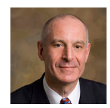
Fed Moves to Average Inflation Targeting

New policy framework effectively prioritizes maximum employment.

September 2020



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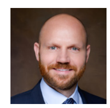

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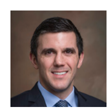

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KEY INSIGHTS

- The Federal Reserve's new monetary policy framework shifts the balance of its "dual mandate" toward full employment and away from low inflation.
- The Fed has made explicit its commitment to allow inflation to drift above its 2% target as it seeks to compensate for "undershoots" with "overshoots."
- The changes are likely to support markets, but investors still await a stronger commitment to a particular rule or formula governing inflation targeting.

Federal Reserve Chair Jerome Powell delivered a speech on August 27 summarizing the results of the central bank's review of its monetary policy framework and announcing that the Fed will adjust its inflation targeting to allow moderate overshoots of its 2% inflation goal to offset undershoots of the target. This change effectively means that policymakers will not tighten monetary policy until they are convinced that inflation can sustainably stay above the target and that employment gains have been robust and inclusive of the middle- and lower-income demographic segments. We view the change as supportive for risk assets, including corporate credit and stocks, but a test of the Fed's willingness to permit inflation over 2% is probably years away.

It's important to note that inflation averaging around the 2% goal is an aspiration, not a commitment to conduct monetary policy tethered to any particular formula or rule, and the strength of this aspiration is uncertain. The Fed plans to review its monetary policy framework approximately every five years and could make meaningful adjustments to its goals and practices going forward.

Larger Emphasis on Employment

There will be a larger emphasis on the employment side of the Fed's mandate rather than on inflation, with the framework of employment as a "broad based and inclusive goal." The Federal Open Market Committee (FOMC) policy framework statement also replaced references to "deviations" from maximum employment when determining monetary policy with "shortfalls," acknowledging that shortfalls are likely to persist for at least the next few years.

More broadly, the language change is meant to convey policymakers' diminished confidence in their

2%

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assessments of maximum employment, which in the past was often referred to as the non-accelerating inflation rate of unemployment (NAIRU). Effectively, Fed policymakers are putting their models to the side and waiting for actual higher inflation data to consistently appear prior to taking any actions that may tighten financial conditions. This would prevent the Fed from preemptively tightening monetary policy when the unemployment rate reaches NAIRU, as it did in late 2016.

The FOMC has never had an explicit employment target. However, along with noting that they will now allow an overshoot on inflation with no formulaic approach, policymakers have also given themselves a wide range of employment indicators to use for evaluating whether they've achieved their now more influential employment mandate.

Asymmetric Monetary Policy Capacities

In the current environment of low-equilibrium real interest rates, monetary policy capacities are asymmetric: While there is unlimited scope for policy restraint via higher rates, the effective lower bound of 0% limits the space for rate cuts. As a result, it is structurally more difficult for the Fed to limit inflation undershoots than to cap overshoots. In this context, the Fed's previous inflation target was bound to yield average inflation of less than 2%.

Even if market participants saw the 2% objective as both a ceiling and a floor, in practice, monetary policy can enforce the former more strictly than the latter. The result would be an anchoring of inflation expectations below 2%—which could contribute to a downward spiral in actual inflation and nominal (inflation-adjusted) interest rates, and room to lower rates before reaching the effective lower bound. In order to anchor longer-term inflation expectations at 2%, the FOMC now explicitly seeks to achieve inflation that averages 2%. As a practical matter, this means that the Fed will now allow moderate overshoots of the 2% goal to make up for undershoots.

Financial Stability

While the Fed has no shortage of measures to bring inflation overshoots down, the question remains whether this can be accomplished without triggering high levels of volatility in financial markets. Thus, in tandem with making explicit a more dovish approach to monetary policy, the FOMC's increased emphasis on financial stability in the revised policy framework reflects the backdrop against which the central bank now pursues its dual mandate objectives of full employment and price stability. In his speech, Powell pointed out that the recent series of economic expansions that have been unusually long have ended not because of rising inflation, but due to financial instability, which prompted the Fed to try to strengthen the financial system. This is not to say that achieving a moderate, late-cycle inflation overshoot would obviate financial stability risks, as raising rates to simultaneously sanction and smooth an inflation overshoot would be a delicate task. The first inflation-induced tightening cycle since the late 1980s could be disruptive to financial markets and, in turn, the real economy.

Economic Implication: Spread the Benefits of a Strong Labor Market

The broad economic implication of the Fed's policy framework change is that it will allow a little overheating to spread the benefits of a strong labor market as broadly as possible. While policy will still be forward-looking, it will be less so as far as inflation is concerned. The burden of proof for impeding labor market improvement is higher with a more tolerant approach to inflation symmetry. The asymmetry in policy capacity described above means that there is less risk in allowing inflation to demonstrate overshooting than there is in acting to thwart an anticipated overshoot that never arises.

We see the monetary policy framework adjustments as increasing the chances of a longer-running expansion and lowering the odds of a slowdown induced by monetary policy. At least at the margin, this is supportive for equities and credit, as well as Treasuries. However, the overall shorter-term impacts of the FOMC's changes are likely limited unless the Fed makes a stronger commitment to a particular rule or formula governing inflation targeting. In addition, we anticipate that it will be years before inflation reaches 2%, testing the new policy toward inflation averaging.

WHAT WE'RE WATCHING NEXT

We will be closely analyzing the FOMC's Summary of Economic Projections, which presents data on policymakers' individual forecasts for economic growth, inflation, unemployment, and the federal funds rate in future years. The September 16 update will extend the forecast horizon by one year, to 2023. Unchanged policy rates alongside a rising inflation profile would help convey the Fed's commitment to allowing a cyclical inflation overshoot.

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ID0003603 (09/2020)
202009-1326098