Tim Duy's
Fed Watch
SEPTEMBER 26, 2017

Dueling Federal Reserve Presidents

The battle over that final rate hike of 2017 continues as some policymakers find it increasingly difficult to ignore weak inflation numbers in recent months. Such concerns, however, do not appear likely to take center stage in December. Indeed, the Fed looks fairly committed to a rate hike at that meeting. But the consensus on that meeting and beyond is being held together by forecasts of a rebound of inflation next year. It will be hard to maintain that consensus if inflation numbers don't soon give more hope to those forecasts.

New York Federal Reserve President William Dudley touched on the US economy in a speech Monday, reiterating his view that transitory factors account for recent inflation weakness:

> *With a firmer import price trend and the fading of effects from a number of temporary, idiosyncratic factors, I expect inflation will rise and stabilize around the FOMC's 2 percent objective over the medium term. In response, the Federal Reserve will likely continue to remove monetary policy accommodation gradually.*

Dudley represents the consensus view at the Fed. There is fairly strong resistance to idea that the inflation shortfall is more persistent than transitory. The view that policy needs to remain preemptive to maintain a gradual pace of rate hikes dominates the policy discussion.

That said, important cracks in that consensus view emerged in recent weeks. In a speech Monday, Chicago Federal Reserve President Charles Evans followed in the footsteps of Federal Reserve Governor Lael Brainard by raising concerns about inflation expectations:

> *Expectations of future inflation play an important role in the inflation process...In effect, actual inflation can take on a bit of a self-fulfilling nature, as expectations of future inflation become embedded in current wage and price decisions. I am concerned that inflation expectations are too low today, making it harder to achieve our 2 percent target.*
>
> *Admittedly, we do not have clean, accurate measures of the inflation expectations being used by workers and firms as they decide how to set wages and prices. But some of the measures that we do have—say, the pricing of financial market instruments that are linked to inflation outcomes, such as Treasury Inflation-Protected Securities (TIPS), and survey measures from households—suggest inflation expectations are low. Expectations for continued low inflation appear to be embedded in the labor market as well...*

What are the policy implications? For now, a solid economy leaves Evans in line with the consensus:

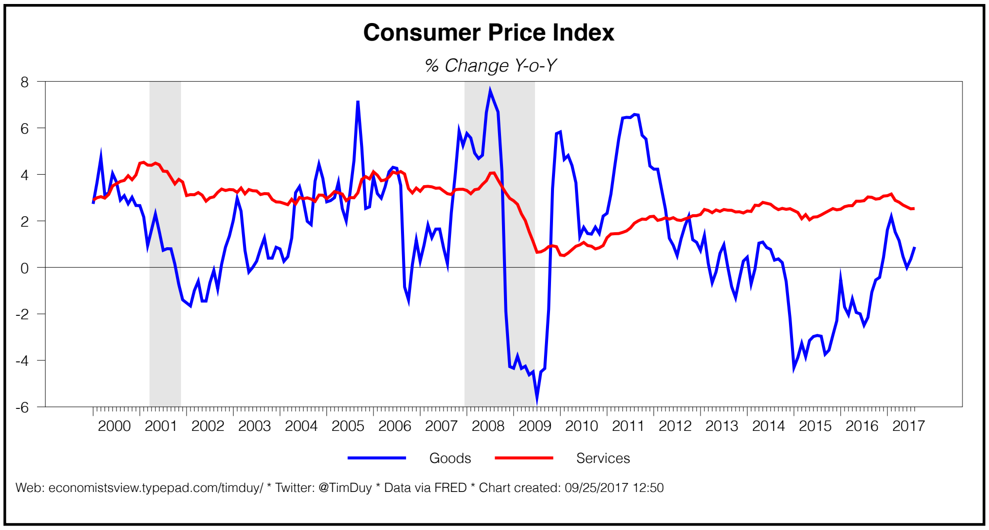
> *Looking ahead at the future path for the funds rate, given my current outlook, I am broadly comfortable with the projections associated with the median SEP, which see the rate rising to 2.7 by the end of 2019.*

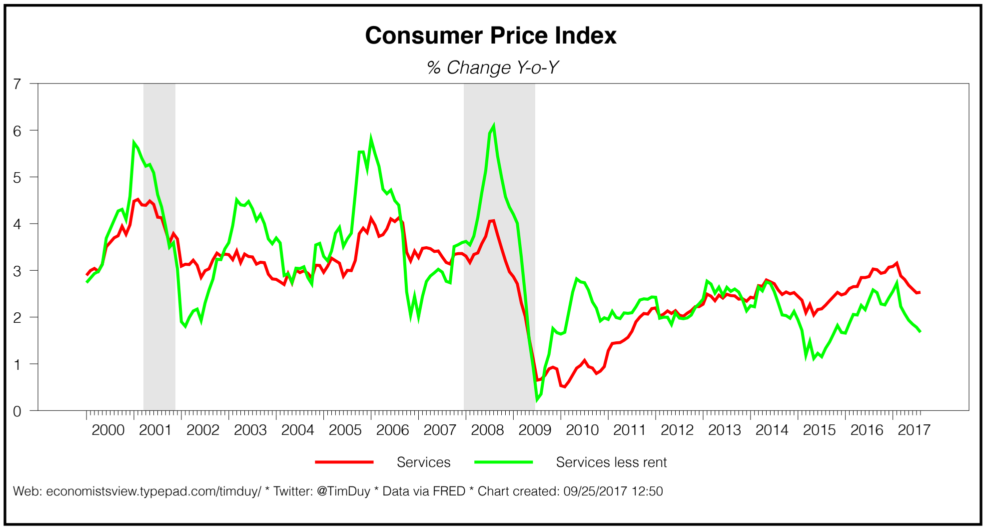
That said, Evans wants to see evidence that their forecasts are more realistic than not:

