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Daiwa's View

Fed Chair Jerome Powell's speech at Jackson Hole: Makes formal announcement of shift to flexible average inflation targeting in advance

- Aiming to foster "as strong a labor market as possible"

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Fed Chair Jerome Powell's speech at Jackson Hole: Makes formal announcement of shift to flexible average inflation targeting in advance

Aiming to foster "as strong a labor market as possible"

Speaking in Jackson Hole at the Economic Policy Symposium sponsored by the Kansas City Fed on 27 August, Fed Chair Jerome Powell announced the formal adoption of a soft average inflation target that the Fed calls "a flexible form of inflation targeting." Under this new approach, the Fed is shifting to a framework within which it "will seek to achieve inflation that averages 2% over time," and "following periods when inflation has been running below 2%," it "will likely aim to achieve inflation moderately above 2%."

The Fed chairman emphasized that it was not adhering to a rigid approach that would automatically bind it to specific numbers over a specific period of time. This is exactly what the market expected. Meanwhile, one of the major features of the latest new strategy statement and Mr. Powell's speech is the emphasis on "fostering as strong a labor market as possible for the benefit of all Americans," with the clear aim of eliminating any shortfalls from maximum employment. This suggestion of policy oriented toward a high-pressure economy is dovish.

◆ **Fed Chair Jerome H. Powell** (27 Aug 2020)

・It is hard to overstate the benefits of sustaining a strong labor market, a key national goal that will require a range of policies in addition to supportive monetary policy. … With regard to the employment side of our mandate, our revised statement emphasizes that maximum employment is a broad-based and inclusive goal. This change reflects our appreciation for the benefits of a strong labor market, particularly for many in low- and moderate-income communities. …This change may appear subtle, but it reflects our view that a robust job market can be sustained without causing an outbreak of inflation. We will seek to achieve inflation that averages 2 percent over time. Therefore, following periods when inflation has been running below 2 percent, appropriate monetary policy will likely aim to achieve inflation moderately above 2 percent for some time.

Nevertheless, although this announcement came earlier than expected, the market has already priced in the transition to a soft average inflation target, and Mr. Powell did not clarify the tools and communication methods to be used in the process of rethinking the monetary policy framework. Another reason the announcement did trigger a rise in interest rates (curve steepening) is that there was no hint of what the specific tools for additional easing would be (a strengthening of forward guidance and transition to open-ended QE) and when they would be applied.

Several speeches by key FOMC members are scheduled for next week, including from Fed Vice Chair Richard Clarida. The Fed will probably use this opportunity to guide the market's expectations of the September FOMC meeting.

In step with Mr. Powell's speech, the Fed voted unanimously to revise its Statement on Longer-Run Goals and Monetary Policy Strategy. Because the market had expected the Fed chairman to limit what he said during the Jackson Hole speech to the broad direction of that strategy, it was surprised when he formally announced the shift to average inflation targeting in advance of the FOMC meeting.

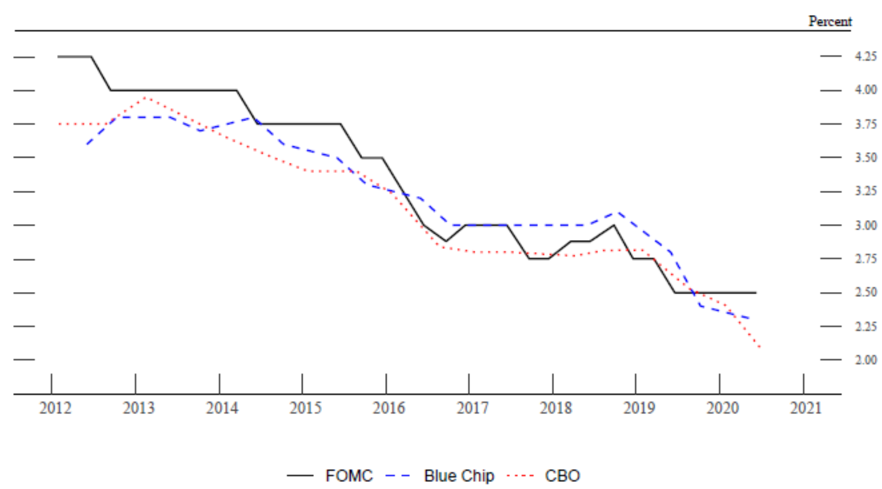
◆ Four reasons the Fed was motivated to change its strategic framework

In his speech, Mr. Powell explained the four key developments that motivated the Fed's strategic review. First was the decline in the economy's potential growth rate brought by demographics and productivity declines. This resulted in the second development, which was the significant decline globally, including in the US, of the equilibrium real interest rate r* (also called the natural rate of interest), which made the effective lower bound (ELB) on interest rates an even bigger factor. The revised strategic review included language about this.

