Northern Trust

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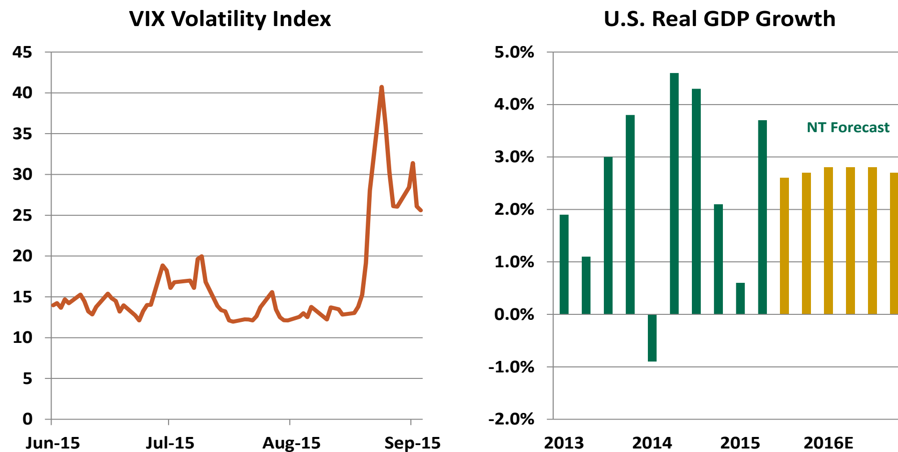
- **Will Unsettled Markets Unsettle the Federal Reserve?**
- **Inflation Targeting Is an Imprecise Science**
- **The U.S. Gets Closer to Full Employment**

A partner of mine recently observed that market advances take the stairs, while declines take the elevator. That is an apt way to describe the recent actions of the world's equity markets, which worked their way up to record highs earlier this year before enduring a sharp correction.

This same pattern can be seen in the actions of the world's central banks, which are typically cautious when raising rates but aggressive when lowering them. Yet with interest rates at zero in developed markets and quantitative easing losing its effectiveness, monetary policy cannot provide much more assistance to economic activity. This knowledge may defer the Federal Reserve's first step upward.

The question of how events in the Far East will affect the Fed has come up frequently in recent conversations. At the outset, it should be noted that central banks do not center their policies on the levels of asset markets or the level of volatility. Monetary policy focuses on the outlook for economic performance and its impact on prices and employment.



Sources: Bloomberg, Northern Trust

Fed officials have stated that they would be watching for signs that China's moderation was affecting U.S. growth, but none have been noted so far. Some exporters have seen orders from China decline, but exports to China comprise less than 1% of U.S. gross domestic product (GDP). American investors have scant direct exposure to Chinese equities, and Chinese sales account for a small fraction of revenue for the S&P 500. Second-quarter U.S. GDP growth was strong, and the anecdotal information in the Fed's Beige Book was positive.

Expectations for softer Chinese production have placed energy prices under renewed pressure. While not helpful to America's petroleum industry, cheaper gasoline will be a positive for consumers.

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The strength of the dollar, which has gained ground amid global uncertainty, has been mentioned as a *de facto* easing of monetary policy. In theory, a stronger currency allows a country to purchase overseas products for less, thereby "importing" disinflation. But research presented at the Fed's recent conference in Jackson Hole, Wyoming, seemed to suggest that this influence is weaker than previously thought.

At that same conference, Bank of England Governor Mark Carney stated that interest rates in Britain were still on course to begin rising early next year. U.K. growth has been strong and should be able to withstand modest headwinds from Asia.

All of this certainly provides some comfort. But the economic numbers we have in hand pre-date the interval of world market volatility. Looking forward, there are risks to consider.

The outlook hinges on how much contagion China will cause.

If China's troubles continue to impair its vendors and countries that are dependent on commodities, the damage to global growth will become more severe. Canada has entered recession as its energy sector contracts; it represents 19% of U.S. exports. In his post-meeting press conference this week, European Central Bank President Mario Draghi downgraded forecasts for eurozone growth and noted the downside risks presented by China.

In addition, the psychological impact of falling and volatile markets may affect U.S. growth. Worried investors become more averse to risk; worried companies don't hire and expand; and worried consumers spend more cautiously. If asset prices fail to stabilize in the weeks ahead, this could darken the outlook.

Our central expectation remains that China will right itself, albeit at a lower level of economic growth. As that occurs, commodities and currency markets should recover, relieving pressure on emerging markets. The global economic picture will become clearer and more positive.

But that clarity is unlikely to be in place when the Federal Reserve gathers in the middle of this month. As long as there are fears that even a small step might send markets down the elevator shaft, the Fed might be content to stand where it is.

