EDITORIAL

THE FEDERAL RESERVE ENTERS A NEW ERA OF INFLATION TARGETING

The Federal Reserve has changed its longer-run goals. Going forward, monetary policy will focus on the shortfall of employment from its maximum level, rather than on the deviations from this level. More importantly, the central bank will now seek to achieve inflation that averages 2 percent over time. The announcement implies a more accommodative stance because the timing of the first rate hike is now pushed further into the future. It also means that, eventually, the Fed's reaction function will become more difficult to read: when will average inflation –a concept that remains to be defined- warrant a policy tightening? Such ambiguity would then lead to increased volatility, unless guidance takes an even bigger role.

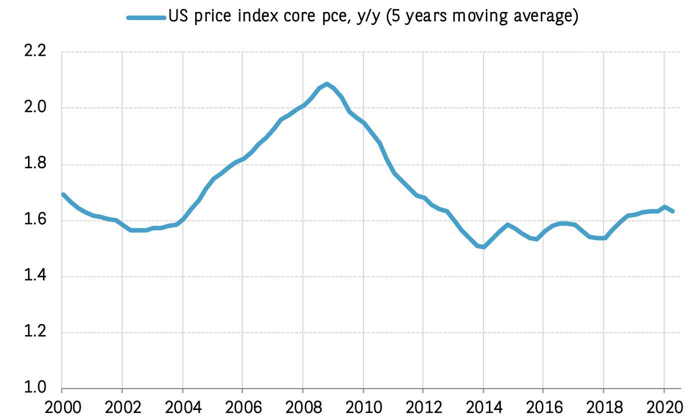
The Federal Reserve Bank of Kansas City's annual economic policy symposium in Jackson Hole has a long tradition of important speeches[1]. In 2012, Fed Chair Ben Bernanke signaled that a third round of quantitative easing was coming. Mario Draghi's speech in 2014 was considered as indicating that the ECB was going to introduce QE as well. In 2018, Fed Chair Jerome Powell talked about the difficulties of 'navigating by the stars', referring to inflation expectations, the neutral rate of interest and the natural rate of unemployment[2].

This year's event, which was held online, was no exception, quite to the contrary. In his speech, Jerome Powell explained the revised Statement on Longer-Run Goals and Monetary Policy Strategy. This revision is the outcome of the review of the Fed's monetary policy framework[3]. The document is important because it lays out the goals and the framework of monetary policy. It serves as the foundation for the FOMC's policy actions[4]. Like before, the Federal Reserve refrains from specifying a numerical goal for unemployment, considering that the maximum level of employment *"is not directly measurable and changes over time for reasons unrelated to monetary policy"*. In addition, it is still of the view that a longer-run inflation rate of 2 percent is most consistent with its mission of promoting maximum employment and price stability. What has changed is how the employment situation will influence the policy decision. Going forward, the assessment will be based on the shortfall of employment from its maximum level, rather than on the deviations from this level. As stated by Jerome Powell, *"this change may appear subtle, but it reflects our view that a robust job market can be sustained without causing an outbreak of inflation."* As a consequence, the labour market will have an asymmetric influence on the policy stance with a high level of unemployment triggering easing whereas a very low level will not necessarily cause a more hawkish stance, unless inflation or instability risks would be on the rise.

1. See e.g. *Jackson Hole's greatest hits keep focus on Fed's annual retreat*, Bloomberg, 27 August 2020
2. For more detail, see *Fed: avoiding the risks of stargazing,* BNP Paribas, Ecoweek, 31 August 2018
3. For an earlier analysis, see: *The Federal Reserve's strategy review: towards a target range for inflation?,* BNP Paribas, Ecoweek, 21 February 2020
4. *New Economic Challenges and the Fed's Monetary Policy Review*, Remarks by Jerome H. Powell, Chair Board of Governors of the Federal Reserve System at "*Navigating the Decade Ahead: Implications for Monetary Policy,"* an economic policy symposium sponsored by the Federal Reserve Bank of Kansas City, 27 August 2020

