GLOBAL MACRO PERSPECTIVES

THE FED'S CREDIBILITY PROBLEM

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- **The Fed's new reaction function is the acknowledgment of a surprising problem: the central bank's credibility is too high.**
- **Fed policymakers' track record of keeping inflation not just low but below its own target has complicated efforts to stimulate the economy.**
- **We're not convinced that the new reaction function solves the problem. The Fed's prioritization of flexibility above all else in setting monetary policy leaves its future policy choices subject to interpretation, limiting the impact of the changes it has made.**
- **The result: the Fed won't be able to achieve its objectives on its own, so fiscal policy has become the most important macroeconomic lever.**

Over the past decade, pundits and Fed watchers have frequently worried that the central bank's policy choices would reduce its credibility. Zero interest rates and quantitative easing (QE), many feared, would lead to a collapsing dollar, spiking inflation and broad economic instability, undoing the good work the Fed had done in the past 30 years.

Of course, the opposite has happened. Despite moving further and further into "unconventional" monetary policy tools, Fed policy has contributed to the longest postwar economic expansion on record—brought to a halt only by the COVID-19 pandemic earlier this year. In the aftermath of this year's crisis, however, it has become apparent that the Fed's success over the past decade has complicated its efforts to meet its objectives today. Simply put, in an environment in which higher inflation is a desirable macroeconomic goal, the Fed's track record of keeping prices in check has made it much more difficult to push them higher now. The market simply doesn't believe that the Fed will allow prices to move higher, even though higher prices are precisely what the Fed wants.

Why Higher Inflation is Needed

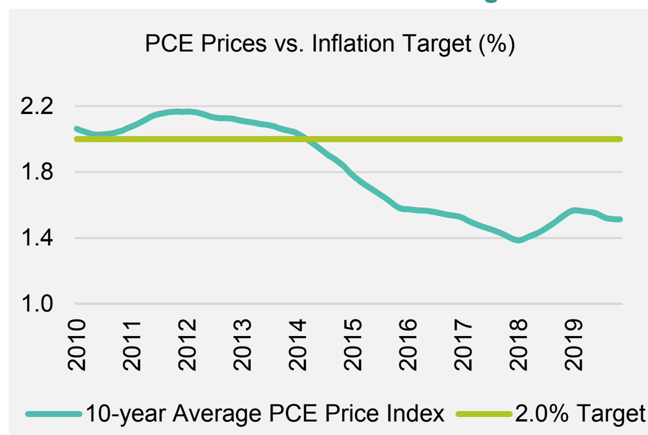
It may seem counterintuitive for a central bank tasked with price stability to pursue higher inflation. Yet that's exactly what's needed in the current environment. From a monetary policy perspective, higher inflation would help the Fed provide more support to the US economy. To understand why this is the case, it's worth reviewing the conventional understanding of how monetary policy works.

Monetary policy's impact is transmitted to the economy through the real interest rate—the difference between the nominal interest rate and the expected inflation rate. When the economy is weak, the Fed lowers the nominal target rate to push real rates lower; when the economy is strong, it does the opposite. Lower real interest rates encourage borrowing and investment because the rate of return on investments has a lower hurdle to clear before becoming profitable.

Of course, moving the nominal rate changes the real rate only if inflation expectations are stable. If inflation expectations change, the real rate moves, too—and that's exactly what has happened. Over the past decade, the Fed has been too successful at keeping inflation at bay. Based on the central bank's preferred measure (the price index for personal consumption expenditures), inflation has averaged roughly 1.5%, about 0.5% below the 2.0% target, and has been above 2.5% less than 10% of the time).

It's no coincidence that market-based measures of inflation expectations have fallen by about 0.5% over that same period. That puts real interest rates 50 basis points (b.p.) higher today than they would have been—essentially, monetary policy is 50 b.p. tighter than it would have been a decade ago in the same circumstances. That restrains growth, a cost that the Fed faces for having been too effective at keeping inflation low.