The 2% Solution

With U.S. labor markets nearing full employment, discussions at the upcoming meeting of the Federal Open Market Committee (FOMC) are likely to center on the assessment of progress toward the Fed's 2% inflation target. Since this objective has become so critical, it seems appropriate to step back and ask how it was established and how it operates in practice.

Broadly speaking, the Fed is chartered with engineering price stability. For most of its history, the institution pursued this goal without relying on an inflation target. There were a number of reasons for this.

- Inflation is not easy to measure. Collecting accurate prices, adjusting for changing features and accounting for shifts in the "basket" of things in an index are among the many challenges economic statisticians face. Determining which components are more transitory and which are more stable is an additional complication. And as we discussed earlier this year, technology creates special complications.

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- Once a target measure is established, defining how the target will be tied to policy presents a new set of challenges. Holding inflation exactly at the targeted level at all times is unrealistic, but how far should it be allowed to stray before prompting a response? Should this assessment be based on today's reading or on some forecast of where inflation will be in the future? And if the latter, how far into the future?

  Should the target be a point estimate or an average? A single number or a range? Should the target be viewed as a maximum or as a goal to approach from both directions? A scan of inflation-targeting regimes around the world reveals a wide variety of practices, all covered under the umbrella of inflation targeting.

Selected Central Bank Inflation Targets

Country	Objective
U.S.	Inflation at 2% is most consistent over the longer term with the Federal Reserve's mandate for price stability and maximum employment
Eurozone	Inflation below, but close to, 2% over the medium term
U.K.	2% target; excesses below 1% or above 3% require notification to the Chancellor of the Exchequer
Australia	An inflation rate of 2–3 per cent, on average, over the cycle
New Zealand	Inflation within a range of 1–3 percent on average over the medium term
Canada	Inflation at the 2 per cent midpoint of a target range of 1 to 3 per cent over the medium term

When Ben Bernanke became the Fed chairman, the institution's posture on inflation targeting began to shift. In a series of speeches, and undoubtedly behind closed doors, Bernanke made the case for the discipline of an inflation target, while continuing to allow discretion over how it would be used in setting policy. The FOMC ultimately adopted a target of 2% in early 2012.

It is not clear why 2% is a magic number for inflation.

Technically, 2% is not absolute price stability. But setting a target of zero raises the risk of deflationary periods that central banks have a hard time handling. And technically speaking, the Fed does not exactly target 2%. Its most-recent statement suggested that policy was keyed off progress toward the objective of 2% inflation over the longer run. What constitutes progress, and how long the long run is, can be the subject of considerable debate.

The choice of 2% was, and remains, something of a mystery. The first central bank to select an inflation target, the Bank of New Zealand, established a range of 1% to 3%. Canada followed the next year, and the United Kingdom the year after that; both selected 2%. The number has been set into stone, although it is not clear that one size should fit all markets.

There isn't a clear body of evidence suggesting that use of an inflation target enhances economic performance. There isn't even evidence that an inflation target provides the desired discipline. In the case of the United States, actual year-over-year inflation has run below the Fed's objective for 39 consecutive months, raising the ire of those on the Fed's left wing.

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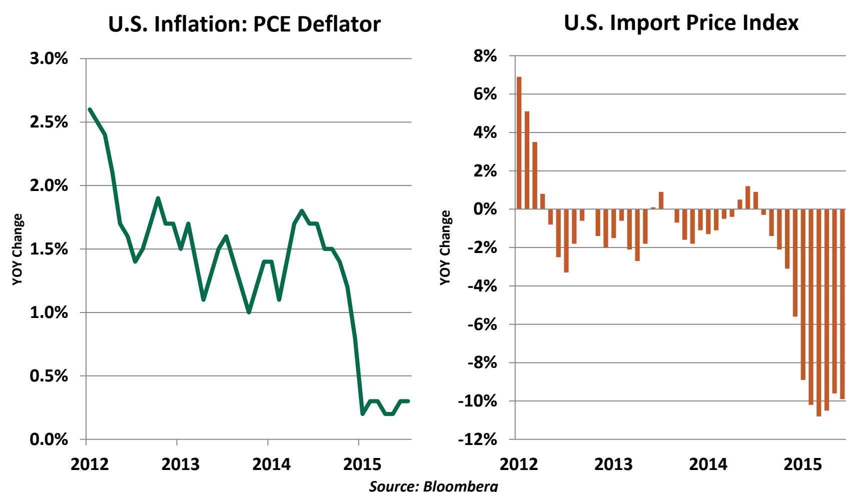
Further, not all markets have the same degree of control over their inflation rates. And the smaller the country, the less control it might have. Over the decades, supply and demand have become more global. This is certainly true for commodities and increasingly so for labor. The ability of an individual central bank to steer the price level by altering local credit conditions has consequently become more limited.



