish fan charts and alternative scenarios. Bernanke, for example, proposed a quarterly “Economic Review” prepared by Fed staff that would include a comprehensive, internally consistent forecast and alternative scenarios. He argued that this would enhance transparency, clarify the Fed’s reaction function and allow for more contingent forward guidance. Instead, relying on the staff forecast distances FOMC participants from the assumptions underlying their policy choice and concentrates analysis at the center (the Board in Washington, DC), where those materials would be produced.

Chair Powell immediately broke in the new framework in the mountains of Jackson Hole. Contrary to its standard operating practice of signaling one meeting in advance, the FOMC was silent about future policy in its July statement. Chair Powell used his Jackson Hole remarks to settle matters, mostly.

The chair acknowledged that the dual mandate was pulled in opposite directions. Labor demand was soft, putting employment growth closer to a stall speed that increased downside risk, and the backup in consumer price inflation by July erased the progress of the first half of the year. In addition, more impetus from tariffs is coming. However, Powell offered the comforting possibility that, “A reasonable base case is that the effects will be relatively short lived — a one-time shift in the price level.”¹

In such circumstances, “...risks to inflation are tilted to the upside, and risks to employment to the downside.” He then applied the new framework: “When our goals are in tension like this, our framework calls for us to balance both sides of our dual mandate... with policy in restrictive territory, the baseline outlook and the shifting balance of risks may warrant adjusting our policy stance.”²

That latter signal opens the door to easing policy at the next meeting.

We expect the Fed to cut its policy rate 25 basis points (bps) at the September FOMC meeting. According to the latest SEP, they were headed in that direction, and concerns about employment should tip the balance. Indeed, two FOMC voters dissented in favor of easing at the July meeting before the latest payroll data, and that internal pressure could intensify if the Senate acts expeditiously on the nomination of Stephen Miran as governor.

This internal tension probably explains why Powell didn’t open the door to a rate cut more explicitly. He has some colleagues who are restive at that prospect (as was clear from the minutes of the July meeting),³ and he offered them the consolation that easing will go forward only absent upside surprises in employment and inflation for August. The quarterly publication of the SEP gives them another mechanism for compromise. We think that they will temper market enthusiasm about future cuts by plotting a shallow descent of the dots in the remainder of 2025 and 2026. That is, the September meeting will likely bring a “hawkish” cut that disappoints some in its size, just 25 bps, and more in the projected modest declines that follow.

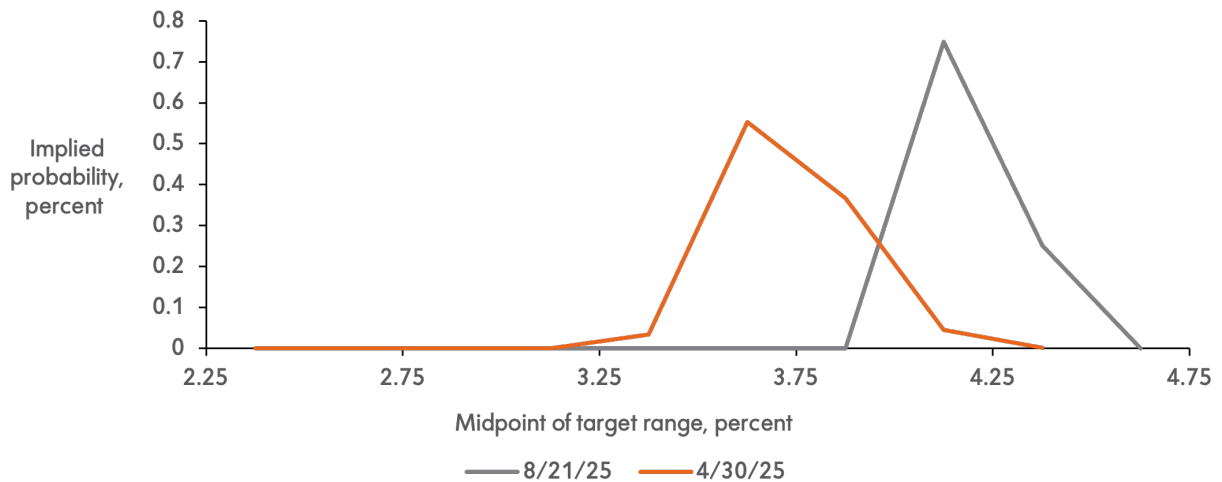
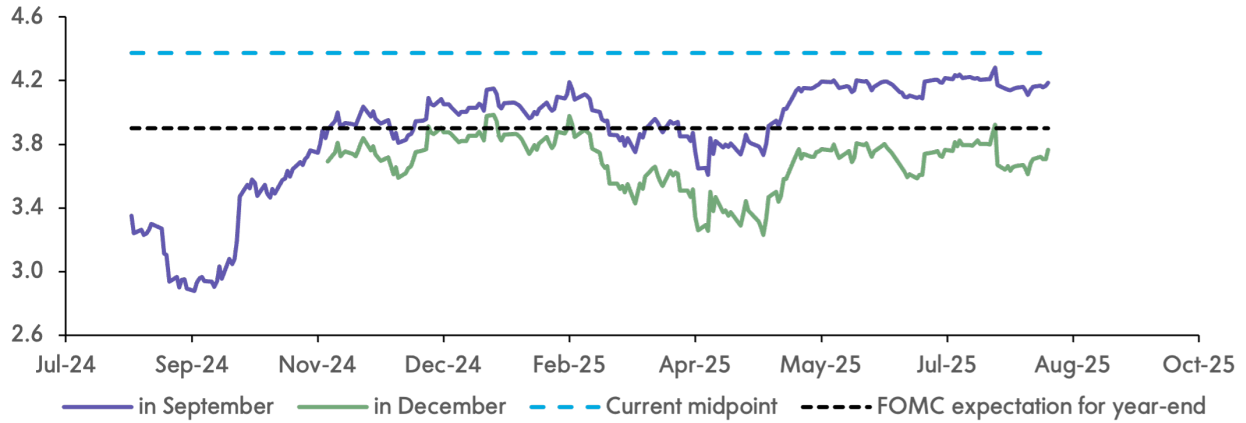
Market participants did not quite see it this way on the day the chair spoke. Financial market prices rallied sharply, and the policy-sensitive two-year Treasury yield shed 10 basis points (bps). However, the policy rate expected after the September meeting implied in futures market prices rose a bit (as in the purple line of the chart on the next page, Midpoint of FOMC Target). There was probably some disappointment that the chair did not endorse easing more enthusiastically and a worry that the data releases in early September might take a cut off the table. We think, however, those surprises would have to be significantly outsized to arrest the momentum rolling down the mountains of Jackson Hole.

