THE FED SHIFTS WEIGHT

For the past four decades, central banks have been hawkish on inflation. Beginning in the 1980s, when price increases were running at over 10%, Paul Volcker took charge of the Fed with a promise to 'slay the inflation dragon'.

US interest rates were hiked to 20% in 1981. As expected, the economy fell into recession and unemployment reached 10% in 1982. But inflation did begin to drop, falling to just over 3% in 1983 (and remaining in the low single digits since).

Despite the fact that the FED has had a 'dual mandate' since 1977 - aiming for both stable prices and maximum sustainable employment, the emphasis on inflation continued. Ben Bernanke, former chair of the FED, formalized this in 2012 when he set an explicit target of 2% inflation.

At the end of last month, the FED announced it would relax this focus. It would tolerate higher inflation to make up for past shortfalls, Jay Powell, chair of the FED, announced. Previously, the FED's aimed for inflation to be as close to 2% as possible. Now, it hopes for inflation to *average* 2% "over time". This means that if inflation falls below 2% this year, the FED will seek to push inflation above 2% next year to make up the shortfall. The FED will keep interest rates lower for longer, hoping to maximize employment.

Can the FED influence inflation expectations?

There are questions, however, about whether the FED will be able to achieve this. Along with other central banks around the world it has struggled to spur inflation in the last decade.

Since 2012, inflation in the US has only exceeded 2% in 16 of the past 102 months. This is despite a decade of historically low interest rates, steady economic growth, and declining unemployment. The FED hopes it can move people's expectations of inflation closer to 2% by announcing it will tolerate higher inflation in the future. This will feed back into current inflation: if you expect the FED to accommodate higher inflation in the future, then this (in theory) affects wage bargaining, pricing decisions and the yields investors seek. This bids up current inflation and provides the FED with more space to ease policy.

The experience in Japan, however, serves as a warning to the FED. Since the 1990s, Japan has battled persistently low inflation. The Bank of Japan adopted an "inflation-overshooting commitment" in 2016 but inflation has remained stubbornly stuck at zero. Trying to manufacture inflation expectations appears difficult and will likely remain so given the pandemic-induced downturn.

The FED has also not deployed any new measures to stimulate inflation. There has been a reluctance to move interest rates below zero. Richard Clarida, Vice Chairman of the FED, has also said there will be no immediate move to implement 'yield curve control', a policy that would tie down rates on government debt.

Adapting to new realities

The combination of low pre-pandemic unemployment and sluggish inflation is what has allowed the FED to turn its focus to maximizing employment. If previous increases in employment had led to surges in inflation, the FED might be more cautious about trying to maximize employment. Previously, the FED worried that increases in employment beyond a certain point would ignite inflation (a relationship known as the *Phillips curve*). Now, there is evidence that this relationship has broken down.

Any impact from the FED's shift in emphasis will probably not filter through immediately. Yields on US government debt and market expectations of inflation have remained muted since Mr Powell's announcement (see chart).

Inflation expectations have edged only slightly higher
5-Year Forward Inflation Expectation Rate

Source: Board of Governors of the Federal Reserve System

The more immediate implications, instead, are likely to be in how other central banks react. Both the ECB and the Bank of England are currently reviewing their monetary policy strategies and might decide now is the time to allow higher inflation.

Ultimately, the shift in FED strategy is subtle and, as Adam Posen of the *Peterson Institute* notes, probably just a reflection of current reality. A decade of low interest rates, low inflation and a flat Phillips curve mean the FED is able to give inflation a longer leash. Ultimately though, the factors that might eventually push inflation higher in the months to come are ones out of the FED's control, namely higher government spending, pent-up consumer demand, and supply constraints caused by the pandemic.

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