> *However, my views about this path are not set in stone. As the FOMC comes to decision points over the coming months, I think we need to see clear signs of building wage and price pressures before taking the next step in removing accommodation. We should avoid taking policy steps that could be misread as a lack of concern over the inflation outlook. In my view, that would be a policy misstep that would further delay achieving our inflation objective.*

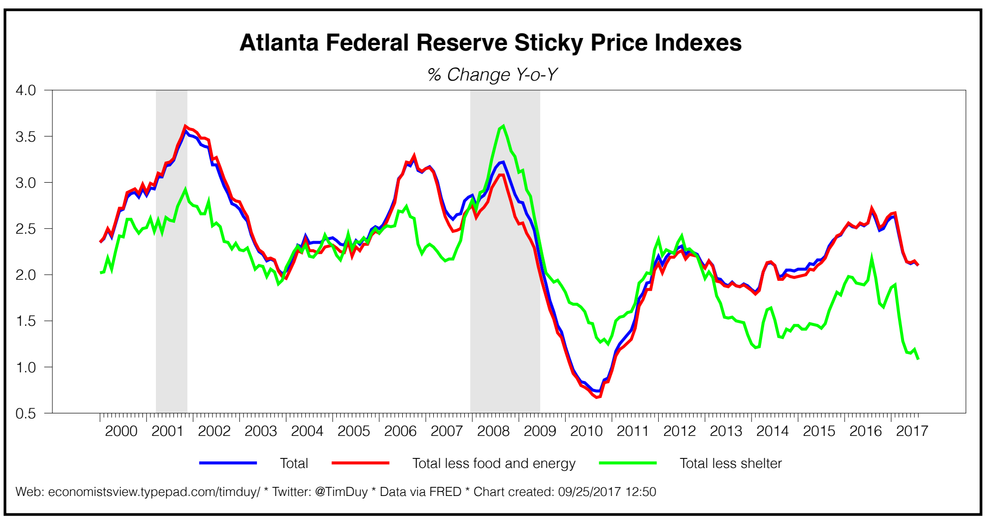
This seems like a fairly strong warning: Evans remains on board with the Fed's consensus for now, but will soon jump ship if actual price pressures fail to emerge. This December meeting could be contentious – Evans could join Minneapolis Federal Reserve President Neel Kashkari in dissent if their colleagues insist on another rate hike. This could be their last chance to slow the pace of rate hikes before next year's rotation of voting members and new appointments to the Board of Governors.

To date, policymakers have been generally dismissive of low inflation, with most sticking with Dudley's story regarding the importance of transitory factors. Services inflation, which offsets the persistently disinflationary force of goods, has been notably weak in recent months, and held up largely due to rising rents. This feels more persistent than transitory. Moreover, it is not unreasonable to expect that upward force from rents will soon wane in the wake of the multifamily building boom across major metro areas in recent years.





In addition, it is worth keeping an eye on sticky price measures. Such prices, which change infrequently, are considered important to forming inflation expectations. The Atlanta Federal Reserve measure of sticky prices has been in a downtrend in recent months, and absent shelter costs is at record lows for the series. The general downward trend in sticky price inflation should be of more concern to Fed officials than appears to be the case.



Bottom Line: The Fed's rate projections are held together by the view that weak inflation is only transitory. But if this bet is wrong, the Fed risks a policy mistake that threatens the expansion and further entrenches inflation expectations below target. This is particularly risky given that the Fed believes that in a low interest rate world, policymakers are more likely than not to face the effective lower bound on policy rates in the future. Policy making would only be more difficult if that happened in an environment of already soft inflation expectations. It appears that the Fed is waking up to the risk only very slowly.

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Professor Duy received his B.A. in Economics in 1991 from the University of Puget Sound, and his M.S. and Ph.D. in Economics in 1998 from the University of Oregon. Following graduate school, Tim worked in Washington, D.C. for the United States Department of Treasury as an economist in the International Affairs division and later with the G7 Group, a political and economic consultancy for clients in the financial industry. In the latter position, he was responsible for monitoring the activities of the Federal Reserve and currency markets. Tim returned to the University of Oregon in 2002. He is the Senior Director of the Oregon Economic Forum and the author of the University of Oregon Statewide Economic Indicators, Regional Economic Indicators, and the Central Oregon Business Index. Tim has published in the Journal of Economics and Business and is currently a member of the Oregon Governor's Council of Economic Advisors and the State Debt Policy Advisory Commission. Tim is a prominent commentator on the Federal Reserve. MarketWatch describes his blog and "influencial," the Huffington Post identified him has one of the top 26 economists to follow on Twitter, and he is listed on StreetEye as one of the top 100 people to follow to discover finance news on Twitter. Major national and international news outlets frequently quote him, including the *New York Times*, the *Washington Post*, the *Financial Times*, the *Wall Street Journal*, and *Bloomberg*. He also writes a regular column for *Bloomberg Prophets*.

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