Weekly Update of U.S. Economy

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Burden of Inflation Control Is Biased Toward Monetary Policy

Are Natural Rates Being Underestimated?

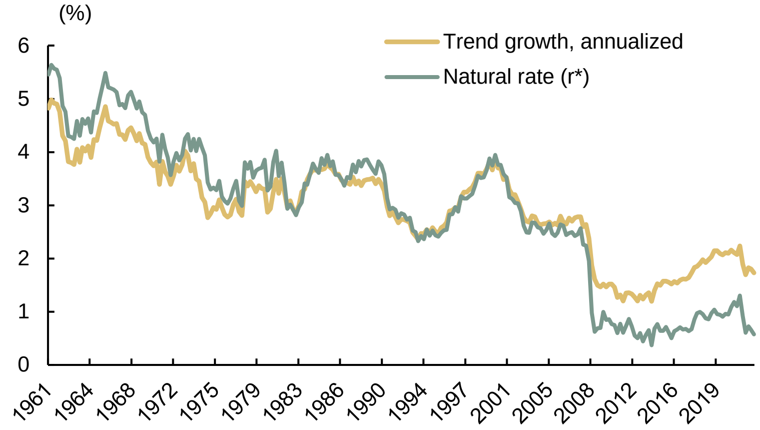
- Federal Reserve Board ("Fed") Chair Jerome Powell, participating in an economic forum hosted by the European Central Bank, was asked if the Federal Open Market Committee (FOMC), which did not raise interest rates this month, would raise policy rates every other meeting in the future. He responded that most FOMC members expect at least two more rate hikes before the end of the year, and he also expressed a hawkish view, saying that he would not rule out a consecutive rate hike.
- Such an in-depth statement, whether or not the Fed actually raises interest rates consecutively in the near future, would first of all be part of the Fed's communication policy to demonstrate that the central bank is making a serious commitment to curb inflation. However, if there is a growing consensus within the Fed that the natural interest rate, which is considered price-neutral, may actually be higher than previously thought, this can lead to the conclusion that further rate hikes are necessary to contain inflationary pressures.
- The natural (or neutral) rate of interest is the level of interest rates in real terms that balances investment and savings for an economy; in other words, it is the neutral level that supports the economy at full employment while stabilizing inflation.
- The position of the natural rate of interest has been further obscured by the major changes in the labor market and global supply constraints that resulted from the March 2020 COVID shock, and the considerable amount of income transfers from the federal government that have greatly changed private sector cash flows and balance sheets.
- However, recently updated estimates of the natural interest rate by the Federal Reserve Bank of New York (FRBNY) revealed that there was no dramatic change in the downward trend of the natural rates even after the COVID shock. If these estimates are correct, then the current policy rate level is extremely restraining to the economy.