US Inflation Has Been Well Below Target

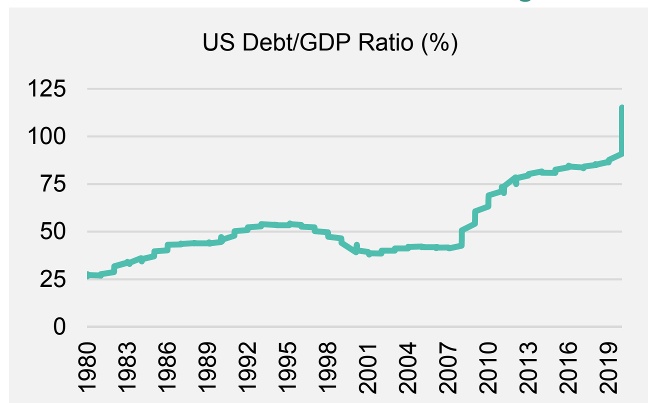


Through September 30, 2020
PCE = personal consumption expenditures
Source: Refinitiv Datastream

Historically, that cost might not have been very significant: the Fed could simply lower interest rates to bring real interest rates back to the desired level of policy accommodation. That's not possible in today's world, of course, with the policy rate already at zero and rates below 75 b.p. for maturities out to 10 years. Unless the Fed wants to experiment with negative interest rates (and there are good reasons why it doesn't), nominal rates will stay where they are, and the only way to add stimulus—to reduce real interest rates—is to push inflation expectations up. The best way to do that? Push *actual* inflation higher.

A secondary rationale for targeting higher inflation, though one that the Fed is less willing to admit, is the rising government debt burden. Inflation makes servicing debt easier: debt payments are fixed, but government revenues are flexible; and higher inflation would mean more revenue. Inflation acts as a hidden tax on savers and lenders and is a hidden subsidy to borrowers. The federal government, as we know, is the biggest borrower of all.

The Government Debt Burden Is Growing



Through September 30, 2020
Source: Refinitiv Datastream

Fed chair Jerome Powell has repeatedly indicated that he believes that more fiscal spending is needed; he and the rest of the Fed are well aware that rising rates would quickly put government finances on an unsustainable trajectory. The Fed might not want to admit that it's explicitly enabling government borrowing; but in practice, its policy choices, including the push for higher inflation, are doing just that.

Changing the Framework

The combination of low inflation, low inflation expectations, rising government debt and an inflexible policy rate poses a steep challenge. In response, the Fed recently announced changes to its monetary policy framework. The 2.0% inflation target remains, but the Fed has changed how it interprets that target.

The new regime focuses on average inflation targeting: instead of aiming for 2.0% at every forward point, the central bank is instead striving for 2.0% average inflation *over time*. Because we know that inflation will likely fall short of that target in bad times, it naturally follows that the Fed wants inflation above 2.0% in economic expansions. The changes have also severed the intellectual link between employment and inflation. In past cycles, the Fed has viewed a strong labor market as enough reason to raise interest rates. That's because its theoretical framework suggested that low unemployment would eventually translate to higher inflation.

Now, however, the Federal Open Market Committee (FOMC) indicates that a strong labor market is a necessary but not sufficient reason to consider raising rates. The committee is no longer willing to raise rates based on an *expectation* of inflation—tangible price pressures will need to emerge before rate hikes come back onto the table. This shift is important: if today's framework had been in place during the last cycle, it's very likely that the Fed wouldn't have embarked on a tightening cycle from 2015 to 2018.

From Theory to Practice

How do these policy changes affect the way we should interpret the Fed today? The most obvious implication is that we shouldn't expect higher rates anytime soon. Inflation is well below the Fed's target and has been for some time. It's likely to take several years before inflation averages 2.0% for more than a few months at a time.

Financial markets have already incorporated this information into their inflation expectations. The Treasury yield curve is consistent with the assumption of the policy rate remaining at zero for the foreseeable future—and very low for a long time after that. This acknowledgment should, in theory, push inflation expectations higher as the market digests the idea that the Fed won't respond in this cycle as it has in past cycles.

Other central banks may aid the Fed in its efforts: many of its peers are also grappling with similar problems and have taken similar steps. Those that haven't seem likely to follow the Fed in the coming months. If markets come to understand that most central banks are committed to an

inflation overshoot, it may help alleviate some of the global forces that are holding inflation down.

A Job Half Done

The Fed may have changed its inflation framework, but inflation expectations have barely budged. In our view, the main issue is that the Fed has done only half the job—it has revealed that it wants higher inflation but not how it intends to get there. In other words, the framework changed but not the immediate policy. The expectation that rates won't rise when inflation rises could be a powerful tool later in the cycle, if and when inflation increases. But in the here and now, the Fed hasn't offered anything new to provide a tangible boost to economic growth and price levels.

