United States

In the name of credibility, but which one?

- **After the FOMC maintained a "hawkish-dovish" status quo in late September, the meeting's minutes were awaited with impatience. In the end they did not shed much more light on which way the balance is tipping.**
- **However, the hawks did manage to surprise us with a new argument in favour of a key rate increase: they claim the Fed's credibility is at stake.**

The minutes of the 20-21 September FOMC meeting were awaited with impatience. The Fed managed to announce an imminent key rate increase while reiterating its commitment to low interest rates over the medium term. It is rare for a decision maintaining the monetary status quo to contain both hawkish[1] and dovish signals[2]. This is the prism through which the minutes must be read: was the decision more hawkish or more dovish? In the end, it is another factor that caught our attention.

The hawkish side of the 21 September decision consisted mainly of a new sentence in the press release: "The Committee judges that the case for an increase in the federal funds rate has strengthened". The minutes give the impression that it resulted from a compromise, a concession by the doves to rally some of the undecided members into their camp. Note that some FOMC members were uncomfortable with the return to a kind of calendar-based forward guidance, and thought it better to maintain – rather than water down – the data-dependency.

On the dovish side, discussions on changes in the neutral rate are given a prominent place in the minutes.[3] The FOMC members lowered their estimate of the neutral rate again in September, and the minutes show that the deciding factor for this revision was the low level of productivity gains. This raises the question of the current degree of monetary policy accommodation – which Janet Yellen brought up in the preliminaries to her press conference. If the neutral rate is actually lower than the Fed previously estimated, then its policy might be less accommodating than it intended. This message reinforces that of projections of a more gradual normalisation of monetary policy, one that is slower paced, with a lower end target.

If the neutral rate is lower, then the effective rates should be lower, too. If the economy has reached full employment, then the effective rates should align with the neutral rate. If full employment has not been reached yet, then the effective rates should be lower than the neutral rates (of if full employment has been surpassed, then the effective rates should be higher). All that remains is to agree on the level of neutral rates, and on the state of the job market. While some estimate full employment has been reached[4], there does not seem to be a consensus on this point: many esteem that underemployment is still high.

In the end, the FOMC seems to be split between those who find the economy is at full employment and prefer to raise key rates as quickly as possible, and those for whom maintaining the current monetary status quo would help absorb underemployment without fears for inflation. And then there are the centrists, who will end up tipping the balance. In September, they decided to back the doves, but December might see them rally behind the hawks.

Which of the hawks' arguments could win over the centrists? The one that claims that by waiting too long today to raise key rates, the Fed might have to rapidly tighten monetary policy to combat inflation tomorrow, an over-calibration that would risk plunging the economy into recession. The doves' argument is no less pertinent: the usual link between the labour market and inflation has not been functioning in the recent past, and before conducting monetary policy in keeping with projections based on past models, it is worth waiting to observe evidence that they have become valid again.

There is nothing new about this debate nor these arguments. Without building on their argument, the hawks did adjust it by playing on a tune that is particularly dear to central bankers: credibility. The presidents of the Kansas City and Cleveland Federal Reserve Banks both justified their dissenting votes by claiming that the Fed's credibility was at stake: either it is too discretionary today, or tomorrow it will have to deviate too much from its currently announced path.

At a time when the Fed has "missed" its inflation target for the fifty-second consecutive month, and when its members have little hope of meeting it for another two or even three years, a premature and/or disproportionate tightening move would also deal a blow to the credibility of the symmetry of the 2% inflation target. This credibility is essential, to us but also to the Fed, notably since inflation expectations are often mentioned in the minutes. They are said to be stable, though low, and more crucially, they are cited among the factors that could explain the low level of inflation in recent years. Like in Japan and Europe, and even if it is true to a lower extent in the US, raising inflation expectations is the real challenge facing central bankers. Clearly tomorrow can wait.

[1] Fed officials are generally categorised as either doves (who give greater weight to the full employment mandate) or hawks (who place more importance on the price stability mandate). By extension, those who want to tighten monetary policy are hawks, and those who resist are doves.

[2] "*Rich, deep, serious*" Alexandra Estiot, EcoWeek BNPParibas, 23 September 2016.

[3] The rate that allows the economy to grow at its long-term potential without generating inflationary pressure, and strikes a balance between savings and investment.

[4] "Some participants pointed to the slowing in payroll gains and modest pickup in wages this year and judged that the labour market had little or no remaining slack."