

## Phoney inflation war

This week, markets in Asia and elsewhere will react to the latest hints from the US Fed about how they will deal with sub-target inflation. This obsession with inflation is becoming tiresome



Federal Reserve

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### Headline inflation in the US is 1.7%

Last Friday, the US released its August inflation figures. The month-on-month change came in higher than expected at 0.4% taking the headline rate of inflation to 1.7%. You might well ask, so what's the big deal (which would not be a stupid question)? In fact, the Fed prefers to target a broader measure of inflation called the personal consumer expenditure deflator (PCE). In July, this was running at only 1.0%, a full 0.6pp lower than the equivalent July headline CPI.

That said, most countries use a headline or core CPI as their target, not some local version of PCE, begging several questions. Firstly, does this mean on average, and on a comparative basis, that the Fed is already targeting a higher rate of (equivalent) CPI inflation (it would certainly seem so), and therefore also, what is the "right" inflation target anyway? That last question almost never gets asked, but it is a pertinent one because if you target an inflation rate using interest rates, the residual of that outcome is credit growth, which affects things like asset prices. Get that wrong, and you end up with an asset price bubble, and eventually a bust. That is what worries me and a number of other commentators, but seemingly does not worry any central banks, who keep plugging away at the same old formula.

Another way of doing this, for a central bank, would be to target an appropriate rate of credit growth by setting interest rates and letting inflation vary as the residual. Absent structural shocks to the economy, that should deliver an appropriate credit growth although inflation might fluctuate a bit below or a bit above current target levels, it really doesn't matter - just as it doesn't really matter where you target inflation in an inflation-setting regime, so long as you target a rate you can *actually* achieve - which currently, doesn't seem to be the case for many central banks. Importantly, switching the target of policy, but leaving the policy lever unchanged, would considerably reduce the risk of inappropriate and unsustainable credit flows to asset markets, which have dominated the last number of decades.

Last Friday, despite the higher than anticipated inflation figures, US 10Y Treasury yields fell slightly, perhaps because markets are looking forward to some more soothing words from the Fed this week. This week's Fed meeting is [written up in much greater detail here by James Knightley](#). But interestingly, since his Jackson Hole speech hinting at average inflation rate targeting (an irritating irrelevance in my opinion), a number of FOMC members have suggested that they don't see any great need for changing the Fed's strategy any time soon. I don't really agree with them, I think the strategy needs a radical overhaul, but I would agree that what seems to be being suggested now is not only not necessary, but finessing a policy that is already inherently unsustainable. Moreover, it comes against a backdrop where low-inflation, at least on some measures, is looking less of a problem that it has done for a while, and certainly not a problem that needs addressing with even more accommodation.

## Asia Day ahead

It's a quiet day in Asia for economic releases. Prakash Sakpal has this to add on India's inflation numbers. "India's August CPI and WPI inflation data are due today. The Covid-19 supply shock to food prices and administrative hikes in fuel prices drove CPI inflation above the central bank's (Reserve Bank of India) 6% policy limit in April, which is where it has been since, including the 6.9% recorded in July. We believe there was no let-up in price pressure in August; our CPI inflation forecast for the month is 7.1%. The forecast for WPI inflation is -0.2%, up from -0.6% in July. We believe the RBI is done with its policy easing in this cycle. The next move in policy rates will be upward, though not in the foreseeable future as the worsening Covid-19 situation will delay economic recovery".

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