◆ **Statement on Longer-Run Goals and Monetary Policy Strategy** (27 Aug 2020)

・The Committee judges that the level of the federal funds rate consistent with maximum employment and price stability over the longer run has declined relative to its historical average. Therefore, the federal funds rate is likely to be constrained by its effective lower bound more frequently than in the past. Owing in part to the proximity of interest rates to the effective lower bound, the Committee judges that downward risks to employment and inflation have increased. The Committee is prepared to use its full range of tools to achieve its maximum employment and price stability goals.

Real-Time Projections of Longer-Run Federal Funds Rate

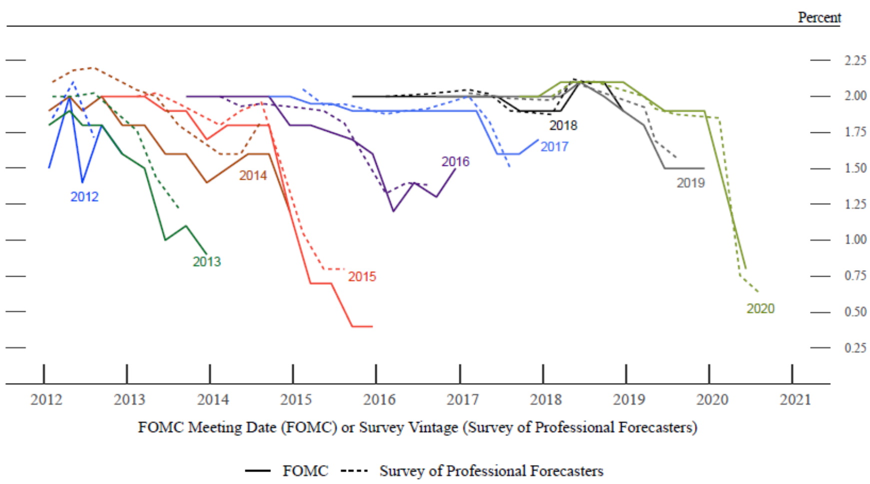


Source: Extracted from "New Economic Challenges and the Fed's Monetary Policy Review" by Jerome H. Powell (August 27, 2020).

Third, what became clear during the economic expansion prior to the pandemic was that realizing extremely tight labor market supply-demand provides substantial benefits to people with low income and minorities, specifically those who had "been left behind too long," and that these benefits were shared more widely across society. Mr. Powell said that it is "hard to overstate the benefits" to racial and ethnic minorities of high employment levels.

The fourth factor, however, is that this "historically strong labor market did not trigger a significant rise in inflation." This provided evidence that the flattening of the Phillips curve made it possible to achieve tighter labor market supply-demand without excessive inflationary pressures arising than previously thought possible.

Evolution of Real-Time Projections for Personal Consumption Expenditures Inflation



Source: Extracted from "New Economic Challenges and the Fed's Monetary Policy Review" by Jerome H. Powell (August 27, 2020).

◆ Shortfall from maximum level of employment

One of the striking features shared by the updated strategy statement and Mr. Powell's Jackson Hole speech is how they strongly reflected the Fed's judgment that strategic changes in employment and the strong labor market are benefiting the low and middle income strata of society. In the updated strategy statement, the Fed split its discussion of the dual mandate of jobs and inflation into two separate paragraphs and also switched their order, putting jobs first.

