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Janet Yellen: Inflation Fighter

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The US central bank Fed hinted at an increase of the Fed funds rate in December at its meeting on 28 October. A bias towards such an increase is referred to as tightening bias.

If the economic data permit it, the Fed will increase the Fed funds rate from practically zero percent. The extent and the speed of the increases will remain low. On a global scale, we can see deflation pressure (pressure for prices and wages to fall). The strong US dollar already has a negative impact on the US economy, the financial markets are still unstable, and the so-called natural interest rate, which comes with full employment and stable and low inflation, has fallen clearly in the past years. The outlook for the risky segments of the financial market remains positive in the short run, but uncertain in the medium term.

Forward Guidance

The tightening bias mainly manifested itself in the core sentence of the published statement: a rate increase in December is justified if the central bank can see further progress in achieving its two goals, full employment and an inflation rate of two percent. In previous weeks differing statements made by members of the central bank had been causing a bit of confusion. Now the preparation of the market with regard to the future monetary policy is working better ("forward guidance").

Phillips-curve

A concept often used by central banks is the Phillips curve. It describes the relationship between the unemployment rate and inflation. Generally speaking, the higher the unemployment rate, the lower inflation. It is important to note that there are two different kinds, which differ to the extent that in one case the inflation expectations of companies, consumer, and markets are stable, and in the other case they are not.

Stable inflation expectations

If the long-term inflation expectations are stable, the current rate of inflation converges towards the inflation target when full employment has been attained. The US Fed is in this camp.

Falling inflation expectations

If the long-term inflation expectations are not stable, for example if they are sliding, inflation remains excessively low even when full employment has been achieved. In order to trigger an increase in inflation expectations, the economy has to work at capacity for a while in order for an increasing degree of wage pressure to build up. This is difficult to achieve if the key-lending rates are already at zero percent. This is the camp the European Central Bank (ECB) is in, having given signals for a further loosening of the monetary policy on 22 October (loosening bias).

Communicating vessels

The different monetary inclinations of the Fed and the ECB have led to the appreciation of the US dollar relative to the euro. This dampens the economy in the USA and supports the economy in the Eurozone, and as a result also dampens the extent of potential rate hikes in the USA and of potential loosening in the Eurozone. Currencies and key-lending rates are communicating vessels.

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