It isn't clear that the Fed can do much more to ease conditions further—even in an economic environment that would normally call for aggressive rate cuts. The policy rate is already at zero, and the Fed is already expanding its balance sheet on an open-ended basis by purchasing Treasuries and mortgage-backed securities. The Fed could eventually push the policy rate negative but is unlikely to move far enough into negative territory to offset the decline in inflation expectations. It might try yield caps, but since the market is already pricing in a lack of rate hikes for several years, the impact would likely be quite limited.

Absent any tangible new steps, the Fed is left to rely on forward guidance: the way it communicates its future policy approach to market participants. Because that guidance has been vague and subject to interpretation, the market's default setting remains to rely on the Fed's track record—not its purported willingness to behave differently in this cycle. The forward guidance is simply too vague to reverse the Fed's hawkish inflation reputation, for several reasons:

1) The new framework explicitly calls for average inflation targeting, but the Fed has refused to clarify the time frame for that average. In fact, Powell has been clear that there is no mathematical formulation and no predetermined amount of time.

2) The Fed didn't clarify how long it would allow inflation to overshoot 2%, indicating only that it will be "for some time." The FOMC considered and rejected the idea of suggesting that "a sustained period" of overshooting would be desirable. Again, a lack of specificity and a preference for the more conservative option suggest that whatever the theoretical framework is, the committee might remain hesitant in practice.

3) There has been no explanation of how much of an inflation overshoot it would tolerate. When Powell was asked about this during his press conference, he merely indicated that a "moderate" overshoot is desirable. That hardly sounds like the sort of aggressive change that would undercut years of inflation-fighting credibility.

4) The Fed has kept its options open, indicating that policy accommodation will be appropriate but not committing to holding rates steady as inflation nears 2.0%. As long as the policy rate is below 2.5% (the Fed's current definition of "neutral"), the central bank could raise rates and still call policy "accommodative." Without more clarification, the vagueness of the language is likely to become apparent later in the cycle, as inflation begins to rise.

The common thread tying together all the imprecisions in the Fed's language is a deep-seated preference for flexibility. The Fed wants to be able to respond to changes in the environment—a preference that's entirely rational. The world can turn very quickly, as we've all discovered this year. Still, flexibility undercuts the power of the Fed's new framework. Flexibility might reasonably be interpreted as a desire by the central bank to protect its own credibility—to allow it to tighten more aggressively than expected in the future. But that credibility is a barrier to persuading market participants to adjust inflation expectations today.

What the Fed needs right now is for the market to believe that its commitment to price stability is less credible—that it will be less responsible in the future. Because the Fed hasn't fully committed, the market seems skeptical. And that skepticism leaves little reason to think that monetary policy alone can cause prices to rise meaningfully.

Joined at the Hip: The Way Forward

The good news in all this confusion is that monetary policy may not have to go it alone. We've believed for some time that the relationship between monetary and fiscal policy has changed. Historically, looser fiscal policy has been met with tighter monetary policy, and vice versa. In the current environment, however, it's more accurate to think of the two as working in concert. With monetary policy nearing the end of its rope, Powell has been unusually explicit (for a Fed chair) in calling for fiscal stimulus. And, of course, the Fed is accommodating that stimulus by keeping rates low and buying mountains of government debt.

The clear hope within the Fed is that fiscal policy will do what monetary policy no longer can do. The FOMC may not have the tools to boost economic demand, but the Treasury does. The transition from monetary to fiscal policy as the primary tool to control economic performance was already well under way, pre-COVID-19. The crisis has accelerated that trend by spotlighting the inadequacy of monetary policy alone in addressing the slow-growth/low-inflation landscape that the crisis will likely deliver in the coming quarters.

Most governments responded to the early days of the pandemic with an admirable sense of urgency, pushing stimulus into the system at an unprecedented pace. We expect that policy thrust to continue, even if it's at a slower

pace, in most major economies. There will be fits and starts; but over time, we expect the need for fiscal support to push policymakers into unconventional fiscal policy. Modern Monetary Theory, “helicopter money” and other forms of monetization are on the table and likely to be implemented in one form or another.

In other words, the Fed has changed its framework, but we expect more aggressive changes to come over the next few years as policymakers struggle to get economic growth and inflation out of the doldrums.

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