

Flash Note

Fed update

Academic debates aside, Fed officials' optimism is on the rise

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Rather than heralding an imminent change in regime, discussions about changing the Fed's strategy (its flexible inflation targeting regime) look more like academic-type brainstorming, in our view.

New York Fed president Bill Dudley – a very influential voice at the Fed – has indicated increased optimism about the US outlook due to the tax cuts and still-loose financial conditions. His views could be an early sign of a broader hawkish shift at the Fed.

We think the risk to our rate-hike forecast is to the upside, with additional rate hikes possible towards year end, particularly if growth stays firm and inflation finally picks up.

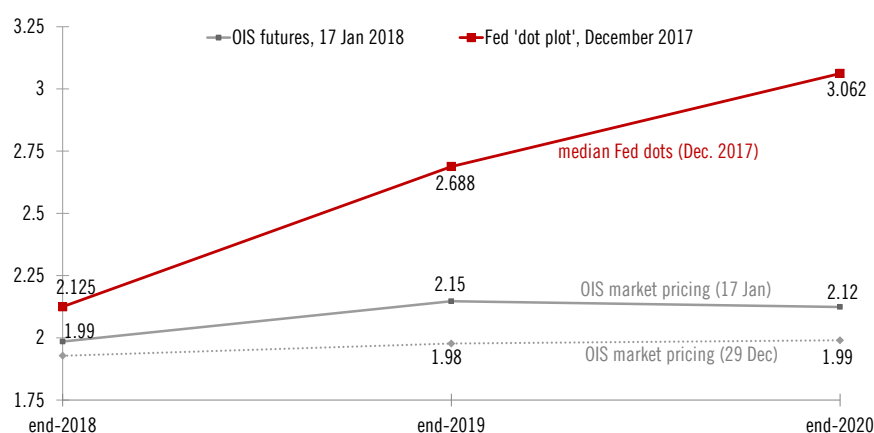
Several Fed officials – mostly regional Fed bank presidents – have given speeches since the beginning of the year, **sending mixed messages to markets in the process**. Complicating matters, the discussion about the short-term cyclical outlook has become mixed up with an **open debate about the Fed's monetary-policy strategy**, with many Fed presidents calling for a change in the current *de facto* flexible inflation targeting regime.

This debate is taking place ahead of the Fed's 30-31 January meeting, when the annual discussion about the central bank's strategy and longer-term goals usually takes place (see [last year's statement](#)). For now, we think that the debate remains theoretical and that **it is highly unlikely that the Fed's policy framework will change in the near term**. With Jerome Powell about to succeed Janet Yellen as Chair, the Fed has more immediate concerns.

Of all recent Fed officials' comments, we have taken particular note of **New York Fed president Bill Dudley's pronouncements**. Citing the tax cuts and still-loose financial conditions, his 11 January [speech](#) showed **significantly more optimism** than before about the 2018 US growth outlook. He even mentioned the risk of "overheating". We think Dudley is an important barometer of Fed policy, and his 'bullishness' may well herald a **more hawkish Fed going forward**.

The bottom line is that while we have been expecting two rate hikes this year (in March and June), we now think there is the potential for **additional rate hikes** in the second half of the year in light of the upside risks to US growth and inflation.

Chart 1: Median Fed 'dots' vs. current market pricing, 2018-2020



Source: Pictet WM – AA&MR, Thomson Reuters.

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Monetary strategy: Flexible inflation targeting to stay

An important debate is taking place among Fed officials about whether its current *de facto* **flexible inflation targeting strategy** is still the most appropriate, or whether it needs an update. The debate comes ahead of the Fed's annual end-January meeting when it spells out its strategy for the year ahead.

The Fed first published a statement on strategy in January 2012, when it set out a 2% inflation target based on the personal consumption expenditures (PCE) price index, cementing the flexible inflation targeting regime still in place. **PCE inflation (and not CPI inflation) had been the unofficial Fed benchmark from the Greenspan years until then.**

While not formally called a 'flexible inflation targeting regime' since the Fed officially has a 'double mandate' of full employment and low inflation, the annual statement on strategy up to now has made it clear that the inflation side is predominant. De facto, **the Fed is a flexible inflation targeter like most other important central banks.**

