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AVERAGE INFLATION TARGETING THE U.S. FED BUYS TWO YEARS OF RESPITE

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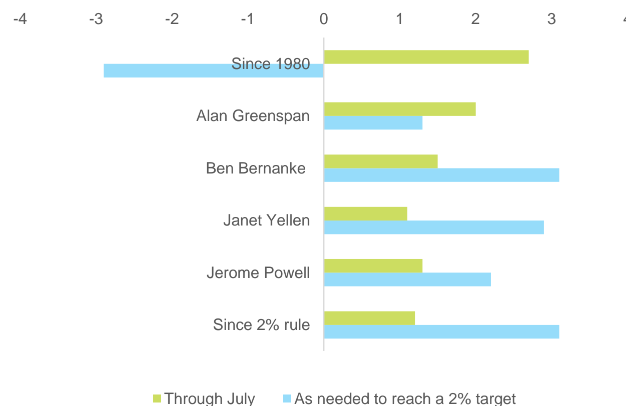
At its meeting on 16 September, the last before the election, the U.S. Federal Reserve confirmed our expectations that it will keep rates at 0% into 2023, and let inflation run higher than 2% for an extended period. It was the first meeting since Chairman Jerome Powell's Jackson Hole speech in which he announced the policy shift to average inflation targeting (AIT) that effectively focusses on pushing inflation up to 2% for an extended period. In particular, the Fed's statement read "The Committee seeks to achieve maximum employment and inflation at the rate of 2 percent over the longer run. With inflation running persistently below this longer-run goal, the Committee will aim to achieve inflation moderately above 2 percent for some time so that inflation averages 2 percent over time and longer-term inflation expectations remain well anchored at 2 percent. The Committee expects to maintain an accommodative stance of monetary policy until these outcomes are achieved. The Committee decided to keep the target range for the federal funds rate at 0 to 1/4 percent and expects it will be appropriate to maintain this target range until labor market conditions have reached levels consistent with the Committee's assessments of maximum employment and inflation has risen to 2 percent and is on track to moderately exceed 2 percent for some time."

In fact, the "dot-plot" accompanying the announcement shows that 16 out of 17 Fed members expect rates to stay near 0% through 2022, and that 13 out of 17 members still expect rates to stay near 0% through 2023. The statement also signaled that the Fed is willing to let the labor market run hotter than it would have before. The Fed also made another move towards more accommodative monetary policy, saying that its bond-buying program, which originally was meant to promote the smooth functioning of credit markets, would now also be used to help boost the economy. The new wording read that the bond-buying would "…help foster accommodative financial conditions, thereby supporting the flow of credit to households and businesses." In the press conference following the announcement Powell said, "My sense is that more fiscal support is likely to be needed. Of course, the details of that are for Congress, not for the Fed. But I would just say there are roughly 11 million people still out of work due to the pandemic and good part of those people were working in industries that are likely to struggle. Those people may need additional support as they try to find their way through what will be a difficult time for them…" Finally, the Fed upgraded its previously overly pessimistic outlook, increasing its forecast for 2020 GDP to -3.7% from -6.5% and lowering its 2020 unemployment projection to 5.5% from 6.5%. Projections for 2021 were also modestly revised in a stronger direction.

Besides indicating the urgency of supporting growth amid the Covid-19 crisis, the AIT move is a confession of the U.S. central bank's powerlessness in hitting the inflation target over the medium-term. Over the last 20 years, all the FOMC Chairs have constantly failed in hitting the 2% target officially adopted in 2012.