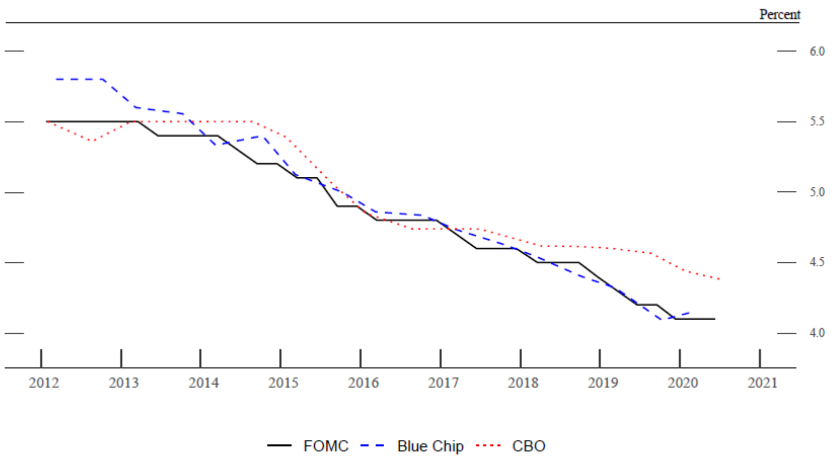
In the revised strategy statement, the Fed described the maximum level of employment as a "broad-based and inclusive goal" and noted that its decisions would be informed by the "shortfalls of employment from its maximum level." It had previously focused on deviations in employment from its maximum level and thus saw a problem if unemployment was either too high or too low, but now it is focused solely on shortfalls of employment from its maximum level.

Mr. Powell said that this change in language "may appear subtle, but it reflects our view that a robust job market can be sustained without causing an outbreak of inflation." He also said that because of significant shifts in estimates of the natural rate of unemployment (u*) in the past, "specifying a numerical goal for employment is unwise."

This means that as long as the risk of inflation overheating does not emerge, the Fed is not going to start tightening just because the unemployment rate reaches estimates of the natural rate of unemployment (u*), one measure of full employment. With this emphasis on "fostering as strong a labor market as possible" (as stated by Mr. Powell), the Fed's updated strategy statement could be perceived as more dovish in that it is suggesting it will manage policy oriented to a high-pressure economy.

◆ Fed Chair Jerome Powell (27 Aug 2020)
・Going forward, employment can run at or above real-time estimates of its maximum level without causing concern, unless accompanied by signs of unwanted increases in inflation or the emergence of other risks that could impede the attainment of our goals.

Real-Time Projections of Longer-Run Unemployment Rate



Source: Extracted from "New Economic Challenges and the Fed's Monetary Policy Review" by Jerome H. Powell (August 27, 2020).

◆ A flexible form of average inflation targeting

Another big change in the strategy statement was in regards to price stability (inflation). As expected, it codified average inflation targeting. In the previous strategy statement it used the term "symmetrical inflation goal," but in the revised statement, it described its strategy of achieving a long-term inflation objective of 2% as seeking to achieve "inflation that averages 2% over time," and went on "following periods when inflation has been running persistently below 2%, appropriate monetary policy will likely aim to achieve inflation moderately above 2% for some time." This is a fundamental change from its previous strategy of letting bygones be bygones.

As the Fed chairman emphasized in his speech, once an adverse cycle of ever-lower inflation and inflation expectations sets in, it can be very difficult to overcome, a lesson learned from other major economies (the fear of Japanization). The Fed is strongly aware that "well-anchored inflation expectations are critical for giving the Fed the latitude to support employment when necessary." In that sense, the act of codifying and systematizing average inflation targeting is in itself a very dovish change in the framework.

This reference to "longer-run inflation of 2%" does not imply any rules-based numerical targets or specific time frames. In his speech, Mr. Powell said "we are not tying ourselves to a particular mathematical formula that defines the average. Thus, our approach could be viewed as a flexible form of average inflation targeting." During the Q&A session, he said that the overshoot would be a moderate one, with no intention of allowing it to last for an extended period[1].

As indicated by Mr. Powell's statement that the Fed's "decisions about appropriate monetary policy will continue to reflect a broad array of considerations and will not be dictated by any formula," the Fed is distancing itself somewhat from a strict approach. In fact, Mr. Powell followed that by saying "Of course, if excessive inflationary pressures were to build or inflation expectations were to ratchet above levels consistent with our goal, we would not hesitate to act." We think the fact that this flexible approach is being taken after forming a consensus within the FOMC it is also important.

[1] That same day, Dallas Fed president Robert Kaplan stated in an interview that a "moderate overshoot on inflation probably means 2.25% to 2.5%."

◆ **Financial system stability**

In fact, the revised strategy statement also contains new language on financial system stability. Mr. Powell said in his speech that [since the Great Moderation and] "prior to the pandemic-induced downturn, a series of historically long expansions had been more likely to end with episodes of financial instability," and the new strategy now includes the phrase "sustainably achieving maximum employment and price stability depends on a stable financial system." This could be thought of as a "crisis management clause" to deal with the risk of financial instability.

