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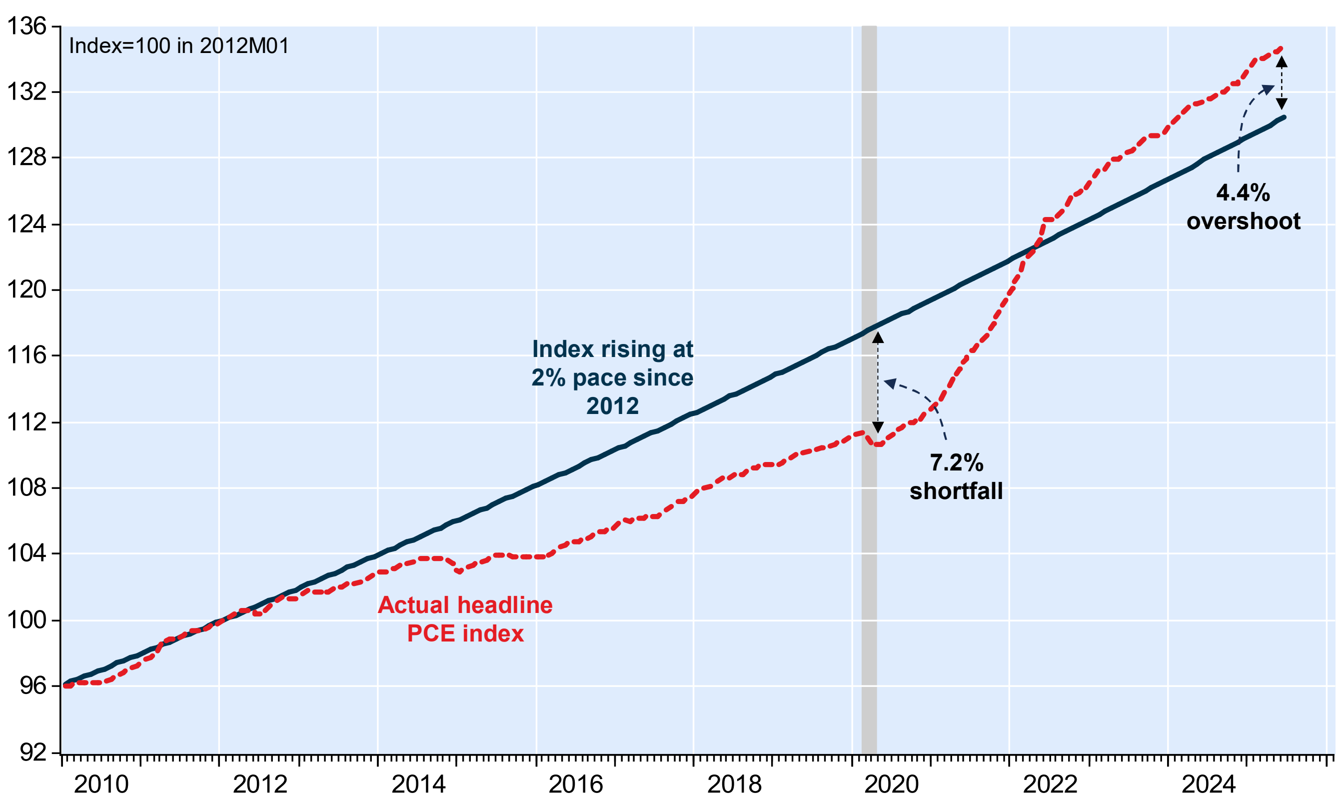
U.S. Watch

By Jocelyn Paquet and Taylor Schleich

Roughly every five years, the Federal Reserve conducts a review of its monetary policy framework. The process is designed to ensure the latter remains effective in achieving the central bank's goals of maximum employment and price stability. Some of our readers may recall that the last review process—which ended in August 2020—resulted in some pretty big changes to the Fed's mandate, including a shift towards flexible average inflation targeting, where the central bank aims to achieve inflation moderately above 2% after periods where it had been running below that level. Although the central bank never specified the time frame for the new mandate, several commentators assumed that it would attempt to compensate for any deviation *since the adoption of the 2% inflation target in January 2012*. Without confirming this assumption, the Fed never saw fit to deny it outright. And so, when inflation began to deviate upward in the wake of the pandemic, the financial press was flooded with comments urging the central bank to exercise caution. Why should it raise rates abruptly if prices remained about 7.2% below where they would have been if inflation had been constant at 2% since January 2012? The Fed obliged for a few months, but it had to relent when inflation really started shooting up. The argument in favour of keeping rates low then quickly died down. Fast forward four years, and this time the debates centers on whether the Fed should *lower* rates. While all sorts of arguments have been made on both sides of this debate, the argument for taking past deviations into account has been conspicuous by its absence. This may be because, unlike in 2021, looking at the past would argue strongly in favour of keeping policy rates in restrictive territory. Indeed, as today's chart shows, the price level as calculated by the personal consumption expenditures deflator is about 4.4% above where it would have been if the inflation target had been consistently achieved. And the gap will only widen, with inflation expected to remain above 2% at least until the end of 2026 according to our forecasts. But don't expect the Fed to dwell on this fact for too long. If asked, it would probably respond that, in 2020, it had specified that it would only take into account deviations from the 2% inflation target on the downside, not on the upside. For all we know, it could also respond that average inflation targeting is unlikely to survive for long, given that another framework review process is currently underway. Many commentators are indeed suggesting that it is on the way out and, if that were the case, we would not mourn its demise for long, because, although it makes a lot of sense from a theoretical point of view, its application in practice has revealed several weaknesses, notably the fact that it makes the Fed more backward-looking and thus less flexible in the face of shocks. Given that the results of the last framework review were announced at the 2020 Jackson Hole symposium, and in light of the title of Jerome Powell's speech at the same symposium on Friday—*Economic Outlook and Framework Review*—more details are surely on the way on this topic later this week.

U.S.: Not hearing much these days about accounting for past PCE misses

Actual headline PCE deflator vs. a hypothetical index rising at a constant 2% pace since January 2012



NBC Economics and Strategy (data via Bloomberg and internal calculations)

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