Federal Reserve System

Fed's traditionalists face tough questions over inflation

Divisions among policymakers increase the uncertainty over interest rates beyond 2017

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Barring a nasty economic setback, the Federal Reserve appears set on announcing a start to the unwinding of quantitative easing within months — that much was clear from the minutes of the latest meeting.

But beneath that determined surface, policymakers at the central bank are heavily divided over how they should respond to the low inflation that is dogging not only the US but a range of advanced economies. This makes the outlook for official interest rates beyond this year far less certain.

Minutes to the June policy meeting reaffirmed the impression of a central bank that wants to get the process of shrinking the $4.5tn balance sheet under way, even if there was a range of views as to the best moment to start. September's meeting appears the most likely beginning for the process, kicking it off comfortably ahead of chair Janet Yellen's possible exit from the central bank in early 2018 and easing some of the political pressure from Capitol Hill conservatives over the Fed's swollen balance sheet.

The central bank's broader strategy for steering the economy appears more internally contentious, however.

Some officials want to see unemployment run below their estimates of the normal long-run rate for a long period of time, bolstering wage growth and helping guarantee higher inflation. Others oppose that approach — informed perhaps by past Fed errors when rate-setters stood by and allowed the economy to become dangerously overheated.

"There is a real divide between the traditionalists who believe inflation is around the corner and those who fear we are stuck in a low inflation trap," said Tim Duy, a Fed watcher who is a professor at the University of Oregon. "It will play out in the path for interest rates in 2018 and beyond."

At the heart of the debate are persistently poor inflation readings in the US — and indeed around the world. The Fed's favourite measure of core inflation was just 1.4 per cent in May, and it has failed to surpass its 2 per cent target since 2012. While the Fed reckons recent inflation undershoots reflect "idiosyncratic factors" including lower mobile phone charges and prescription drug prices, analysts say a broader range of inflation categories are showing weakness.

Economists led by James Sweeney at Credit Suisse point out that shelter costs are now providing a diminishing boost to price growth, while core goods prices have also been softening, pulled lower in part by weaker car prices. Inflation could be stuck at its 20-year average of 1.7 per cent in a year's time, they estimate.

While only one rate-setter dissented against the Fed's June rate increase — Neel Kashkari of the Minneapolis Fed — persistently poor inflation numbers would embolden doves at the central bank in the coming months. This will have a bearing on how aggressive those policymakers are willing to be on rate rises, affecting forecasts for rates next year and thereafter.

Already a vocal contingent is getting edgy. "Several participants expressed concern that progress toward the committee's 2 per cent longer-run inflation objective might have slowed and that the recent softness in inflation might persist," the minutes showed.

For the time being it is the traditionalists who are in the driving seat. Ms Yellen and other senior rate-setters are sticking with standard economic models showing that with unemployment at just 4.3 per cent, accelerating inflation and wages are on the horizon. Financial market developments offer them further arguments in favour of gradual rate rises: existing rate increases have done little to tighten financial conditions, counterbalancing weak inflation readings.

At the margins of the debate a further factor is starting to add weight to calls for tighter policy: the risk of excesses brewing in the financial sector. As things stand, the US central bank does not believe that easy money has stoked unstable conditions similar to the ones that upended the global economy between 2007 and 2009. Indeed, Ms Yellen said last week she was not expecting a re-run of that crisis within our lifetimes.

But the minutes to the Fed’s June meeting noted increased tolerance of risk among investors, who have been chasing asset values higher, as well as subdued volatility, which could lead to a build-up of financial hazards.

Krishna Guha of Evercore ISI says that even if financial stability factors remain second order issues at the Fed relative to the basic balancing act between employment and inflation, that may not still be the case a year from now.

“The minutes hint at the dilemma the Fed could be facing a year from now if progress on inflation stalls,” he says. “They could be dealing with inflation that is stuck at 1.7 per cent alongside frothy asset values and higher leverage. That would present the Fed with a very difficult trade-off between its inflation and financial stability goals.”
