Fed’s inflation discussion

There is a lot of discussion about how, or indeed whether to change the Fed's inflation target - much of this leans in exactly the wrong direction.

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Will somebody stop them!

There is a bit of chat on the newswires today following the Fed minutes overnight - though they don't particularly challenge our house view that we will see another rate cut in October, even if the subsequent December cut may require clearing some higher hurdles.

Greater prominence is given to discussion about the Fed's longer-term strategy for monetary policy, and it is on this that I will focus today.

Some years back (I think it may have been 2012, when this note was published), the US Federal Reserve supplemented its dual targets (already an odd concept) for maximum employment and price stability, by adding an explicit goal to that price stability target. That was PCE inflation of 2%. There has since been a bit of flux over whether or not it is the core rate or the headline rate that they target. Officially, it is the headline, but the core seems to be substituted when it suits them, and I see nothing particularly wrong with that.

The Fed's current discussion on monetary policy (and other central banks facing similar issues) is driven by the concern that in the next downswing, they may once again be faced with having to cut interest rates to zero, or re-adopt unorthodox monetary policies. Meanwhile, they continue to fret that they are missing their 2% inflation target. In their minds, it seems that missing this target raises the probability of the next downturn, and so they are considering efforts to push inflation up, as a means to avoiding that outcome.

This is **entirely** the wrong approach in my view.

Yesterday, I slated a BIS paper on unconventional monetary policy, which seemed to indicate that such unorthodox policies were, by and large, OK, albeit with some minor financial wrinkles to try to minimize. Quite by accident, I also came across a working paper by another group within the BIS called "Monetary policy hysteresis and the financial cycle" , which models an economy with bank financing (realistic but unusual) and drew highly plausible conclusions that low rates beget further low rates. In other words, their model describes the world we live in, where the pursuit of the unattainable with low rates leads to financial distortions, crises, and then even lower rates. It is a pattern that has been repeated since LTCM, the savings and loan crisis, dotcom boom and bust and most recently the global financial crisis. We seem to have learned nothing from each cycle and are trying to repeat it again now. If there is concern that rates now are low, the reason for this is that they were far too low in previous cycles. Cutting them further now merely buys some time before the next lurch down, and even lower rates.

The basic problem is that modern central banks have made the inflation target an **ultimate** goal when it was only ever an **intermediate** goal. There was a time when a monetary policy stance consistent with an economy running fast enough to generate 2% inflation, would also generate sufficient jobs to lead to full employment. It would also allow for credit growth sufficient to allow asset prices of all sorts to grow and "net" wealth to grow consistent with accumulated nominal GDP growth (the economy's P&L account). The inflation target was **not** the goal itself, the other elements were, but hitting the inflation target, on average, would help deliver those other goals.