Finally, some central bankers have asked questions about the wisdom of pressing upward if inflation is below its targeted level. Governor Mark Carney has offered the concept of "good disinflation," such as falling energy prices. Trends like these push inflation below target but are favorable for economic activity. Should a central bank lean hard against these developments?

Inflation targets still leave lots of room for discretion.

To be sure, inflation targeting has some valuable qualities. It does improve the transparency of central bank decision-making by providing an anchor. While it seems remote in today's disinflationary environment, the price level may one day move ahead more briskly. A commitment to containment from monetary authorities can be comforting to investors.

But cynics would say that the practice of inflation targeting today leaves central banks just as much room for discretion as they had before targets were established. And the motivations for easing to reach the targets from below are somewhat less clear than they are for tightening to keep inflation from rising too far.

Goals are best when measurable, attainable and within one's control. It is not clear that inflation targets fully satisfy these three criteria at present. And so they should be applied carefully in the current conduct of monetary policy.

U.S. Employment Conditions: No Clear Signal for the Fed

The eagerly awaited August employment report offers evidence of additional improvements in the U.S. labor market – a lower jobless rate, an increase in payrolls and higher wage growth. But it was neither strong enough to guarantee a rate hike from the Fed later this month nor weak enough to ensure that policy will remain stable.

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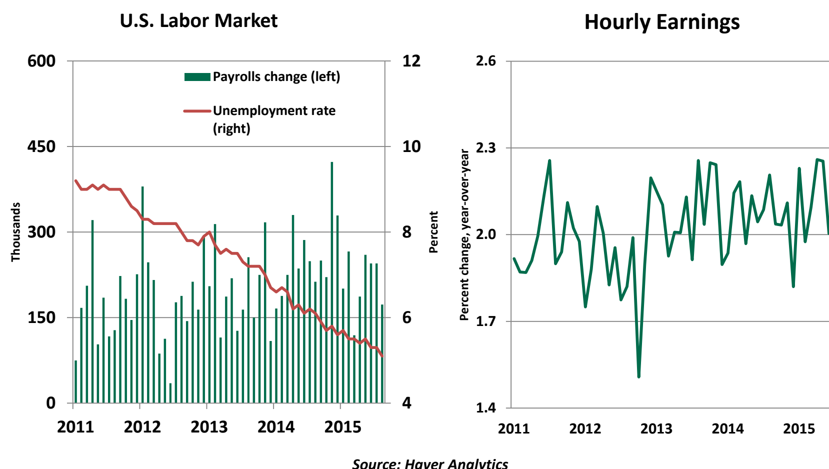
The civilian unemployment rate declined to 5.1% in August from 5.3% in the prior month. The broad measure of unemployment (U6) also edged down one notch to 10.3%. The labor force participation rate held steady in August. Nonfarm payrolls rose 173,000 in August; this below-consensus-forecast number taints the report a bit. Payrolls for June and July were revised up by 44,000, however.

This morning's report reflected solid progress.



Source: Haver Analytics

In August, factory hiring slipped, and retail employment slowed. Private sector jobs increased 140,000, and government employment advanced 33,000. The average workweek was longer in August. Average hourly earnings rose 0.3% from the prior month, the best since January, and it puts the year-to-year increase at 2.2%. Firmer readings for wages enhance expectations of higher inflation.

The August unemployment rate is smack in the middle of the Fed's estimate of the long-run unemployment rate (5.0%-5.2%), considered as a proxy for full employment. Some will therefore suggest that the Fed has achieved the full employment part of its dual mandate. The downside is a flat participation rate, but given the changing demography of the country, an unchanged reading is better than a lower participation rate.

At the Jackson Hole gathering in late-August, there were doubts about the trade-off between unemployment and inflation (technically referred to as a downward sloping short-run Phillips Curve). But, the latest earnings numbers, combined with anecdotal information from the Beige Book about rising compensation trends, suggest that shrinking slack in the labor market will contribute to higher inflation over the coming months.

This development is important because "confidence" about inflation reaching the Fed's 2.0% target down the road is critical for a consideration of tightening monetary policy. Fed Vice Chairman Stanley Fischer echoed this view at Jackson Hole. The latest wage data provide another piece of evidence that might bolster the case for a September hike of the policy rate.

Our call for a higher federal funds rate in September has been in place for more than a year, and we continue to hold that it is a possibility, assuming international developments are not disruptive.

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