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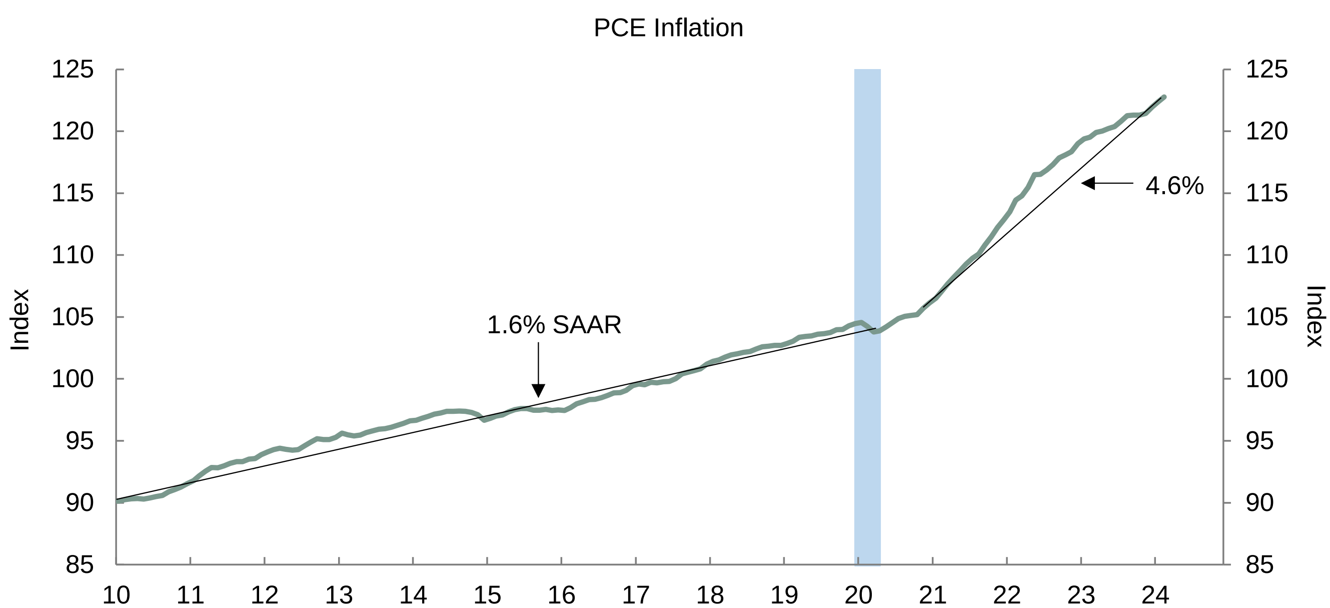
Is the Fed Going to Change Its Inflation Target?

During the last decade, the annualized growth of the headline and core PCE deflators was 1.6% and 1.5%, respectively. Both growth rates were substantially below the Fed's 2% inflation target. When the pandemic led to a government imposed recession, the inflation rate slowed even more. In April 2020, the headline and core PCE deflators were up 0.4% and 0.9% respectively from 12 months earlier. This led to the Fed announcing in August 2020 that the FOMC "seeks to achieve inflation that averages 2 percent over time, and therefore judges that, following periods when inflation has been running persistently below 2 percent, appropriate monetary policy will likely aim to achieve inflation moderately above 2 percent for some time." If policymakers had the foresight to know inflation would be running massively above target in less than two years, this new policy framework would probably not have been adopted.

Over the last three years, inflation has grown at a near 5% annualized rate. Visually we can see how much steeper the slope in the price level is over the past few years compared to the pre-pandemic trend. Prominently, the consumer price index, which US households are much more familiar with, has grown almost 6% annualized since January 2021 — three times the Fed's target! This is the primary reason consumer sentiment has been so depressed despite an historically low unemployment rate. **<u>For the PCE deflator, shown in the chart below, to return to the price level that would have existed had inflation stably grown at 2% over the past three years, the index would have to drop 230 basis points over the next three years</u>**. In other words, the economy would have to experience deflation.

Since the Fed has been consistently talking about the need to bring inflation down to 2% and because their August 2020 framework was only asymmetric — in that it discussed running inflation above target to correct for past errors — there is no reason to think monetary policymakers are going correct in the opposite direction. If this is the case, then it has critical implications for the economy and financial markets. In the past, the inflation rate has never fallen by the current amount it needs to without a recession. **<u>If the Fed is serious about 2% then the only way we do not have a downturn is if potential real GDP growth turns out to be faster than many economists project</u>**. The economy needs a supply-side boost, but in our view, there is nothing to suggest that such a development is on the horizon.



Source: BEA. Haver, SMBC Nikko

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