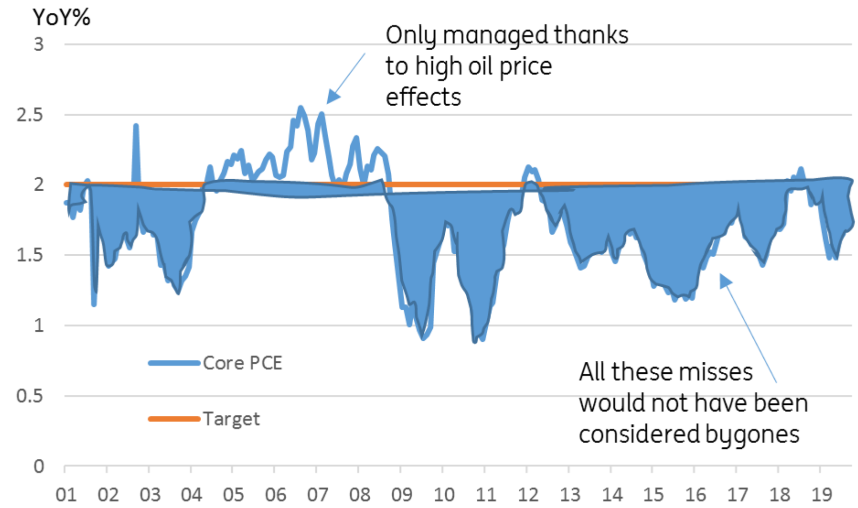
Practice makes imperfect

Even so, in the 225 months since January 2000, the US PCE has met, or exceeded 2% in only 88 months. That is less than 40% of the time. The proportion is considerably less (less than 30%) if we use the core PCE, as most of these increases occurred between 2004 and 2008, when oil prices soared to $140/bbl from about $30/bbl. This doesn't mean that monetary poilicy was too tight - merely that the target was the wrong number.

Using the core PCE deflator, the sum of the annual inflation misses over the period since January 2000 has been more than 5 percentage points. According to a view encouraged by the Fed's Richard Clarida, when the Fed misses its target, it should not consider this a "bygone" as it currently does, but instead, try to make up for that loss. For a policy that met the inflation target on average but missed it randomly, this might entail far more, smaller adjustments, and it is not clear that this would deliver a more stable inflation outcome, or instead, add greater volatility.

But when inflation regularly undershoots the inflation target, as it has done since before even the current target was adopted, then this implies running an even looser monetary policy on average. That means we would have had even easier monetary policy before every bubble since we would have been making up for missed targets earlier, and most likely, more negative rates afterwards, as the burst bubbles would have been even more severe. In other words, it sounds a lot like the model paper I mentioned earlier. Do please give it a read.

US Core PCE and inflation target



Source: ING

Focus on the goal, not the journey

If we instead focus on the ultimate targets, like the unemployment rate, which in the US is now at 3.5%, considerably below the 4.4% rate the Fed considered "full employment" back in 2012, the Fed's job would be done. There would be nothing to worry about. And in the process, it would be less likely that we would once again embark on a journey that will take us down the QE route, or negative interest rates, pushing up all asset prices and resulting in negative yields along yield curves, with all that these distortions entail.

In short, I am very concerned that the Fed and ECB and other central banks seem to be heading in entirely the wrong direction. I'm not even sure how they pull themselves back from here to a less dangerous policy mix. Raising rates is not the answer. The answer would have been not to run them so low in the past, but we can't undo history, even if we do seem doomed to keep repeating it.

Trade - not looking good

The prize for some sort of trade deal today - no matter how trivial - will be to avoid the implementation of further tariffs, now due to land on October 15 and December 15. There are conflicting reports over how the talks are poised to go, with the South China Morning post reportedly suggesting the Chinese negotiators would fly back already tonight (I don't think this is new news), while Chinese state media are apparently taking a more upbeat tone.

I think that a "nothing achieved" outcome from today's talks would return markets to a risk-off mode fairly quickly, with USDCNY potentially pushing up, as US Treasury yields dropped down to begin a new downleg and possibly drop below the September lows.

Brext deal - not looking good either

UK PM Johnson will meet the Irish Prime Minister for lunch today in what is looking like an increasingly desperate attempt to secure a deal. Recent news of widescale Conservative defections if the party campaigned on a no-deal ticket in a forthcoming election may have encouraged

Johnson to look for any vestige of compromise that he could take to Parliament and hold up as an improvement on the Theresa May package. I'm not hopeful that such improvement exists. The outlook for the GBP does not look rosy.

Calendar for today - fairly quiet

China's money supply and lending data, which we thought might come out yesterday now look as if they will be released today. The calendar has already given us very weak Japanese core machine orders (August fell 14.5%YoY), and some soft looking Australian home loans data (0.7%MoM ion August). We may need to review our RBA view to allow for further easing (that doesn't mean we endorse it!).

In the G7, US inflation data is the top billing for the day. Core inflation on a CPI basis is 2.4%, and is expected to stay there. On this measure (which is what most other central banks target) the Fed has not only achieved its target, but strayed a bit beyond it...just saying...

