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Investment Strategy Bulletin

Q&A on the Fed's new policy framework

Investment Solutions 17 February 2021

Q1 - What exactly did the Federal Reserve announce when it adopted a new framework?

Following an extensive review of its policy framework, the Federal Reserve (Fed) adopted an amended 'Statement on Longer-Run Goals and Monetary Policy Strategy' in August 2020. In it, the Fed did the following:

- Acknowledged the fall of "equilibrium" interest rates in recent years, which leaves policymakers with less space to cut rates when needed, as the fed funds rate frequently approaches zero
- Stressed that the maximum employment mandate is a "broad-based and inclusive measure" and linked its policy to shortfalls from this – not directly observable – level of full employment
- Changed its price stability goal to *achieving inflation that averages 2% over time*, promising to let inflation "overshoot" following periods when it runs persistently below 2%.

Q2 - How does this differ from the Fed's previous framework?

First, the shift puts *maximum employment* front and centre. The Fed already had the dual mandate of promoting maximum employment and price stability, but historically the focus on stable prices dominated. In the past, slight upticks in inflation at times sufficed to trigger a tightening cycle, while labour market slack was a lesser concern.

Now, the Fed is placing maximum employment ahead of inflation, and defining it broadly. In the policymakers' assessment, the bigger picture will matter, not simply the achievement of a low headline unemployment rate. Chair Powell's comment last week that the "true" unemployment rate is currently close to 10% illustrates this stance: Powell tells us it would be a mistake to look at the official unemployment rate of 6.3% and think maximum employment is in sight. Broader measures regarding participation, employment security, and wage growth must be part of the assessment.

In addition, the Fed is changing the nature of these objectives. The price stability mandate is seen as symmetric: it will seek to achieve inflation that *averages 2% over time*. This means that following periods of sub-target inflation the Fed will not simply aim for inflation to rise to 2% and then prevent "overshoots" by aggressively tightening policy, often pre-emptively. It will instead allow inflation to exceed the 2% for some time in order to compensate for past undershoots, so that the average level over the whole period is equal to 2% (see chart 1).

Meanwhile, as far as the employment mandate is concerned, policy becomes *asymmetric*. The Fed specifically wants to deal with *shortfalls* from maximum employment. In other words, a high unemployment rate (or insufficiently tight labour market conditions) will call for monetary stimulus. But a low unemployment rate will not push the Fed to tighten unless it actually generates sustained inflation. The Fed has learnt from experience that unemployment can fall below official "full employment" estimates (or NAIRU[1]) and still not generate much inflation (see chart 2) – in which case calls for tighter policy would be premature.

[1] NAIRU, or non-accelerating inflation rate of unemployment, is the concept summarising the idea that there is a specific level of unemployment in an economy, below which inflation would be expected to rise. But both the actual level of unemployment, and the degree of the pressure it generates on inflation, are under debate.

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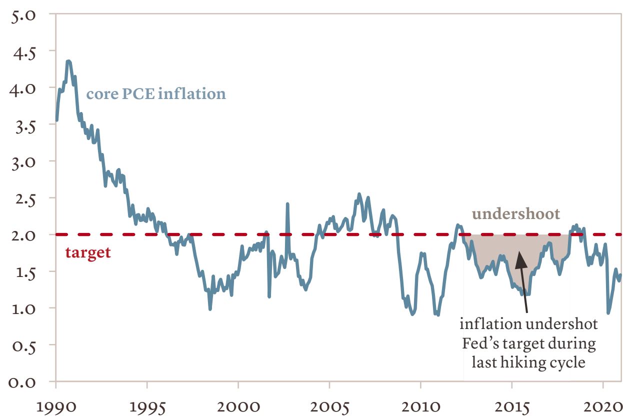
I. Below 2% inflation episodes became frequent in recent decades...

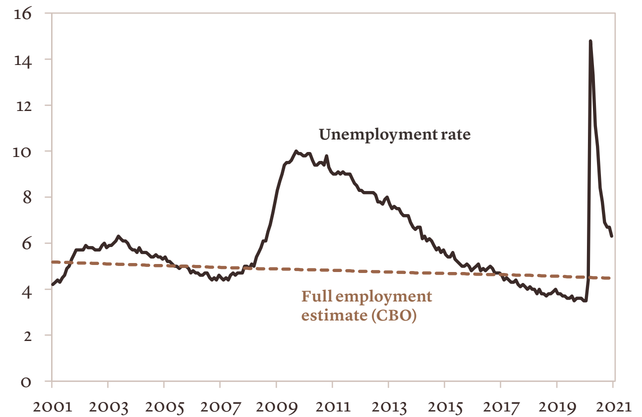
Core PCE inflation vs. 2% target



Sources: BEA, Bloomberg, Lombard Odier calculations

II. ...as inflation failed to accelerate even when unemployment fell below "full employment" estimate

Unemployment rate vs. estimate of "full employment" rate



Sources: BLS, CBO, Bloomberg, Lombard Odier calculations

Q3 - What will these changes mean in practice?

The framework change means that inflation on track to reach 2% at some point in the future is not a sufficient reason for tighter policy – and that such pre-emptive hikes by the Fed can be excluded. Even a few inflation prints above 2% will not trigger rate hikes, as the Fed will delay "lift-off" until inflation has risen to 2%, and it is on track to *moderately exceed 2% for some time*. While "for some time" is deliberately loose guidance as the Fed retains a degree of flexibility (*flexible average inflation targeting* is the more precise term describing this framework[2]), we think this means a period of about one year.

This tactic is crucial in the current context where the post-crisis normalisation of prices may easily see core inflation rise above 2% already this spring, but the broader conditions of maximum employment and moderately above-target inflation will take much longer. Even with our bullish outlook for the US economy, we think the Fed's new framework means rate hikes before mid-2023 are unlikely.

The new framework clearly results in a lower near-term path for interest rates, by delaying lift-off more than the Fed's past framework. It should also mean a higher path for inflation over the cycle, as the Fed will aim for 2% *on average*, which contrasts with recent experience where the 2% practically became the *maximum*. Combined, these changes mean lower real rates versus previous cycles – a development with significant implications across asset classes. We also expect a steeper yield curve at the early stages of the cycle, as the Fed's powerful guidance ties short-term rates near zero while an inflation premium built further down the curve.

Q4 - Should we care?

We should. A dovish shift by the world's pre-eminent central bank has material long-term implications from both a real-economy and a financial-markets perspective. Most crucially, the adoption of average inflation targeting, or AIT, can alter the path of future business cycles.

Historically, the most typical end to an economic expansion (other than external shocks, such as wars or pandemics) has been over-tightening of monetary policy. Central banks, worried about price stability risks, often raised interest rates at the first sign of rising inflation, tightening financial conditions across the economy and causing growth to slow or even causing recessions. A commitment by the Fed to avoid such pre-emptive tightening is a commitment to allow future economic expansions to run farther before monetary policy applies the brakes.

Bill Papadakis, Macro Strategist

[2] See for example the speeches by Chair Powell and by Vice Chair Clarida following the announcement of the new framework

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