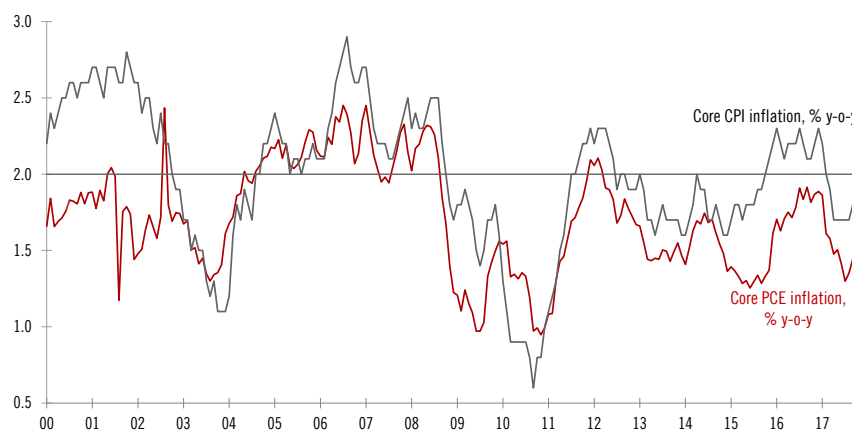
A tweak to the statement on longer-term goals was made in January 2016 when the Fed added that its **2% inflation target was "symmetric"**, i.e. that the Fed needs to avoid high inflation as much a low inflation (for fear of slipping into deflation). In spite of decent growth, inflation, and particularly core inflation (i.e., volatile energy and food prices excepted) have **remained surprisingly subdued**, which explains why the Fed has felt the need to reinforce its commitment supporting inflation 'from the bottom'.

Core PCE inflation has averaged only 1.55% over the past five years, and was only 1.5% y-o-y in November (last data available), despite a decline in the unemployment rate to just over 4%. **The dichotomy of low inflation, a tight labour market and low interest rates forms part of the backdrop to the discussion about changing the flexible inflation targeting strategy.**

At the moment, there are four main alternatives being discussed:

- Higher inflation target rate (e.g., 4%);
- Nominal GDP targeting;
- Price-level targeting; and
- Temporary price-level targeting.

Chart 2: Inflation has been lower than expected in recent years (and in 2017 too)



Source: Pictet WM – AA&MR, Thomson Reuters.

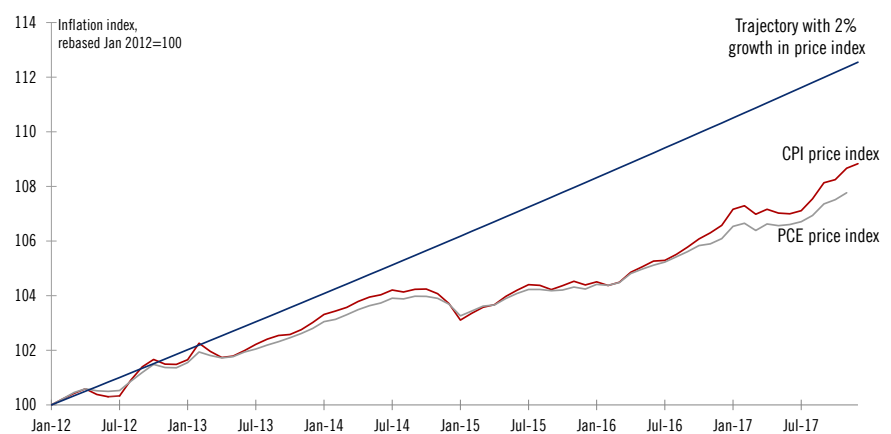
The ongoing debate was well summarised in a 5 January [speech](#) by Cleveland Fed president Loretta Mester at a Philadelphia conference. Mester was of the opinion that the various alternatives need to be further studied, implying that there is **no urgency to change the current framework**. This is also probably the view of most Fed officials, we think.

Indeed, **each alternative has drawbacks**. Any change to the 2% target itself risks creating the impression that the Fed's targets are not set in stone, and therefore **not credible**. This could lead to higher inflation volatility, and therefore have a higher economic cost. Most Fed officials' conceptual backdrop remains marked by the view that the 2% inflation target worked well to tame prices during the difficult struggle against high inflation in the 1980s. Re-discussing the 2% inflation target would probably be seen by them as a **dangerous opening of Pandora's Box**.