Author

Amrita Naik Nimbalkar
Junior Economist, Global Macro
amrita.naik.nimbalkar@ing.com

Mateusz Sutowicz
Senior Economist, Poland
mateusz.sutowicz@ing.pl

Alissa Lefebre
Economist
alissa.lefebre@ing.com

Deepali Bhargava
Regional Head of Research, Asia-Pacific
Deepali.Bhargava@ing.com

Ruben Dewitte
Economist
+32495364780
ruben.dewitte@ing.com

Kinga Havasi
Economic research trainee
kinga.havasi@ing.com

Marten van Garderen
Consumer Economist, Netherlands
marten.van.garderen@ing.com

David Havrlant
Chief Economist, Czech Republic

420 770 321 486
david.havrlant@ing.com

Sander Burgers
Senior Economist, Dutch Housing
sander.burgers@ing.com

Lynn Song
Chief Economist, Greater China
lynn.song@asia.ing.com

Michiel Tukker
Senior European Rates Strategist
michiel.tukker@ing.com

Michal Rubaszek
Senior Economist, Poland
michal.rubaszek@ing.pl

This is a test author

Stefan Posea
Economist, Romania
tiberiu-stefan.posea@ing.com

Marine Leleux
Sector Strategist, Financials
marine.leleux2@ing.com

Jesse Norcross
Senior Sector Strategist, Real Estate
jesse.norcross@ing.com

Teise Stellema
Research Assistant, Energy Transition
teise.stellema@ing.com

Diederik Stadig
Sector Economist, TMT & Healthcare
diederik.stadig@ing.com

Diogo Gouveia
Sector Economist
diogo.duarte.vieira.de.gouveia@ing.com

Marine Leleux
Sector Strategist, Financials

marine.leleux2@ing.com

Ewa Manthey
Commodities Strategist
ewa.manthey@ing.com

ING Analysts

James Wilson
EM Sovereign Strategist
James.wilson@ing.com

Sophie Smith
Digital Editor
sophie.smith@ing.com

Frantisek Taborsky
EMEA FX & FI Strategist
frantisek.taborsky@ing.com

Adam Antoniak
Senior Economist, Poland
adam.antoniak@ing.pl

Min Joo Kang
Senior Economist, South Korea and Japan
min.joo.kang@asia.ing.com

Coco Zhang
ESG Research
coco.zhang@ing.com

Jan Frederik Slijkerman
Senior Sector Strategist, TMT
jan.frederik.slijkerman@ing.com

Katinka Jongkind
Senior Economist, Services and Leisure
Katinka.Jongkind@ing.com

Marina Le Blanc
Sector Strategist, Financials
Marina.Le.Blanc@ing.com

Samuel Abettan
Junior Economist
samuel.abettan@ing.com

Franziska Biehl
Senior Economist, Germany
Franziska.Marie.Biehl@ing.de

Rebecca Byrne
Senior Editor and Supervisory Analyst
rebecca.byrne@ing.com

Mirjam Bani
Sector Economist, Commercial Real Estate & Public Sector (Netherlands)
mirjam.bani@ing.com

Timothy Rahill
Credit Strategist
timothy.rahill@ing.com

Leszek Kasek
Senior Economist, Poland
leszek.kasek@ing.pl

Oleksiy Soroka, CFA
Senior High Yield Credit Strategist
oleksiy.soroka@ing.com

Antoine Bouvet
Head of European Rates Strategy
antoine.bouvet@ing.com

Jeroen van den Broek
Global Head of Sector Research
jeroen.van.den.broek@ing.com

Edse Dantuma
Senior Sector Economist, Industry and Healthcare
edse.dantuma@ing.com

Francesco Pesole
FX Strategist
francesco.pesole@ing.com

Rico Luman
Senior Sector Economist, Transport and Logistics
Rico.Luman@ing.com

Jurjen Witteveen
Sector Economist
jurjen.witteveen@ing.com

Dmitry Dolgin
Chief Economist, CIS
dmitry.dolgin@ing.de

Nicholas Mapa
Senior Economist, Philippines
nicholas.antonio.mapa@asia.ing.com

Egor Fedorov
Senior Credit Analyst
egor.fedorov@ing.com

Sebastian Franke
Consumer Economist
sebastian.franke@ing.de

Gerben Hieminga
Senior Sector Economist, Energy
gerben.hieminga@ing.com

Nadège Tillier
Head of Corporates Sector Strategy
nadege.tillier@ing.com

Charlotte de Montpellier
Senior Economist, France and Switzerland
charlotte.de.montpellier@ing.com