Difficulties in Reversing the Policy Mix

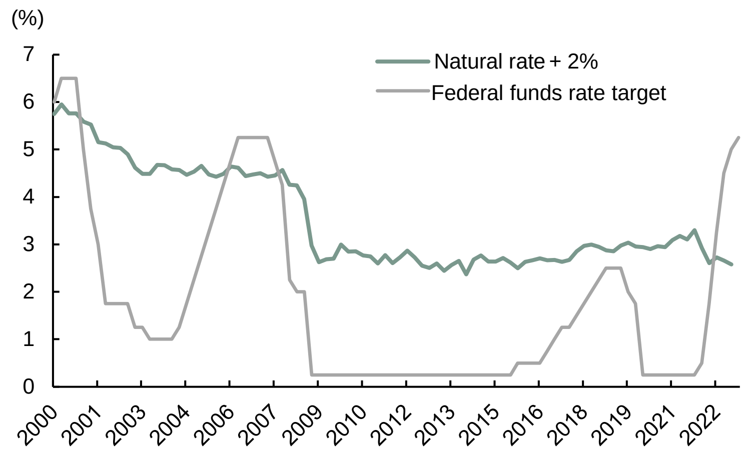
- Meanwhile, many market participants and academic critics have commented that this FRBNY estimate of the natural rate of interest underestimates the rate. If such criticisms are reasonable, then the neutral interest rate, however much higher than the 2.5% the Fed had previously assumed, would require further tightening of the economy to keep inflation in check.
- The reasons for underestimating the natural rate of interest are: (1) the model does not reflect well the current steepening of the Philips curve, (2) the model does not reflect the transformation of the trend since 2000, when excess savings in emerging economies and other countries aggressively financed U.S. Treasuries, pushing down the risk premium implicit in interest rates, and (3) the fact that the model relies on the assumption that monetary policy is all-powerful in controlling the economy and inflation. It is impossible to verify which of these factors is the largest, but the impact of (1) and (2) is likely to be particularly significant.
- However, even if the nature of the U.S. current account deficit remains unchanged, whether other countries will continue to purchase U.S. Treasuries should be dubious due to structural changes and a loss of real income since the pandemic. What's more, the current U.S.-China relationship does not suggest that China, which has been the largest holder of U.S. Treasuries, will continue to purchase U.S. Treasuries.
- If this interpretation gains support within the Fed, it would justify the continuation of further rate hikes. Given that the acceleration of inflation over the past two years has been a byproduct of major monetary and fiscal policies, it would be difficult to restore inflation to its previous level without essentially tightening fiscal policy together with monetary policy. However, it is difficult for the current Congress to pass an austerity budget.
- With a number of strong economic indicators, optimism is emerging in the market about the future economy. However, in an environment where the burden of inflation containment is solely concentrated on monetary policy, the downside risks to the economy are more likely to be amplified, involving instability in the financial system.

Burden of Inflation Control Is Biased Toward Monetary Policy (continued)

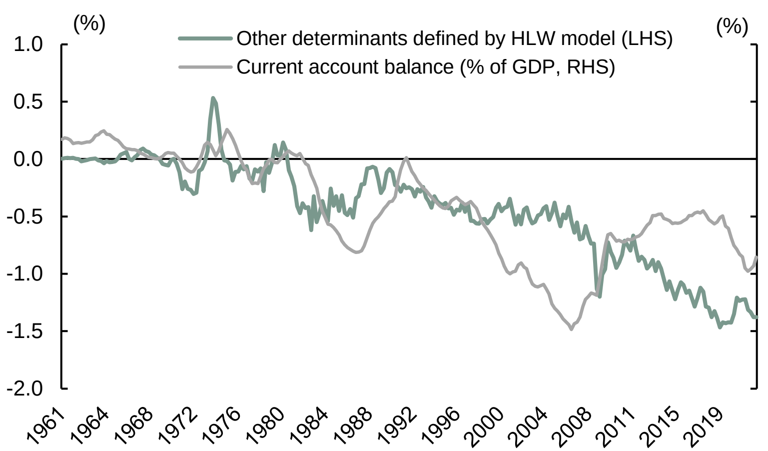
The natural rate is on a downward trend in the long term. It has recently remained near the historical low.



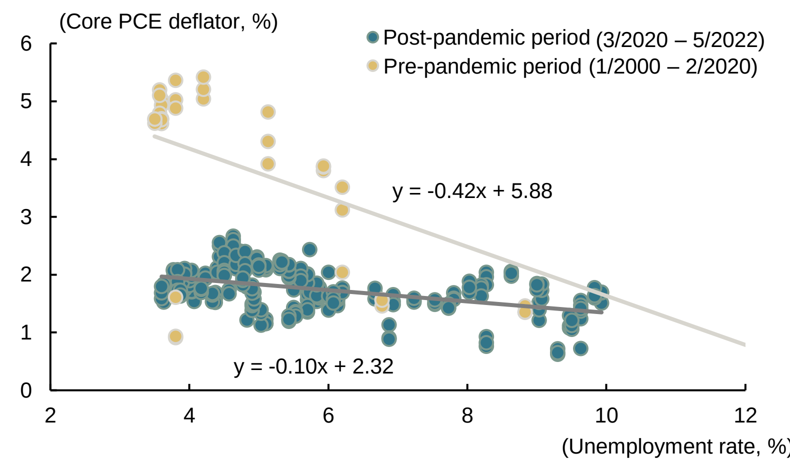
Current policy rates are at restrictive levels relative to the natural rate.



