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RBA Special Report - The Fed's lagging policy and inflation

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We have argued for many years, investors were incorrectly focused on the Fed policy as a leading indicator. Except during the Volker era, the Fed has almost always been a lagging indicator. In other words, the Fed tends to react to the economy rather than guide the economy. Today's Fed has emphasized it is sticking to that lagging indicator decision-making model.

Janet Yellen, during her term as Fed Chair, crystalized this lagging approach through her use of the phrase "data dependent." The term seemed somewhat humorous because what was the Fed before? Did the Fed set monetary policy without consideration of economic data? Of course not.

However, the use of "data dependent" seemed to reflect a broader admission Fed policy would be reactive and lagging. The Fed would collect relevant data, analyze the data, and monetary policy would react to the data, i.e., Fed policy would not be a leading indicator.

The current Fed has given repeated signals they will remain a lagging indicator as far as one can forecast. They seem to have no intention of getting in front of the economy. Although that might seem shocking to some, it's generally been the Fed's *modus operandi*.

The Fed's lagging approach, coupled with a somewhat antiquated focus solely on real asset inflation rather than incorporating the risks associated with excessive financial asset inflation, caused significant problems in the economy. The S&L Crisis, the Tech Bubble, the Housing Bubble, and today's financial speculation all reflect the Fed's reactive approach to setting monetary policy. A pro-active Fed might have warded off all of these speculative periods and avoided subsequent recessions.

With respect to traditional inflation, the Fed's lagging approach worked reasonably well because of the general disinflationary trend. Simply put, the penalty for lagging policy was small because the disinflationary trend within the global economy hid their errors.

However, one should wonder whether the lagging approach today, when combined with massive fiscal stimulus, historic money growth, and ongoing supply disruptions in a broad range of industries, will bring the US economy back to a 1960s/1970s inflation model. The 1960s and 1970s Federal Reserves reacted to budding inflation and, contrary to their own beliefs, inflation was quite difficult to contain. It took the Volker Fed's massive tightening and a double-dip recession to end the inflation spiral.

When today's Fed talks about having the tools to contain inflation, we strongly doubt they are referring to Volker's toolbox. If they are not, they could be making the same monetary policy mistakes of the 1960/1970s.

Investors need to fully consider how the Fed typically reacts to trends rather than sets them, and the potentially significant long-term implications for asset allocation.

If you have any additional questions on our thinking, please reach out to your regional [RBA Portfolio Specialist].