Nominal GDP targeting is a concept similar to targeting the output gap, i.e. the difference between actual GDP and 'potential' growth—in other words, the **cyclical position of the economy**. The "nominal" dimension of this target means adding prices. Conceptually, it is an interesting idea, since nominal GDP targeting would take into account past deviations from potential nominal output, an important 'added value' given that both **prices and GDP have been on a slower trajectory than before the global financial crisis**. This concept would also avoid over-reacting to noisy short-term economic data.

The drawback to nominal GDP targeting is both technical and political—technical because it supposes that one can calculate potential growth with precision, while in practice it is more art than science. Also, the starting point for the calculation can change the picture completely, and many revisions to GDP data (including historical ones potentially spanning several years) are additional complexities. Finally, nominal GDP is a difficult concept to explain to the public. Targeting **2% inflation is a simpler message to convey** (including to US lawmakers).

Chart 3: 'Inflation gap' versus a theoretical price-targeting regime, since 2012



Source: Pictet WM – AA&MR, Thomson Reuters.

Another very important drawback is that it **risks creating political interference**, especially if the Fed's view of potential growth differs from the

administration or Congress's view. This is a topical question since the Trump administration is of the opinion that the US can, with new policies, step up to a new growth regime of at least 3% if not 4% annual GDP growth, compared with 2.2% growth on average since 2010. This view is not necessarily shared by the Fed, which sees real **potential (long-term) GDP growth of 1.8%** (median of longer-run GDP growth, according to the Fed's December economic projections), and only 2.1% and 2.0% real growth in 2019 and 2020, respectively.

The complexities of calculating potential GDP, and the political sensitivities involved, explain why, **at the margin, there is more interest in a price level targeting framework** than nominal GDP targeting. Compared with nominal GDP targeting, this would just keep the 'nominal' (or price element), evaluating the inflation index against a theoretical trajectory of 2%. In other words, a price level targeting framework would take into account **past deviations from the 2% trajectory** (see chart 3). In a sense, the framework uses a longer time horizon than the current regime. This price level targeting has particular support from San Francisco Fed president John Williams.

The question regarding these alternatives is whether they really are an improvement on the current flexible inflation targeting regime. A major advantage with the current regime is precisely its **flexibility**, and its openness to interpretation. In other words, Fed officials have still a lot of discretion in setting rates. The **alternatives' major drawback is that they all tend to tie the Fed's hands more**.

The Fed remains very pragmatic with regards to its 2% inflation target, and takes into account the behaviour of past inflation – *de facto* it **already incorporates some elements of 'price level targeting' in its current policies**. The Fed has been very anxious about the persistence of low inflation in recent years, explaining why the Fed has voluntarily deviated from monetary-policy guidelines such as the Taylor rule, according to which base rates should now be at 4.1%. (Another reason for the deviation is the Fed's view that the real neutral rate has shifted down significantly since the global financial crisis, and is now stuck near zero, versus the classic Taylor rule's 2%).

The Fed has repeatedly argued that it will not rush to hike rates even if inflation creeps up closer to 2%, simply because there has been **such an inflation 'miss' in recent years**. Interestingly, Boston Fed president Eric Rosengren has called for a broader inflation target of between 1.5% and 3% and less fixation on 2%, a pragmatic response to the current debate about alternatives.

The bottom line is that while Fed officials are likely to direct their (very academically oriented) **staff to do more research on alternatives** to the current regime, a change is very unlikely and the January 2018 statement on goals and strategy is likely to be **very similar to last year's**. Another reason for believing that the *status quo* will continue is the current **transition in leadership** from Yellen to Powell. A Fed vice president, who could have an important input in any refreshed strategy, is also likely to be nominated very soon.

Reading between the lines, Fed officials' thinking around potential alternatives continues to show the influence of their **dovish-leaning vision of monetary-policy**, with concerns about **low inflation, low productivity**

growth and the **slow economic recovery since the financial crisis** in general still preeminent.

We would also add that the current debate about alternatives exemplifies once again the importance of the Fed's **powerful dovish-leaning research staff** (led by Thomas Laubach), which **continues to have a strong influence over the course of policy**. The research staff's influence also explains the ongoing resistance to moving rates in line with standard policy rules such as the Taylor rule and the Fed's preference for keeping the rate-hiking cycle "gradual".