Factors other than economic growth dominate in containing natural rates. Savings gluts in other economies contribute to lowering the risk premium incorporated in the market rates.



The Phillips curve has steepened since the COVID-19 shock in 2020.



Sources: FRBNY, Bloomberg, U.S. Census Bureau, Bureau of Labor Statistics

SMBC Economy and Rates Forecast

		2022			2023				2024				2021	2022	2023	2024
		Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4				
U.S.	Real GDP (saar)	-0.6	3.2	2.6	1.3	1.5	-0.8	0.6	0.9	1.4	1.8	2.2	5.9	2.2	1.4	1.0
	Inflation rate (YoY)	5.0	4.9	4.8	4.8	4.6	4.2	3.9	3.2	2.8	2.5	2.2	3.3	5.0	4.4	2.7
	Jobless rate	3.6	3.6	3.6	3.5	3.5	3.7	4.3	4.6	4.7	4.7	4.6	5.4	3.7	3.7	4.7
Euro area	Real GDP (qoq)	0.8	0.4	-0.1	-0.1	0.3	0.2	0.1	0.1	0.4	0.3	0.3	5.4	3.5	0.6	0.9
	Inflation rate (YoY)	8.0	9.3	10.0	8.0	6.2	4.8	3.2	3.1	2.9	2.7	2.5	2.6	8.4	5.6	2.8
	Jobless rate	6.7	6.7	6.7	6.6	6.6	6.6	6.7	6.8	6.8	6.9	6.9	7.7	6.7	6.6	6.9
Japan	Real GDP (saar)	5.6	-1.5	0.4	2.7	1.7	1.0	0.9	0.9	0.8	0.8	0.7	2.3	1.1	1.0	0.9
	Inflation rate (YoY)	2.1	2.7	3.8	3.5	3.3	2.8	2.3	2.9	2.7	2.6	2.2	-0.2	2.6	3.0	2.6
	Jobless rate	2.6	2.5	2.5	2.6	2.5	2.4	2.4	2.3	2.3	2.3	2.3	2.8	2.6	2.4	2.3
China	Real GDP(YoY)	0.4	3.9	2.9	4.5	8.4	5.7	6.3	5.4	5.2	5.1	5.0	8.4	3.0	6.3	5.2
	Inflation rate (YoY)	2.2	2.8	1.8	1.3	1.6	1.4	1.5	1.6	1.9	2.0	2.0	0.8	1.7	1.5	1.9
	Jobless rate	5.8	5.4	5.6	5.5	5.4	5.1	4.9	4.9	4.9	5.0	5.0	5.1	5.1	5.2	5.0

Rates		2022	2023				2024				2022	2023	2024
		Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4			
U.S.	FF target range	4.25 ~ 4.50	4.75 ~ 5.00	5.00 ~ 5.25	5.25 ~ 5.50	5.25 ~ 5.50	5.00 ~ 5.25	4.75 ~ 5.00	4.50 ~ 4.75	4.25 ~ 4.50	4.25 ~ 4.50	5.25 ~ 5.50	4.25 ~ 4.50
	2yr UST	3.43	4.03	4.90	4.20	4.00	3.80	3.60	3.40	3.20	4.20	4.00	3.20
	10yr UST	3.87	3.47	3.86	3.60	3.60	3.60	3.60	3.50	3.50	3.60	3.60	3.50
Germany	ECB refi rate	2.50	3.50	4.00	4.25	4.25	4.25	4.25	4.00	3.75	2.50	4.25	3.75
	ECB depo rate	2.00	3.00	3.50	3.75	3.75	3.75	3.75	3.50	3.25	2.00	3.50	3.25
	2yr Schatz	2.50	2.68	3.20	3.20	3.00	2.80	2.50	2.40	2.30	2.50	3.00	2.30
	10yr Bunds	2.20	2.29	2.42	2.30	2.30	2.30	2.20	2.10	2.10	2.20	2.30	2.10
Japan	IOER	-0.10	-0.10	-0.10	-0.10	-0.10	0.10	0.10	0.10	0.10	-0.10	-0.10	0.10
	2yr JGB	0.04	-0.06	-0.06	0.10	0.15	0.20	0.30	0.30	0.30	0.04	0.15	0.30
	10yr JGB	0.42	0.35	0.40	0.75	0.75	0.75	0.90	0.90	0.90	0.42	0.75	0.90
China	Policy rate	2.75	2.75	2.65	2.55	2.55	2.55	2.55	2.55	2.55	2.75	2.55	2.55
	2yr gov bond	2.40	2.41	2.15	2.17	2.25	2.33	2.40	2.50	2.60	2.40	2.25	2.60
	10yr gov bond	2.83	2.85	2.65	2.65	2.70	2.75	2.80	2.85	2.90	2.83	2.70	2.90

