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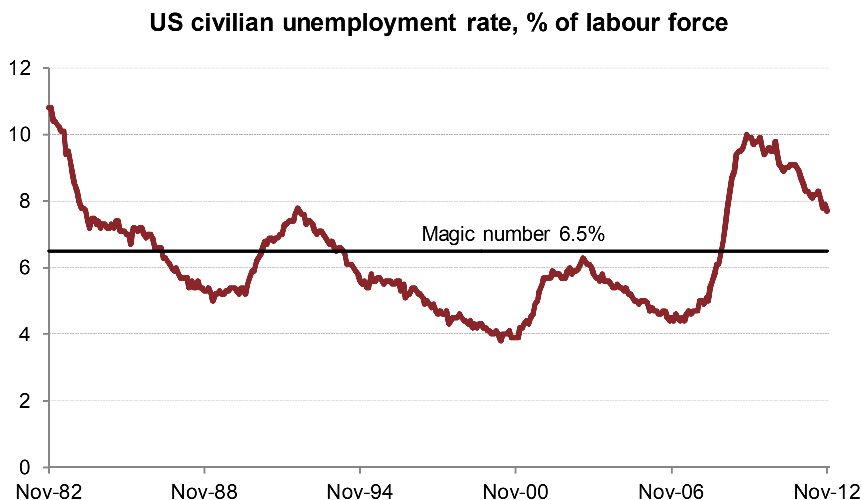
Less than meets the eye

Fed could tighten well before 2015

I do not, as a rule, like to react to latest news. However, as I did write a comment on whether central banks are abandoning inflation targeting (11th October this year), I do want to make a brief comment on two recent developments.

First, the Fed's statement from last night, tying monetary policy to unemployment. The Fed will keep interest rates at current levels until unemployment falls below 6½%, subject also to inflation developments. ("In particular, the Committee decided to keep the target range for the federal funds rate at 0 to 1/4 percent and currently anticipates that this exceptionally low range for the federal funds rate will be appropriate at least as long as the unemployment rate remains above 6-1/2 percent, inflation between one and two years ahead is projected to be no more than a half percentage point above the Committee's 2 percent longer-run goal, and longer-term inflation expectations continue to be well anchored."). This is generally perceived to mean sometime in 2015.

But does it? The US unemployment rate has been falling fairly steadily since peaking at 10% in October 2009. Even with growth below trend, the rate has come down to 7.7% by last month. It is likely to pick up somewhat in the first half of next year, almost regardless of what happens to the fiscal cliff, as concerns over said cliff is making business and consumers vary of spending. But it should then begin to fall again. On current trends it should drop below 6½% sometime in mid-to-late 2014. That is perhaps not far from mid-12015, but early enough to be unpleasant for bond markets. (Incidentally, the previous time unemployment reached above 10% it took about four years for it to come below 6½% again. A similar development now would imply that the magic number could be reached in 2013.)



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However, bear in mind that unemployment is a lagging indicator. The rate may be kept up by people returning to the labour force if the economy and the employment situation look like picking up. But if the rate keeps falling, the Fed is likely to want to start to normalise interest rates earlier, rather than later.

For the time being, the Fed's policy is good for bonds. But one day (and we all wish we knew *the* day) this will reverse. Contrary to appearances, yesterday's Fed statement has not postponed that reversal.

On central bank policy, we should bear in mind that the Fed has always had employment as part of its mandate, so this is not a fundamental change of stance. However, the incoming Governor of the Bank of England has stirred up interest by hinting that it might be time to abandon (or perhaps modify) the Bank's inflation-targeting mandate in favour of targeting nominal GDP. There have always been some vocal commentators clamouring for such a target.

Inflation-targeting is not perfect, nor is inflation (CPI, RPI, PCE deflator) a perfect measure. But GDP is published with a lag of two to three months; is much more difficult to measure than inflation; and is regularly revised, sometimes substantially so. Monetary policy should be forward-looking. Whatever the intentions, its practice with nominal GDP-targeting will ultimately be rearward-looking. That doesn't mean that it won't happen. It only means that the flaws and failures of such a policy will become apparent fairly soon, but will in the meantime cost us all dear.

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