Interestingly, Fed officials have been making **little mention of incorporating more financial-stability goals into monetary policy**, i.e. using interest rates to stem potential excesses (the so-called 'lean against the wind' vision). **Hiking rates for financial-stability purposes has been dismissed as unworkable by most Fed officials**. This includes the past three chairs of the Fed: Yellen, Ben Bernanke and Alan Greenspan. Yellen would say she prefers to use financial regulation rather than rates, which she believes should be used only as a **last resort**.

That said, cracks in the standard Fed line are appearing, and **more Fed officials are calling for better incorporation of financial stability goals** given current high market valuations. Fearing rapidly rising commercial real estate prices, Boston Fed president Eric Rosengren has been particularly vocal about the need for higher rates.

We would argue that even if not mentioned explicitly, or sometimes only as a secondary factor, **high market valuations are increasingly behind Fed officials' calls for additional rate hikes**. This financial-stability factor is likely to continue to gain importance in the coming months, in our view, especially if financial conditions continue to fail to reflect Fed tightening.

Fed speeches – Watch Bill Dudley's optimistic turn

Recent Fed officials' speeches have been an eclectic mix lately, but taken at face value, they suggest that the Fed remains on a **path of slow rate normalisation**. That said, we would argue that **some of these speeches are already a bit 'outdated'**. Debates about monetary-policy rules aside, they show ongoing cautiousness about coming rate hikes. For example, Chicago Fed president Charles Evans, who dissented against the decision to hike rates in December, has **called for a pause on further rates until there is more evidence that inflation is indeed on the rise** (mid-2018, in his view).

Some other officials – like Dallas Fed president Robert Kaplan, St Louis Fed president James Bullard, Atlanta Fed president Raphael Bostic and Minneapolis Fed president Neel Kashkari – have, to various degree, demonstrated concerns about the **flattening of the yield curve** (the fact that short-term interest rates are about to 'bump' into long-term rates), with some of them fearing this would limit the Fed's flexibility.

Another interesting characteristic of recent pronouncements is that most Fed officials have been rather **unimpressed by the economic impact of the recently enacted tax cuts**. Echoing Yellen's press conference at the December Fed meeting, **most officials see the cuts as having only a modest impact on growth and inflation**. In December, the Fed raised its year-end 2018 growth forecast by to 2.5% from the previous 2.1%. San Francisco Fed president John

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Williams, echoing the broader view at the Fed, mentioned a boost from tax cuts of “only” a quarter point.

However, and more importantly, there seems to be **an increasingly positive reassessment of the 2018 growth outlook** and of the tax cuts’ impact on the economy. In that regard, we think **New York Fed president Bill Dudley’s 11 January speech is particularly crucial**, since Dudley has sharply upgraded his growth assessment. He raised his 2018 growth forecast by a sizeable 0.5-0.75 point, **bringing his forecast to a range of 2.5-2.75%**, well above the median Fed average of 2.5%.

Reading between the lines, **Dudley seems to be on the verge of raising his forecast for 2018 Fed rate hikes too**. Even going so far as mentioning the risk of “overheating”, Dudley said that a prospective three rate hikes this year were just a “starting point”.

While Bill Dudley will leave his role next summer, we think that his influence on the Federal Open Market Committee is **particularly important at the moment** given the leadership transition between Yellen and Powell. His recent speech should therefore be given more weight than those of other Fed officials, especially those of regional Fed presidents who do not have voting power this year (aside from Dudley, the four regional presidents voting this year are Cleveland Fed president **Loretta Mester**, Richmond Fed president **Thomas Barkin**, Atlanta Fed president **Raphael Bostic**, and San Francisco Fed president **John Williams**.)

In a similar vein to Dudley, we believe that other Fed officials could reassess the **tax cuts in a more positive light**, especially as economic data continue to be upbeat. James Bullard, for instance, recently hinted at some upside risks when he said that “there is some possibility” that the tax cuts could “light a fire under investment and really drive growth higher”. We think it will be particularly key at the moment to watch wage growth, and particularly the average hourly earnings measure in upcoming payroll reports. **A pick up in wage growth could assuage many dovish Fed officials’ fears about the recent core inflation undershoot**.

While it is too early to say, there are some early signals that 2018 growth outlook could be upgraded at the Fed’s March meeting (when new economic projections are released). Some Fed officials could also be sensitive to the recent uptick in **market-based inflation rates** (breakeven rates), which had been dormant throughout 2017.

In other words, it is possible that communication from the Fed could turn more hawkish in the coming weeks.