Source: SMBC

SMBC FX Forecast

		2022	2023				2024				2022	2023	2024
		Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4			
USD/JPY	Range	130.58 ~ 151.95	127.23 ~ 137.91	128.00 ~ 146.00	126.00 ~ 142.00	123.00 ~ 137.00	121.00 ~ 135.00	119.00 ~ 133.00	116.00 ~ 130.00	116.00 ~ 130.00	113.47 ~ 151.95	123.00 ~ 145.00	116.00 ~ 135.00
	End of period	133.00	132.86	145.00	136.00	133.00	130.00	128.00	126.00	123.00	131.12	133.00	123.00
EUR/USD	Range	0.9633 ~ 1.0735	1.0484 ~ 1.1033	1.0400 ~ 1.1400	1.0300 ~ 1.1300	1.0200 ~ 1.1200	1.0100 ~ 1.1100	1.0000 ~ 1.1000	1.0100 ~ 1.1100	1.0100 ~ 1.1100	0.9536 ~ 1.1495	1.0200 ~ 1.1400	1.0000 ~ 1.1100
	End of period	1.0705	1.0839	1.0873	1.0700	1.0600	1.0500	1.0500	1.0600	1.0600	1.0705	1.0600	1.0600
USD/CAD	Range	1.3275 ~ 1.3885	1.3291 ~ 1.3832	1.2900 ~ 1.4100	1.3000 ~ 1.4200	1.3300 ~ 1.4500	1.3300 ~ 1.4500	1.3300 ~ 1.4500	1.3300 ~ 1.4500	1.3300 ~ 1.4500	1.2477 ~ 1.3885	1.2900 ~ 1.4500	1.3300 ~ 1.4500
	End of period	1.3554	1.3516	1.3266	1.3700	1.3900	1.3900	1.3900	1.3900	1.3900	1.3554	1.3900	1.3900
CAD/JPY	Range	96.76 ~ 109.11	95.13 ~ 100.59	98.00 ~ 110.00	95.00 ~ 108.00	90.00 ~ 102.00	86.00 ~ 97.00	85.00 ~ 96.00	85.00 ~ 96.00	83.00 ~ 94.00	89.77 ~ 110.06	90.00 ~ 110.00	83.00 ~ 97.00
	End of period	96.76	98.28	109.03	99.27	95.68	93.53	91.43	90.65	88.48	96.76	95.68	88.48
EUR/JPY	Range	138.81 ~ 148.40	138.19 ~ 149.00	142.00 ~ 155.00	139.00 ~ 153.00	134.00 ~ 148.00	130.00 ~ 144.00	128.00 ~ 142.00	126.00 ~ 140.00	123.00 ~ 137.00	124.40 ~ 148.40	134.00 ~ 155.00	123.00 ~ 144.00
	End of period	140.41	144.01	157.28	145.52	140.98	136.50	134.40	133.56	130.38	140.41	140.98	130.38
Oil price (WTI futures)		82.64	75.99	73.58	75.00	80.00	80.00	75.00	77.00	78.00	98.74	76.37	77.50

Source: SMBC

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