October 7, 2020

Raising the bar

The Fed moves to an average inflation target

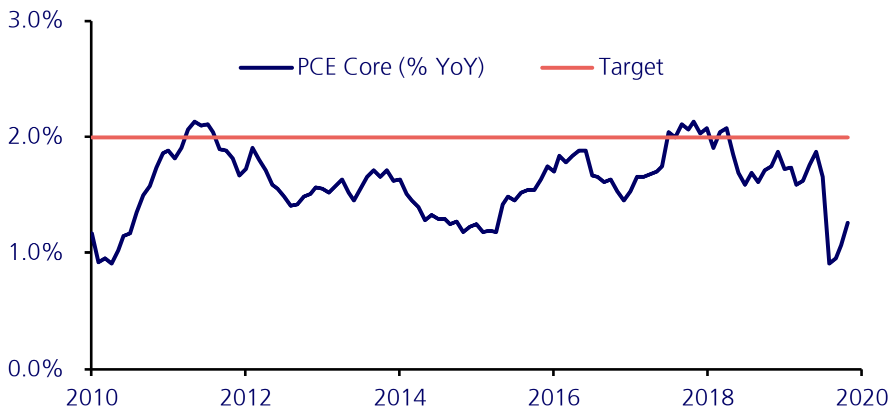
As the Fed's labour market objective of maximum employment is not a precise policy target, inflation will become the dominant factor for monetary policy. Although no new measures have been announced, the Federal Open Market Committee's (FOMC) commitment to keep rates on hold until inflation rises above 2% will have a profound impact on the Fed's future policy and rates are expected to remain low for longer.

Source: iStock

The Fed moves to an average inflation target

At this year's Jackson Hole Conference in August, the Fed announced its shift to an average inflation target. Further details around the new monetary framework were provided at its recent meeting in September. While the Fed did not immediately step up its efforts to reach the new inflation target the shift has nevertheless the potential to significantly alter its reaction function in the future. With the new framework the Fed intends to move away from pre-emptively hiking rates in reaction to reduced slack in the labour market. Instead, the Fed wants inflation to rise above 2% and stay there for some time before beginning to tighten its policy.

Inflation consistently undershoots the Fed's target



Source: Bloomberg

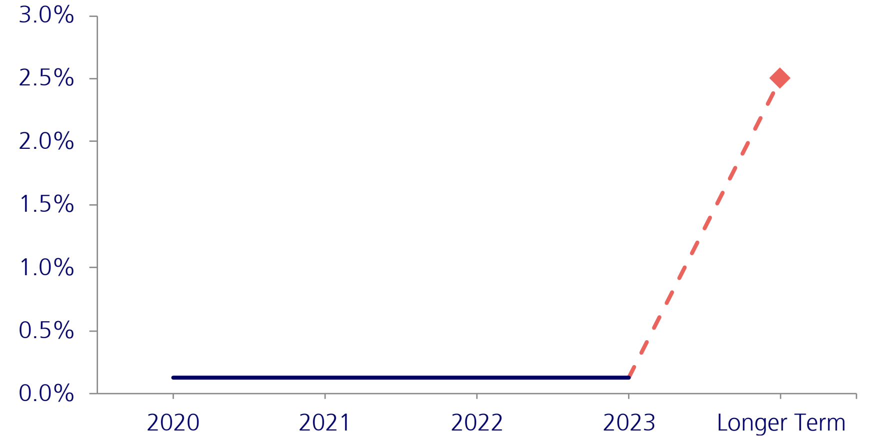
The Fed hardly ever reached its inflation target in the past decade

According to the Federal Reserve Act the Federal Open Market Committee (FOMC) shall maintain long-run growth of the monetary and credit aggregates to promote the goals of maximum employment, stable prices and moderate long-term interest rates. Given that immediately before the COVID-19 crisis the unemployment rate fell to the lowest level in more than fifty years one can certainly say that the Fed reached its objective with regard to the labour market. With regard to inflation, however, the Fed has hardly ever met its target of 2% over the past decade, calculated by the Personal Consumption Expenditure (PCE) Core Price Index, the Fed's preferred inflation measure. The average inflation rate over the past ten years was 1.6%, rising to 2% or higher for only about a tenth of the whole time period.

High inflation is bad, but inflation being too low can be problematic as well

History has repeatedly shown that inflation rates being too high is detrimental to an economy as it erodes away households' and businesses' purchasing power and can undermine trust in a currency. However, inflation being too low can also be harmful as it undermines a central bank's ability to push real interest rates down enough to revive

The Fed expects rates to stay low for several years



Source: Bloomberg, Fed

growth during a recession. In addition, constantly missing an inflation target may result in a central bank losing its credibility. If inflation expectations get anchored at a level that is considered too low, sub-target inflation rates could become self-fulfilling and reaching the target would then require even more aggressive measures.