The Fed tries to avoid surprising markets on FOMC day. If officials run true to form, expect subsequent nudges from Fed talk and authoritative media reports in the runup to the policy announcement on September 17 that make the decision to ease 25 bps on September 17 cut and dried.

We are also out of sync with financial markets for the rest of the year. Futures prices are consistent with roughly 2½ cuts of 25 bps by the FOMC meeting on December 10 (the green line in the chart on the next page), somewhat more than Fed guidance in the latest SEP. The rationale heard most often is that once the Fed starts cutting, it keeps on cutting. While that’s mostly true, we do not believe it is this time. Easing in September is not a pivot in policy. It is a continuation in removing policy restraint begun one year ago. The Fed is recalibrating the nominal funds rate in line with its durable progress in reducing underlying inflation on the assumption, to repeat the chair’s August 22 remarks that the effects of tariffs “...will be relatively short lived — a one-time shift in the price level.”

Midpoint of FOMC Target

Implied from 30-day interest rate futures, percent



Source: CME FedWatch Tool, Federal Reserve, Summary of Economic Projections (various), and firm analysis, retrieved 8/22/25. We apply the CME's estimates of implied probabilities of policy action to recover the midpoint of the target range. "SEP guidance" is taken as the entry for the year-end appropriate funds rate in the Summary of Economic Projections as on June 2025.

A sharp reset of policy may be in the cards if economic activity weakens materially, which is not our baseline forecast. Indeed, we don't share Powell's confidence that the effects of tariffs on prices will be orderly and well contained over the remainder of the year. That's why we think there's only a little better than even odds on one additional move, penciled in our forecast for December.



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Vincent is the firm's Chief Economist and Macro Strategist. In this role, he is responsible for developing views on the global economy and making relative value recommendations across global bond markets, currencies and sectors.

Previously, Vincent served as the Chief US Economist and a managing director at Morgan Stanley. For the prior four years, he was a resident scholar at the American Enterprise Institute (AEI). Vincent also spent 24 years at the Federal Reserve, holding several roles including Director of the Division of Monetary Affairs and Secretary and Economist of the Federal Open Market Committee (FOMC). His responsibilities at the Federal Reserve included directing research and analysis of monetary policy strategies and the conduct of policy through open market operations, discount window lending and reserve requirements. Prior to these roles, he was the principal liaison with the domestic desk at the Federal Reserve Bank of New York and was responsible for preparing a document outlining policy alternatives for each FOMC meeting. He was Deputy Director in the Division of International Finance and Associate Economist of the FOMC and spent five years at the Federal Reserve Bank of New York in both the domestic and international research departments.

His academic publications primarily concern the conduct of policy and issues related to the monetary transmission mechanism as well as an analysis of alternative auction techniques and Treasury debt management. After an undergraduate training at Fordham University, he received graduate degrees in economics at Columbia University.

Endnotes

¹ Powell, Jerome. "Monetary Policy and the Fed's Framework Review." Federal Reserve website, Aug. 22, 2025.

² Powell, Jerome. "Monetary Policy and the Fed's Framework Review." Federal Reserve website, Aug. 22, 2025.

³ Federal Open Market Committee. "Minutes of the Federal Open Market Committee." Federal Reserve website, July 29-30, 2025.

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