COMPANIES & MARKETS

Flaws are evident in Fed's approach to inflation

Frederic Mishkin

Markets Insight

he US Federal Reserve has been mugged by reality. Current inflation now exceeds 6 per cent, a level on the sent and the sent and is proving to be far more persistent than Fed pollcymakers have projected. Why is Fed monetary policy behind the curve in tightening monetary policy to control inflation?

Three flaws in the Fed's monetary policy to control inflation?

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First, there has not been enough focus on demand shocks. The Fed has based its view that the inflation surge would be shortlived on the extensive negative supply shocks that Covid-19 has imposed on the extensive negative supply shocks that Covid-19 has imposed on the extensive negative supply shocks are one source of the surge in Inflation, the Fed has not paid enough attention to very strong positive demand shocks.

Pent-up demand from households who were unable to spend during the pandemic and extraordinary expansionary fiscal policy promoted by the Biden administration have led to high demand for goods and services.

It is true that inflation will be temporary when it is the result of supply bottlenecks that dissipate over time. But strong positive demand shocks result in persistent high inflation, which is what we are experiencing currently.

is what we are experiencing currently The second flaw is the Fed's view

the Phillips curve, the theory that unemployment and inflation have an

unemployment and mination nave an inverse relationship.
Officials have pronounced that the Phillips curve is dead because unemployment is below its "natural rate" (where the economy is at a full employment level). That supposedly meant higher employment rates are no longer

a main factor driving inflation higher. Research that I presented with co-authors at the US Monetary Policy Forum several years ago suggests that the Phillips curve is not dead but rather is hibernating. A weak link between unemployment and inflation depends on the Pail this proposition of the Pail this proposition. on the Fed taking pre-emptive strikes against rises in inflation, a policy that it

as nowabandoned. Instead, the Fed has committed to Instead, the Fed has committed to keep monetary policy expansionary until full employment has been reached. A summary by the policy-setting Federal Open Market Commit-tee of economic projections suggests

The outcome will not only be persistent inflation well above its objective but far higher interest rates

that this will occur at a natural rate of unemployment of close to 3.5 per cent. Unfortunately, past economic research indicates that the natural rate of unemployment is a number that is notoriously hard to estimate. Indeed, other indicators of labour market tightness, such as the high number of unfilled jobs and rising wages, hint that we have already hit full employment, is the natural rate of unemployment is

we have already hit full employment, so the natural rate of unemployment is above the 3.5 per cent target level. Underestimates of the natural rate of unemployment have led to severe infla-tionary policy mistakes in the past; the so-called Great inflation period of the late 1960s and 1970s is a classic example where the Fed assumed that the natural rate of unemployment was about 4 per cent when later evidence demonstrated



It was a couple of percentage points higher.

A third flaw is the Fed's poor execution of the new "average" inflation targeting framework. The Fed's switch to an average inflation target, where the target is a 2 per cent average over a specified horizon, say five years, is a policy I and many other economists have advocated.

But the Fed has been unwilling to communicate the horizon for the average, which in effect makes the 2 per cent inflation target less credible.

A long horizon means that inflation can stay above the 2 per cent level for a very long time without raising the average very much.

The unwillingness of the Fed to provide more information about the horizon for the average inflation target has therefore weakened the Fed's credibility to keep inflation near 2 per cent.

Inflation expectations may become unanobread which makes a resistant.

bility to keep inflation near 2 per cent. Inflation expectations may become unanchored, which makes persistent high inflation amuch likelier possibility. Although US CPI inflation is highly likely to come down from its current level of 6.8 per cent as supply bottlenecks from Covid diminish, it will continue to substantially exceed the Fed's target.

The Fed needs to recognise the flaws in its monetary policy framework and return to more pre-emptive policies to control inflation. If it doesn't, the outcome will not only be persistent inflation only will be come will not only be persistent inflation.

control initiation. If it doesn't, the out-come will not only be persistent inflation well above the 2 per cent objective but eventually far higher interest rates to drive inflation back down, which will do serious harm to the economy.

Frederic Mishkin is the Alfred Lerner professor of banking and financial institu-tions at Columbia Business School and a former governor of the US Federal Reserve

The day in the markets

What you need to know

 European stocks suffer worst daily session since late November
 Sell-off in US Treasuries sends 10-year yields near 2-year high

Bitcoin drops below \$40,000 for the
first time since September

Stocks on both sides the Atlantic fell

Stocks on both sides the Atlantic fell sharply sesterday as investors priced in the prospect of central banks raising interest rates sooner than expected. The Stock Europe 600 index sank 1.5 per cent, the region-wide benchmarks worst day since late November. The continent's tech sector, which has benefited from the low interest rate environment triggered by the pandemic, was the poorest performer, tumbling 3.6 per cent to its lowest level since mid-October.