Figure 1: Average inflation performance (through July 2020) of the Fed's different leaders (%)



Sources: Wall Street JournalIHS, Allianz Research

Our modified version of the Fed's reaction function points toward a rate hike in Q3 2023 only. In order to estimate the impact of the change in the Fed's objectives, we first estimate a reaction function where the Fed Fund Target rate is explained by the 4-year average level of inflation (attached coefficient is C(1)), the spread of current inflation (observed in quarter t) versus the objective of 2% (attached coefficient C(2)), and the Nairu Gap (level of unemployment rate observed in quarter t – NAIRU, attached coefficient C(3)). This estimate allows us to factor in the fact that the Fed has adapted its stance to different regimes of inflation since 1970. The three coefficients attached to our three variables are significant with a value of C(1) = 1.35, C(2) = +0.3 and C(3) = -0.7, respectively. The signs of our estimate are conventional in the sense that a situation where unemployment is above its equilibrium level triggers a rate cut by the Fed, while a situation where inflation is above the 2% target triggers a hike of the U.S. official rate. The coefficient C(1) shows that the average level of official rate is proportional indeed to the regime of inflation.

In a second step, and starting when the official target of 2% for inflation was officially adopted in 2012, we use the coefficients of our above estimate to propose a modified version of this reaction function, incrementally giving more weight to job market stabilization and less weight to inflation stabilization as long as a 4-year average of inflation would stand below 2%. The rule becomes the following.

- If in quarter t-1, the 4-year average observed inflation <2% then
    - FFR_t = C(1)*4-year average $inflation_{(t)}$ + $C(2)_t$* (Observed inflation in quarter t - 2%)+ $C(3)_t$*NAIRU $GAP_{(t)}$

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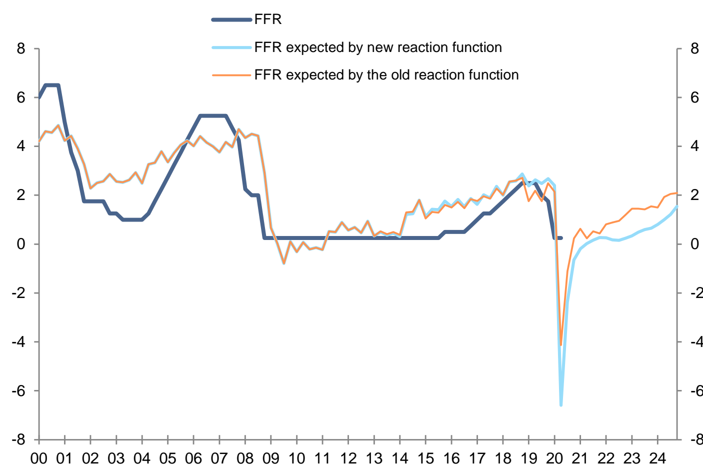
- $C(2)_t=C(2)_{t-1}-0.01$
- $C(3)_t=C(3)_{t-1}+0.01$

- If in quarter t-1, the 4-year average observed inflation > 2% then
  - $FFR_t = C(1)*\text{4-year average inflation}_{(t)} + C(2)_t*(\text{Observed inflation in quarter } t - 2\%) + C(3)_t*\text{NAIRU GAP}_{(t)}$
  - $C(2)_t=C(2)_{t-1}+0.01$
  - $C(3)_t=C(3)_{t-1}-0.01$

This new Taylor rule for the Fed gives two years of respite to the economy until the Fed hikes for the first time. **The adoption of average inflation targeting will maintain official rates at a lower level for longer, which is likely to further intensify the influence of the Fed as a volatility compressor.** By factoring in our central scenario for inflation at the horizon of 2024, we can see that a first rate hike could be conceivable as early as the third quarter of 2021 in the "old" reaction function. In the "new" reaction function, a first hike is conceivable from Q3 2023 only. In the meantime, the Fed will be able to use its unconventional monetary policy should any weakening of the economy require it in a context of the proximity of interest rates to the effective lower bound. In particular, we expect the Fed to accelerate the pace of its securities purchases between Q4 2020 and Q2 2021. Any hike in the Fed Funds Target rate would be preceded by a levelling off in the size of the Fed's balance sheet between Q2 2022 and end-2023, while a tapering could start taking place in H1 2023. This uncanny situation certainly means that the risk of seeing further decoupling between fundamentals and the prices of the market will continue increasing in the coming months.

Figure 2: Fed Fund Target rate estimated on the basis of a new (and old) reaction function of the Fed after integrating average inflation targeting (%)



Source: Allianz Research

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