◆ **Statement on Longer-Run Goals and Monetary Policy Strategy** (27 Aug 2020)

・Monetary policy actions tend to influence economic activity, employment, and prices with a lag. In setting monetary policy, the Committee seeks over time to mitigate shortfalls of employment from the Committee's assessment of its maximum level and deviations of inflation from its longer-run goal. Moreover, sustainably achieving maximum employment and price stability depends on a stable financial system. Therefore, the Committee's policy decisions reflect its longer-run goals, its medium-term outlook, and its assessments of the balance of risks, including risks to the financial system that could impede the attainment of the Committee's goals.

◆ **Actual implementation of a flexible average inflation targeting strategy**

The newly revised strategy statement is still scheduled to be reaffirmed every January. The Fed also announced that it would conduct a public review of its policy tools and strategy every five years. The Fed is not tied to any specific time frame for adhering to the flexible average inflation targeting strategy it has just adopted, but it could conceivably last for five years.

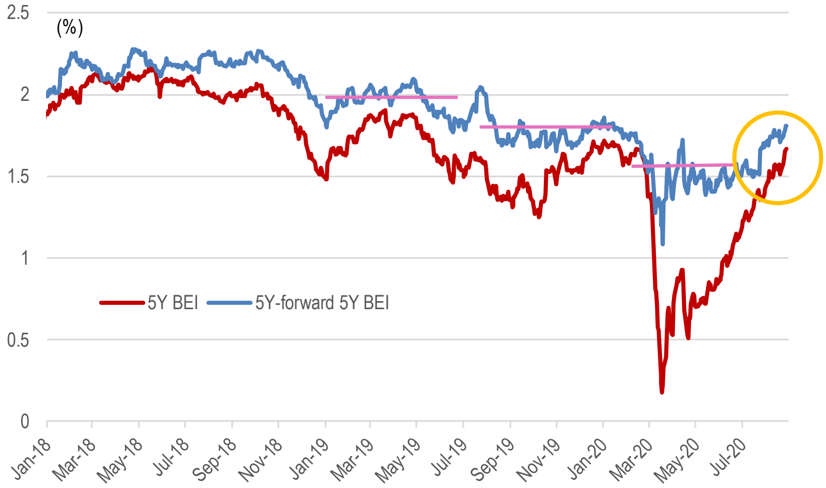
Although the Fed has officially adopted an average inflation target approach, the FOMC has not yet indicated specifically how it will be implemented. In other words, despite the Fed chairman having stated at his press conference following the July FOMC meeting that all would be clarified, there was no clarification of how the tools and communication methods would be changed in the monetary policy framework. Because the market had already expected this transition to average inflation targeting, the announcement did trigger a rise in yields (steepening of the curve)[2].

Additionally, whether this strategy actually raises inflation and inflation expectations will depend on the Fed's actions. Another reason the market reacted the way it did is that there was no hint of what the specific tools for additional easing would be (a strengthening of forward guidance and transition to open-ended QE) and when they would be applied so as to ensure the effectiveness of the new strategy. Although this early announcement of its revised strategy statement could be interpreted as having given the FOMC more options at its September meeting, if the Fed Chairman saw the need for additional action in September, we think he would have been more biased in his communication. In that sense, we think the probability of the Fed next taking action at the November FOMC meeting increased marginally.

Ahead of the blackout period prior to the September FOMC meeting, several speeches by key Fed officials are scheduled for next week. Speeches are scheduled for Fed Vice Chair Richard Clarida on 31 August, Fed Governor Lael Brainard on 1 September, New York Fed President John Williams and Cleveland Fed president Loretta Mester on 2 September, and Chicago Fed President Charles Evans on 3 September. The speeches were clearly scheduled to communicate deliberately prior to the September FOMC meeting, and the Fed will probably use this opportunity to guide the market's expectations of the September FOMC meeting.

[2] Because the shift to average inflation targeting was formally announced early, without waiting for the September FOMC meeting, the market's initial reaction was a decline in interest rates and weakening of the dollar.

US Inflation Expectations (5Y BEI, 5Y-forward 5Y BEI)



Source: Bloomberg; compiled by Daiwa Securities.

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[Standard & Poor's]

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February 2020

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