September 7, 2020

The Federal Reserve changes the rules

At the latest Fed meeting, Jay Powell confirmed
that the Fed was prepared to tolerate higher inflation as it steers the economy through the aftermath of the coronavirus pandemic. He also announced major shifts in how the central bank guides the economy, signalling it will make job growth pre-eminent and will not raise interest rates to guard against coming inflation just because the unemployment rate is low.

In emphasizing the importance of a strong labour market and the tolerance of faster price gains, Mr Powell laid the groundwork for years of low interest rates which could translate into long periods of cheap mortgages and business loans that foster strong demand and a solid job market.

The central bank is formally shifting its inflation approach, aiming to average 2% inflation over time, rather than as an absolute goal. In doing so, the Fed is trying to convince the public and investors that it will also allow prices to rise a little bit faster. Higher inflation may seem like an odd goal to anyone who buys groceries or pays rent, but excessively weak prices and weak gains can actually have damaging effects on the economy. A circle of stagnation has played out in countries including Japan, in which lower price gains leave less room to cut rates, limiting policymakers' ability to stimulate the economy and revive inflation.

But by establishing the new rules, several questions and criticism were raised:

FIRSTLY, WHILE THE FED HAS DEMONSTRATED IMMENSE POWER TO MOVE MARKETS AND ASSET PRICES OVER THE LAST DECADE, IT HAS SHOWN NO SIMILAR POWER OVER THE ECONOMY; SO WHY WOULD IT BE DIFFERENT THIS TIME AROUND?

Its conventional tools are no longer enough to push inflation permanently above 2%. As the Fed has not yet revealed the details on how inflation could be coaxed above 2%, investors rightly believe that it will simply be more dovish than before. It is doubtful that this alone will steer inflation above 2%.

SECONDLY, WHAT WILL THIS NEW SHIFT RESULT IN LONGER TERM?

Over years, the Fed's argument was that the persistence of low inflation is consistent with low unemployment. In reality,

inflation has remained sub-2% because the Fed's policies have failed to stimulate a persistent increase in nominal GDP above productive capacity, so that, with little excess demand, there is only a modest inflation. But will the Fed's ultra-easy policies actually stimulate accelerating economic activity, or just pump up asset prices and make the stock market happy?

In our opinion in longer term, the Fed's new shift is a commitment to liquidity supports, supportive of stronger stocks, and a weaker dollar (which will also be beneficial to the emerging markets). The new Fed framework is expected to allow the US yield curve to steepen. The jury is still out on that perspective. With the Fed more tolerant on potential inflation overshoots, short-term rates are going to be anchored at low levels for longer, potentially constraining upward moves in long rates. A continued flat yield curve and low rates will probably prolong current trends within the stock market, with financial shares being clobbered, and growth beating value.

Lastly, is this shift open the door to political interference?

For most economist that have been working with inflation targeting as a monetary policy framework, the recent policy shift by the US Federal Reserve to using an average of past inflation rates as the target, is sensible.

Despite the announcement of an inflation target, it is true that most central banks have kept an eye on past and expected future inflation rates in setting interest rates. The recent announcement makes this official but avoids announcing the averaging period explicitly, reducing transparency, which was one the objectives of the inflation targeting framework.

Nevertheless, averaging of inflation rates may

also allow for a shift in the inflation transmission mechanism, with the resulting uncertainty in the leads and lags between tight labour markets and wage inflation and tight product markets and product price inflation. Against this backdrop, the new framework of using averages sensibly gives more room for judgment in policymaking and political interference.

Food for thought...

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