The Fed wants to keep rates low for longer

It is in this below-target inflation environment that the Fed conducted its monetary policy framework review. Although the FOMC decided to keep the target range for the federal funds rate at 0% to 0.25%, the accompanying statement reveals the shift in focus and a crucial change in the Fed's policy approach. According to the statement, the FOMC expects that it will be appropriate to maintain the current target range until labour market conditions have reached levels consistent with the committee's assessments of maximum employment **and** inflation has risen to 2 percent **and** is on track to moderately exceed 2 percent for some time.

Maximum employment is not a precise policy objective

The new commitment underlines the Fed's willingness to keep rates at historically low levels until inflation has risen above the former target of 2%. Of the Fed's two main mandates the unemployment rate always seemed to have been the less binding constraint given the difficulty to precisely define the non-accelerating inflation rate of unemployment (NAIRU). Accordingly, the Fed was willing to let the unemployment rate fall significantly below what it believed to be the natural rate. In fact, Jerome Powell recently noted that the Fed's mandate of maximum employment cannot be reduced to a number the way inflation can, but that it comprises a broad range of factors.

The new framework and the announced focus on shortfalls from the maximum level of employment rather than deviations from it imply that the FOMC will put even more emphasis on reaching its inflation target. It acknowledges that the exact level of the NAIRU cannot be known in advance but is rather deduced from inflation's behaviour. As indicated by the constant shifting of the projected natural rate of unemployment, the Fed implicitly already put more emphasis on inflation in the past. However, the clear and explicit commitment now brings the Fed more in line with most other central banks, which generally focus on inflation (i.e. price stability) as their key mandate.

No new policy measures despite projected inflation below target

The fact that market-implied inflation expectations and longer-term yields hardly moved after the publication of the Fed's statement shows that investors were not surprised that the FOMC intends to remain on hold for a long time. The Fed did not announce any new measures in order to reach the average inflation target, but substantially increased its growth forecast for the current year. Interestingly, the Fed's latest economic projections still only see inflation rising back to 2% in 2023 which, accordingly, leads to the FOMC not seeing any rate hikes over that period. This, of course, hinges on inflation not surprising to the upside if, for example, price pressure increases more than expected due to a partial dismantling of global supply chains and a push for more local sourcing. Despite limited upside potential longer-term yields should start to anticipate higher average inflation in the future at some point.

Fed projections for inflation and unemployment almost never materialised at the same time in the past

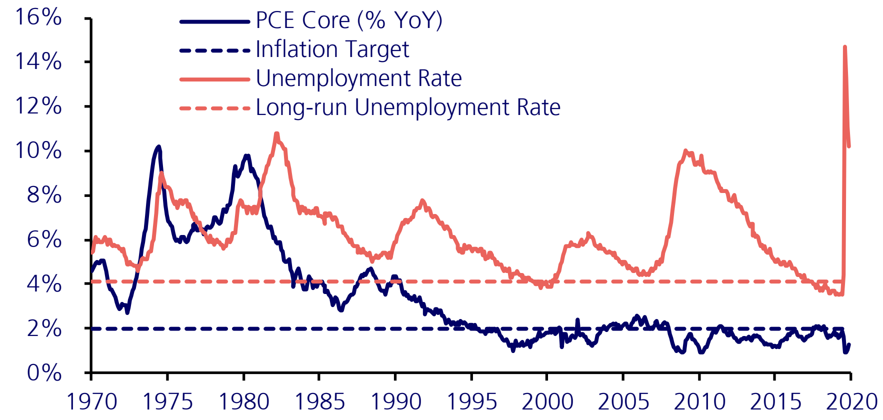
In the past, the FOMC started to raise rates when inflation was on the rise and expected to reach 2% over the forecast horizon, guided by unemployment falling below the perceived natural rate as indicated in the long-run projections.

Had the new policy already been in place a few years ago the Fed would most likely have refrained from hiking rates in 2015 and 2016 and potentially even until early 2018 when PCE Core inflation rose above 2% while the unemployment rate dropped to 4%. In fact, when inflation rose above 2% at the same time that the unemployment rate fell below the Fed's current estimate of the longer run neutral rate of unemployment for a period in 2018 it was a very rare occurrence - having never happened over the past fifty years.

Realised inflation becomes the dominant factor for monetary policy

That does not mean, of course, that the Fed would never have hiked rates in the past had the new framework already existed. As indicated above, the Fed's estimate of NAIRU is a moving target and has constantly been lowered over the past few years. The adjustment was necessary to acknowledge the fact that an ever lower unemployment rate did not significantly push up inflation. This is another way to say that the Philips Curve, which links unemployment and inflation (or rather unemployment and wages), has become too blunt a tool for monetary policy decisions. The Fed's flexibility regarding the NAIRU shows that inflation will be an even more decisive parameter for the FOMC's policy decisions going forward.

Reaching both targets at the same time hardly ever happens



Source: Bloomberg

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