MHRI Brief September 26, 2017

The US economy: topic of the month

Asset reduction begins, mystery of inflation remains

Makoto Ono, Senior Economist, Research Department – Europe and the Americas

On September 20 the Federal Open Market Committee (FOMC) announced that it would commence its "balance sheet normalization plan" from October, while leaving its target interest rate unchanged. Although hurricanes triggered large-scale flooding disasters just prior to the FOMC meeting, the committee presented the judgment that "past experience suggests that the storms are unlikely to materially alter the course of the national economy over the medium term" and embarked on the plan in line with prior predictions. Furthermore, it was helpful to the FOMC that political and budgetary issues were solved before the meeting. That is, the US Congress decided on a continuing budget resolution for fiscal 2018 and an extension of the debt ceiling waver alongside a supplementary budget for disaster assistance.

A decade ago, just prior to the financial crisis, the securities held in the FRB's SOMA account was less than $800 billion. But it has now ballooned by more than five times that to $4.2 trillion. This is the result of large-scale asset purchases (LSAP) program, better known as "quantitative easing" or QE. The FRB purchased US Treasuries and agency mortgage-backed securities (MBS)), albeit intermittently, with the goals of stabilizing the financial system, preventing deflation and restoring employment.

QE proved successful and the labor market in particular showed a dramatic improvement. In November 2014, the FRB halted QE and began to keep its bond portfolio constant through the reinvestment policy. By the latest decision, FRB's portfolio will finally shrink gradually within the pre-announced cap (or "speed limit" for your better understanding). The initial cap of the asset reduction is set to $10 billion ($6 billion of US Treasuries and $4 billion of MBS) per month. Under the FRB's plan, the cap should be lifted every three months and fixed at $50 billion after the first year has passed. Although the reinvestment policy will continue for some time because redemptions exceed the cap, it can be said that the policy will effectively end late next year.

The balance sheet reduction, the reverse of QE, will not be expected to have a material impact on the financial market. Existing research shows that QE drove down 10-year treasury yield by a cumulative 100bp (1%). The asset reduction is expected to reduce such effects to 60bp. It should be an extremely gentle impact on a per year basis.

On the other hand, in managing its remaining interest rate policies, the FOMC is yet to solve the difficult puzzle of "low inflation under full employment."

As of July, the core inflation rate, based on the personal consumption expenditure deflator, was only y-o-y

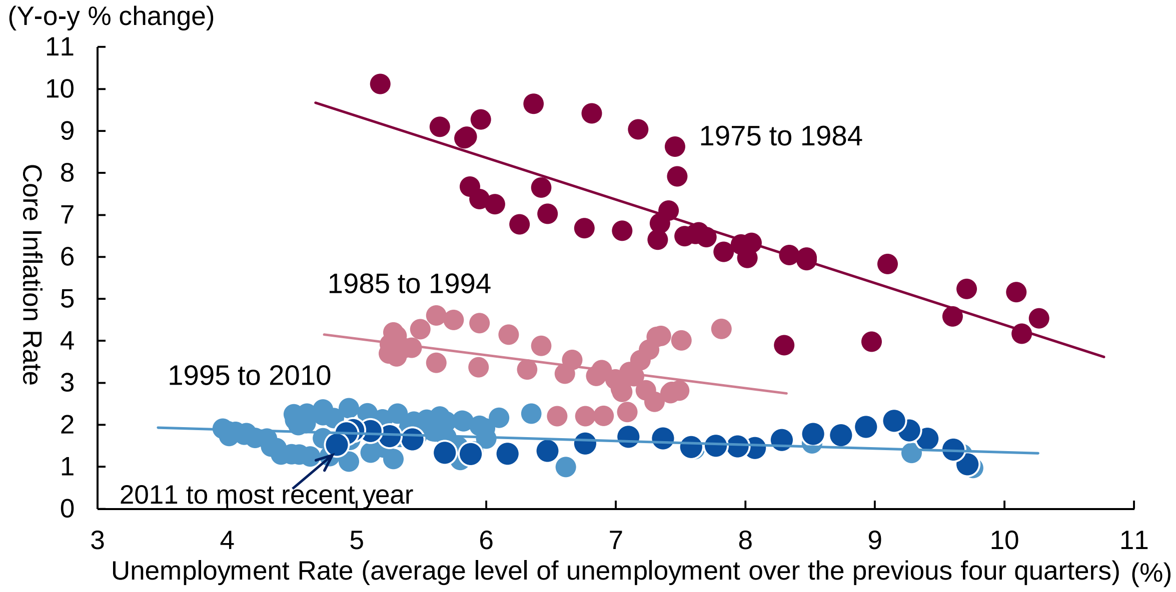
+1.4%, well below the price stability goal of 2% that was established in January 2012 under then FRB Chair Ben Bernanke. FRB Chair Janet Yellen has shown her view that “the downward swing in the inflation rate is being caused by transitory price changes in specific items, such as a major decline in mobile-phone service charges, and those influences will disappear.”

However, Yellen also called it a “mystery” that low inflation is persisting this year despite the disappearance of those factors, and noted that this is “a more widespread phenomenon” that is not limited to specific items. She even went as far as mentioning reviewing the pace of interest rate hikes, saying, “if we conclude that the low inflation is not temporary, we will no doubt need to adjust monetary policy.”

The “mystery” of low inflation is never a new challenge for FRB. The US Phillips curve has been flattening for a long period. Since 1995, it has been implying almost no correlation between the output gap (or labor slack) and the inflation rate (**Chart)**. If Yellen is attempting to seriously confront the “mystery,” she should be very careful when the core inflation begin to move toward the 2% goal. What if such upward movement of price itself might be transitory?

Looking back now, the core inflation rate has never touched the 2% goal since the mid 2012. This experience tells us that it might be necessary to adopt “wait-and-see” stance more strongly than before to confirm whether the core inflation rate is shifting to 2% persistently.

[Chart: US Phillips curve]



Source: Made by MHRI based on material from the US Department of Labor and US Department of Commerce