The Prize and the Price of Opportunistic Tightening

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The U.S. bond market’s post-election optimism has now evaporated: The 10-year nominal U.S. Treasury yield has dropped by almost half a percentage point from its mid-March 2.62% post-election high, with lower implied inflation rather than lower real yields accounting for most of the decline. Ten-year breakeven inflation, at 1.7%, now stands some 70 basis points below the Fed’s inflation target, more than fully reversing its rally following the November election. (Note that the 2% target for personal consumption expenditure (PCE) inflation translates to a consumer price index (CPI) target of about 2.4%, and Treasury Inflation-Protected Securities (TIPS) are linked to CPI.)

Several factors likely contributed to the deflation of inflation expectations:

- The Fed remains focused on what I call “opportunistic tightening,” as illustrated by the 14 June rate hike, the virtually unchanged dot plot plan for more rate hikes and the just-released details of the balance sheet run-off targeted for later this year.
- Prospects for significant fiscal stimulus anytime soon have dimmed further in recent months.
- Oil prices, which are frequently correlated with inflation expectations, have been soggy recently on concerns about higher supply.

Most importantly, however, lower bond yields and breakeven inflation reflect the disappointing inflation data of the past three months, with core CPI inflation dropping to only 1.7% year-on-year in May. Following the June Federal Open Market Committee (FOMC) meeting, the Fed chose to characterize inflation softness as temporary and stuck to its Phillips curve-based reasoning that unemployment below the natural rate of unemployment would promote higher inflation over time. We have argued for some time that this reasoning is questionable. The bond market seems to agree, especially as the weakness in inflation appears to be fairly broad-based across the core goods and the core services components.

Why tighten?

So how should we interpret the Fed’s seemingly steadfast focus on opportunistic tightening in the face of disappointing inflation data and sagging inflation expectations, and what are the likely consequences? This has been the subject of animated debate at PIMCO over the past few weeks.
Here’s a glimpse of the main arguments:

First, most of us at PIMCO agree that if short rates are kept very low for an extended period of time, the negative side effects on banks and the broader financial sector – and thus on the transmission mechanism of monetary policy – start to mount. In a recent paper, Princeton economists Markus Brunnermeier and Yann Koby formalized this argument in the form of a “reversal interest rate.” They argue that if rates drop below the “reversal rate,” accommodative monetary policy reverses its intended effect and becomes contractionary for the macro economy because of its negative effect on lending, which is caused by the shrinkage of banks’ net interest margins. If rates stay below the reversal rate, the latter creeps up over time as the negative effects on lending grow. This could provide an argument for the Fed to raise interest rates. However, the flattening of the yield curve that has accompanied rate hikes this year is bad news for banks’ profitability.

Second, some of my PIMCO colleagues sympathize with the neo-Fisherian thesis that low nominal interest rates beget low inflation, and higher rates beget higher inflation. This thesis is based on the undisputable identity, introduced by Irving Fisher in 1930, that the nominal interest rate equals the real interest rate plus (expected) inflation. Neo-Fisherians then (more disputably) assert that the Fed cannot control the real interest rate for long – that over time, the real rate will be set by the market. If so, and applying the Fisher equation, if the Fed keeps the nominal short rate very low for a long time but the real rate must gravitate toward the market real rate, inflation will have to come down to ensure that the excessively low nominal rate still equals the (higher) real rate plus (lower) inflation. By this logic, if the Fed raises nominal rates, inflation will eventually follow nominal rates higher. So far, realized and expected inflation haven’t followed the fed funds rate up but have rather moved in the opposite direction. Yet neo-Fisherians claim that it’s too early to tell, as monetary policy works with long and variable lags.

Third, the Fed’s motivation for hiking rates despite low inflation may be to regain monetary policy space, so that it will be able to cut rates more when the next downturn arrives. Obviously, the higher rates go in this cycle, the more basis points the Fed will be able to “spend” in the next recession before it hits the zero bound. However, the risk is that by hiking rates too fast and too far, the Fed brings about exactly what it is so afraid of – the next recession.

Fourth, the Fed may be trading its inflation objective against financial stability. The thesis here is that the Fed is concerned about asset bubbles developing if it keeps rates low for too long – a key lesson from the run-up to the 2008 financial crisis – and is willing to accept a prolonged undershoot of its inflation target in return. In my view, this is the strongest argument in favor of opportunistic tightening. We are not in a bubble right now, but it’s better to remove the punch bowl before the party gets out of hand.

**Is the prize worth the price?**

However, the prize of opportunistic tightening comes at a price: By hiking rates and starting balance-sheet runoff when inflation keeps undershooting, the Fed risks cementing inflation expectations firmly below target. Some argue that this is a price worth paying. After all, does it really matter whether inflation is running at 2% or 1.5% or 1%?
Well, the difference doesn’t really matter until it does. While the economic expansion continues, below-target inflation is not a major problem. However – and this is the catch – when the next downturn hits, there won’t be much of an inflation safety margin against deflation. With core PCE inflation running at 1.5% in a nearly fully employed economy, we are only one major adverse shock away from a serious deflationary scare. That’s why there is substantial risk that the Fed’s opportunistic tightening campaign is a hawkish mistake.

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