



Monetary policy outlook: How much does inflation matter?

Edward Al-Hussainy, Senior Interest Rate and Currency Analyst



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So the tension for the Fed is, "Do we tighten policy despite the fact that inflation hasn't gone to 2%, or do we wait for it to get there, wait for the economy to overshoot and then hike?"

If we think about the pace of the recovery that we've had in the U.S. over the past five years, growth has been very stable at around 2%. On the other hand, inflation has undershot the Fed's 2% target, practically every year for the last decade.

What the Fed has done is really start to discount the fact that inflation is undershot, and focused on other things like financial conditions, the fact that credit spreads are quite tight, the fact that equities are making record highs. And so from a growth perspective, the Fed sees a very healthy economy, and an economy that can handle hikes.

They've told us that they'd like to hike three times in the course of 2018, and, again, three times in the course of 2019. It's a very moderate pace of hikes. If we think about what's happening in parallel, the Fed's balance sheet has started to shrink. That shrinkage will accelerate in the course of 2018, and that's equivalent to about a hike on its own.

In terms of inflation, what we're left with is a deeply unsatisfactory picture in the sense that growth is pretty good, the labor market is pretty tight, and yet we don't have inflation. And the Fed has tried to address this by saying, "Well, there's a set of temporary factors that have pulled inflation down."

Increasingly they're coming to terms with the fact that these are not temporary factors, but these are structural factors, and, in fact, the center of gravity for inflation is probably closer to 1.5% than 2%, which means getting to 2% is going to be that much harder.

Now, what is the Fed to do about this? And the path that the Fed has chosen, so far, is to say, "We're going to discount the shortfall in inflation more and lean more on the fact that the growth story's pretty good," And we expect that stance to continue.

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