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Richard Clarida

Is It Time for the Fed to 'Level' With Markets?

As the saying goes, "You only have one chance to make a first impression." This is true for you and me, and it's also true for Federal Reserve chairs. Janet Yellen made her public debut as Fed chair recently, providing the semiannual testimony to House and Senate committees on the state of U.S. monetary policy. She acquitted herself well by hewing closely to the December 2013 and January 2014 FOMC (Federal Open Market Committee) statements that outlined the policy framework she will inherit from Chairman Ben Bernanke. This framework includes a continuing, measured tapering of the pace of Treasury and MBS purchases as well as forward guidance indicating that it will be appropriate to maintain the current range for the federal funds rate "well past the time" that the unemployment rate declines below 6.5%, and for "a considerable time" after asset purchases end. If anything, Fed Chair Yellen went out of her way to write the headline for news services by stating, "I expect a great deal of continuity in the FOMC's approach to monetary policy."

But in fact, Chair Yellen does not have the luxury of presiding over "continuity" with regard to the Fed's guidance on the future policy rate. U.S. unemployment will likely soon cross the 6.5% threshold, at which point the clock will start ticking on the "well past the time" language. Moreover, the Fed appears to be set on a Bernanke/Yellen course to taper at each of the eight Fed meetings this year, which would imply that quantitative easing will end by December 2014,

at which point a second clock will start ticking on the "considerable time" language. So the Yellen Fed will likely feel compelled – if not by consensus, then by markets – to refine the forward guidance that it provides to the public today.

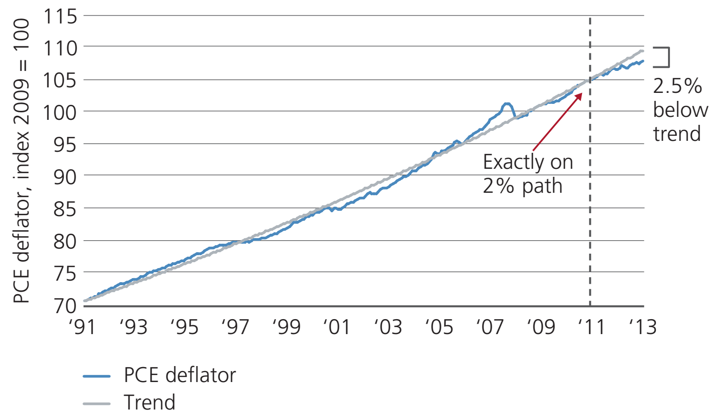
There are a variety of ways the Fed might choose to improve forward guidance, several of which (including calendar-based, outcome-based and optimal control guidance) we reviewed in the November 2013 *Global Perspectives*, "Guidance Counselors." And today, the Fed may find still another extension of forward guidance proves compelling.

A price level target

In the 20 years through 2011, the level of the U.S. Personal Consumption Expenditures (PCE) deflator – the Fed's preferred index of prices – followed a path corresponding to the Fed's inflation target of 2% in each and every year (note the Fed first announced this specific target in January 2012). Of course realized inflation was not equal to 2% each of those years (1992–2011), thus the fluctuations about the trend line (see Figure 1). But by luck or design (and probably both!), the Fed achieved longer-term price stability on average over the last 14 years of Alan Greenspan's tenure as Fed chair and the first six years of Bernanke's.

As we know from two speeches she delivered in 2012, Chair Yellen has studied closely the research on the optimal control approach to monetary policy developed in theoretical research by Michael Woodford and others. A key finding of this research is that under optimal control, the Fed should commit to run a policy that tries to keep the price level as close as possible to the path depicted in Figure 1 – at least, the path as it appears through 2011.

FIGURE 1: PCE DEFLATOR INDEX SUGGESTS PRICES SINCE 2012 ARE DRIFTING BELOW THE FED'S TARGET



Source: Bloomberg, Bureau of Economic Analysis monthly data December 1991 – December 2013

However, because inflation has been running consistently below 2% in recent years, the PCE deflator price level has drifted further and further below the desired path that it was on from 1992 to 2011. Indeed, as of December 2013, the level of the PCE is 2.5 percentage points below the desired path.

This shift represents an opportunity for the Yellen Fed to embrace at the outset a price level target – together with more holistic measures of the state of the labor market – as a replacement for the 6.5% unemployment threshold that will soon – if not already – become irrelevant for offering guidance on the future pace of policy normalization.

What if it works? What if it doesn't?

One immediate implication of adopting a price level target is that it would likely be accompanied by language that would shift further into the future expectations of the timing of the first rate hike as well as the pace of policy normalization

following that first hike. The likely impacts of a price level target would be to lower bond yields in the belly of the curve, to raise the price of inflation-indexed bonds and to increase break-even inflation. As a result, yields on longer-duration bonds would likely rise. Equities and credit spreads would likely rally.

Of course, there is no free lunch in economics, and Chair Yellen knows this. Unlike in the textbook models, there are two risks to a price level target that the Fed would have to consider. The first is that the credibility of the Fed's inflation target might be damaged were it to pursue a policy that aims to push inflation above 2% for some time to compensate for the years since 2011 when it has been below the 2% target. The second risk is that the commitment to tolerate above-2% inflation for a while would not in fact be credible as markets would price in that once inflation returns to 2%, the Fed will adjust rates to keep it there and not allow an overshoot.

For these reasons and others, no modern central bank has yet committed to a formal price level target, and it would not be an easy call for the Fed to be the first. But the Fed has been struggling for some time to replace the calendar date guidance that was in place from August 2011 until December 2012. Yellen has several times extolled the insights derived from the optimal control approach for monetary policy. Don't be surprised if forward guidance by price level target makes its way someday from the chalkboard to the Fed statement.

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Newport Beach Headquarters
840 Newport Center Drive
Newport Beach, CA 92660
+1 949.720.6000

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