The pattern was repeated on Wall Street, where the tech-heavy Nasdaq Composite was down 2 per cent by lunchtime in New York, while tech was again among the weakest sectors of the blue-chip S&P 500, which was 1.3 per cen

lower.
"Why it's taken until now for investors to really price-in the prospect of US rate rises might seem to be something of conundrum," said Danni Hewson, financia analyst at AJ Bell. "[But] rolling inflation has flagged the need for months and the Fed has been shifting to an increasingly hawkish stance with every nuanced

ord. In anticipation of higher interest rates, ore government bonds sold off

sterday. Adding to last week's rout, the yield on e 10-year US Treasury climbed a



further 1 basis point to 1.78 per cent, its highest level in almost two years. Despite yesterday's stock losses, Mark Haefele, chief investment officer at UBS Global Wealth Management, was more bullish about the medium-term path for

He forecast three rate hikes this year, He forecast three rate hikes this year, starting as soon as March, although "that shouldn't end the equity rally", he said, adding: "Historically, stocks perform well in the morths leading up to the first rate hike of a cycle." Haefele said: "Since 1983, the S&P 500 has risen 5.3 per cent on average in the

three months before the first Fed rate

hike."
Bitcoin retreated, falling below \$40,000 for the first time since September.
The crypto token fell as low as \$39,635, marking a steep fall from the highs of almost \$69,000 it reached in November.

almost \$64,000 if reached in November.
Other cryptocurrencies have also come
under intense selling pressure in recent
weeks, with an FT Wilshire index of the
top five tokens excluding bitroin down 47
per cent since early November.
Global oil benchmark Brent crude and
falling more than 1 per cent to \$00.89 a
barrel. Ray Douglas and Adam Samson

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Wall Street

Zynga, the social game developer, surged after agreeing to be bought by video after agreeing to be bought by video game group **Take-Two Interactive** for \$9.86 per share — a 64 per cent premius on Friday's closing price.

Zynga shareholders would receive \$3.50 in cash and \$6.36 in Take-Two

\$3.50 in cash and \$6.36 in Take-Two stock for each share in a deal that gave the FarmVille publisher an enterprise value of \$12.76 in. Take-Two Interactive fell sharply following reports of the transaction. Agria jumped on news that the provider of home healthcare equipment was being bought for \$14.50 in by Owens & Minor, a healthcare solutions company. The \$37.50 per share offer represented a Ze per cent premium on Apria's closing price on Friday. An unexpected quarterly profit pushed Tillray, the Canadian pot producer, higher.

Tilray, the Canadian pot producer, higher For its fiscal second quarter, net income rose to \$6m from a net loss of

income rose to \$6m from a net loss of \$59m for the same period a year earlier. Broadcaster Sinclair raillied following a Bloomberg report that said it was close to signing a deal to air NBA baskerball games on its new streaming service. Pharma group Reviva raillied after being given the green light by the Food and Drug Administration to carry out phase 3 trials for Brillaroxazine, its expenditude of the contraction of the contr ntal treatment of schizophrenia

Europe

rofit warning. Full-year revenue was forecast reached

around €10.8bn, representing a year-onyear fall of 2.4 per cent on at constant currency basis against "stable" sales projected in July.

projected in July.
Free cash flow, meanwhile, was
anticipated to come in at minus €420m
versus a previous guidance of "positive".
Citi said the Atos downgrades
translated to a 20 per cent cut to
consensus operating profit estimates for

2022.

Danish beverage group Royal Unibrew rallied following Friday's news that It would be acquiring the remaining 75 per cent of Hansa Borg Bryggerier in order to take over the Norwegian brewer.

Berenberg said the deal "should be positive for Royal Unibrew as Hansa Borg Bryggerier has been the longstanding runner-up in the duppoly.

Borg Bryggerier has been the longstanding runner-up in the duopoly beer market of Norway — with 20 per cent volume and value share versus Carisberg at 44 per cent?

Eurofins Scientific sank after Jefferies downgraded the dagnostics group to "hold" from "buy?

The Luxembourg-based company was nearing the broker's price target, "buoyed in part by stronger for longer demands in Covid testing". Ray Douglas

London

An upbeat update sent Plus500 higher with the trading platform declaring its full-year 2021 performance "outstanding" and "ahead of market expectations". venue and core profits of \$718m and \$387m were 13 per cent and 21 per cent ahead of Liberum's forecasts, respectively. This was "driven by

ahead of Liberum's forecasts, respectively. This was "driven by consistently high level of customer trading activity with active customer numbers remaining well ahead of prepandemic levels"; said the broker. Biotech company Avacta Group tumbled on news that it was pausing the sale of its Sars-Cov-2 lateral flow text. Its product was effective an identifying high viral loads of the Omicron variant of coronavirus but further lab analysis showed that the sensitivity of the test was reduced at lower viral loads. Alastati Smith, chile executive, said Avacta's test may not be alone in its inability to accurately spor low doses of Omicron. "It is essential that similar Omicron sensitivity studies be performed on all Sars-Cov-2 antigen tests." Housebulders retreated after reports that the UK government would be asking developers to stump up £6th to cover the costs of the removal of dangerous cladding from tens of thousands of buildings.

Redrow, Persimmon and Barratt all fell