Laura Straeter
Behavioural Scientist
+31(0)611172684
laura.Straeter@ing.com

Valentin Tataru
Chief Economist, Romania
valentin.tataru@ing.com

James Smith
Developed Markets Economist, UK
james.smith@ing.com

Suvi Platerink Kosonen
Senior Sector Strategist, Financials
suvi.platerink-kosonen@ing.com

Thijs Geijer
Senior Sector Economist, Food & Agri
thijs.geijer@ing.com

Maurice van Sante
Senior Economist Construction & Team Lead Sectors
maurice.van.sante@ing.com

Marcel Klok
Senior Economist, Netherlands
marcel.klok@ing.com

Piotr Poplawski
Senior Economist, Poland
piotr.poplawski@ing.pl

Paolo Pizzoli
Senior Economist, Italy, Greece
paolo.pizzoli@ing.com

Marieke Blom
Chief Economist and Global Head of Research
marieke.blom@ing.com

Raoul Leering
Senior Macro Economist
raoul.leering@ing.com

Maarten Leen
Head of Global IFRS9 ME Scenarios
maarten.leen@ing.com

Maureen Schuller
Head of Financials Sector Strategy
Maureen.Schuller@ing.com

Warren Patterson
Head of Commodities Strategy
Warren.Patterson@asia.ing.com

Rafal Benecki
Chief Economist, Poland
rafal.benecki@ing.pl

Philippe Ledent
Senior Economist, Belgium, Luxembourg
philippe.ledent@ing.com

Peter Virovacz
Senior Economist, Hungary
peter.virovacz@ing.com

Inga Fechner
Senior Economist, Germany, Global Trade
inga.fechner@ing.de

Dimitry Fleming
Senior Data Analyst, Netherlands
Dimitry.Fleming@ing.com

Ciprian Dascalu
Chief Economist, Romania
+40 31 406 8990
ciprian.dascalu@ing.com

Muhammet Mercan
Chief Economist, Turkey
muhammet.mercan@ingbank.com.tr

Iris Pang
Chief Economist, Greater China
iris.pang@asia.ing.com

Sophie Freeman
Writer, Group Research
+44 20 7767 6209
Sophie.Freeman@uk.ing.com

Padhraic Garvey, CFA
Regional Head of Research, Americas
padhraic.garvey@ing.com

James Knightley
Chief International Economist, US
james.knightley@ing.com

Tim Condon
Asia Chief Economist
+65 6232-6020

Martin van Vliet
Senior Interest Rate Strategist
+31 20 563 8801
martin.van.vliet@ing.com

Karol Pogorzelski
Senior Economist, Poland
Karol.Pogorzelski@ing.pl

Carsten Brzeski

Global Head of Macro
carsten.brzeski@ing.de

Viraj Patel
Foreign Exchange Strategist
+44 20 7767 6405
viraj.patel@ing.com

Owen Thomas
Global Head of Editorial Content
+44 (0) 207 767 5331
owen.thomas@ing.com

Bert Colijn
Chief Economist, Netherlands
bert.colijn@ing.com

Peter Vanden Houte
Chief Economist, Belgium, Luxembourg, Eurozone
peter.vandenhoute@ing.com

Benjamin Schroeder
Senior Rates Strategist
benjamin.schroder@ing.com

Chris Turner
Global Head of Markets and Regional Head of Research for UK & CEE
chris.turner@ing.com

Gustavo Rangel
Chief Economist, LATAM
+1 646 424 6464
gustavo.rangel@ing.com

Carlo Cocuzzo
Economist, Digital Finance
+44 20 7767 5306
carlo.cocuzzo@ing.com