The change in the measure to assess inflation versus its target is more significant. The Federal Reserve is concerned that a tightening of policy as soon as inflation reaches 2% would imply that in the longer run, inflation would average less than 2%. As shown in chart 1, this is exactly what has happened. The preferred inflation measure of the Fed has –on a moving average basis- rarely been above 2% since 2000. This can end up causing a decline of inflation expectations, making the conduct of monetary policy more difficult. For this reason, the central bank will now 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."* Given the inflation development in recent years, financial markets have, quite understandably, interpreted this change as a message that policy would remain very accommodative for longer (chart 2). The dollar weakened versus the euro and equities rallied. Both reactions were

INFLATION: US PRICE INDEX CORE PCE Y/Y (5-YEAR MOVING AVERAGE)



SOURCE: BEA, BNP PARIBAS

> Eventually, the Fed's reaction function will become more difficult to read: when will average inflation –a concept that remains to be defined- warrant a policy tightening? Such ambiguity would then lead to increased volatility, unless guidance takes an even bigger role.

short-lived however. Treasury bond yields moved higher, pricing in the prospect that the Fed would tolerate a higher level of inflation.

The message of *'low policy rates for longer'* should support activity and demand. It should also underpin risk taking in financial markets. After all, fluctuations in the required risk premium are closely tied to Federal Reserve policy. Low policy rates for longer would imply higher asset valuations –such as tighter corporate bond spreads versus treasuries or a higher price/earnings ratio in equities- but this will likely lead to an increased sensitivity and volatility when policy is tightened after all. Following the change to the Statement, communication and guidance on future policy thus becomes more important, in particular considering that the Fed is not tying itself to a particular mathematical formula that defines the relevant inflation average.

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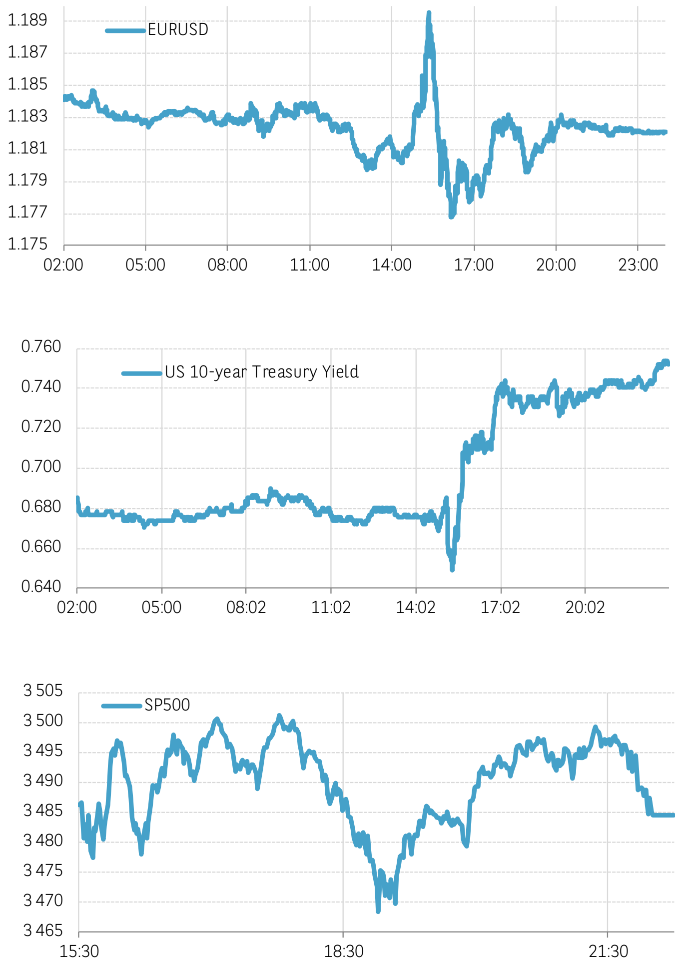
FINANCIAL MARKETS REACTION TO JEROME POWELL SPEECH



SOURCE: BLOOMBERG 27 AUGUST 2020