Scotiabank
Global FX Strategy

FX SNAPSHOT
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Moving the Inflation Goalposts? Nothing Good for the Dollar

Hedge-fund manager Bill Ackman has argued that the Fed should not raise interest rates and should introduce a new 3% inflation target. Musing on recent market developments, Ackman suggested that tighter Fed policy could tip the US into recession. He argued that the 2% inflation target was outdated and, considering rising geopolitical risk, de-globalization and tariffs, plus AI and energy sector investment needs, 3% was a more "realistic ambition for the new world".

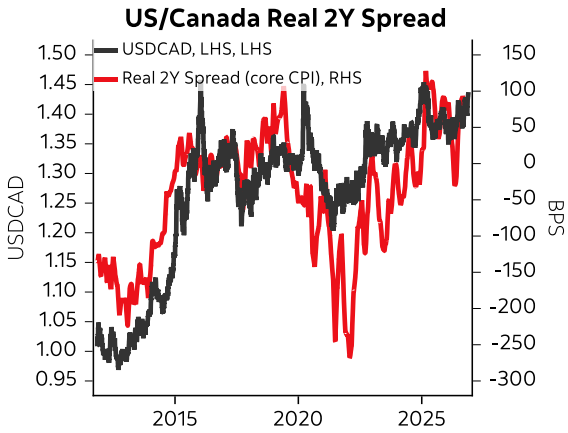
This note is no more than a thought exercise on what shifting the Fed's inflation target might mean for the USD. The short answer is nothing good, most likely. But the first question is perhaps how the Fed might go about raising its inflation objective. The answer appears to be quite easily – in theory.

The Fed's dual mandate set by the Federal Reserve Act is to maintain maximum employment and price stability. Neither of those goals has an explicit target, however. The 2% target was formally adopted in 2012 and mirrors the inflation objectives pursued by many major central banks (with minor variations) since the 1990s. Changing the target could in principle be introduced as part of an internal review of the Fed's framework. Or it could be introduced by the "back door" via an informal tolerance for quicker price growth. Given the current focus on affordability, there would likely be significant internal and external resistance to a more permissive inflation environment, however. Legal challenges could also emerge.

For the markets, a shift to a higher inflation target would represent a significant regime change at the Fed. From a currency market perspective, the initial reaction from the USD would very likely be negative as markets priced in lower real yields and real yield spreads – an important driver of the USD's broader performance. Gold and commodities would strengthen as US real interest rates declined. The outlook for yields is complex – and not something we have time to get into here – but the Treasury curve would likely steepen, adding to USD headwinds. A higher Fed tolerance for inflation relative to other major central banks could erode the attraction of USD assets and, at the margin, the USD's reserve asset appeal in the longer run.

A few major central banks have tweaked their inflation targets in the past. But these changes have typically reflected a refinement of their objectives, undertaken while inflation was anchored. There is no obvious precedent among the major central banks for changing the objective while inflation is above target. Investors might well wonder; if the Fed then struggles to reach 3%, how about 4%? Central bank credibility is a vital commodity.

The Fed's 2020 shift to average inflation targeting offers a glimpse of how markets might respond. Following the announcement at the August Jackson Hole meeting, the USD fell, the Treasury curve steepened, stocks rallied and breakevens jumped. A formal shift to a 3% target would go further. It might give the Fed more room to manoeuver, but perhaps at the cost of lower real yields, greater inflation uncertainty and potentially weaker policy credibility. None of that looks particularly USD-friendly.



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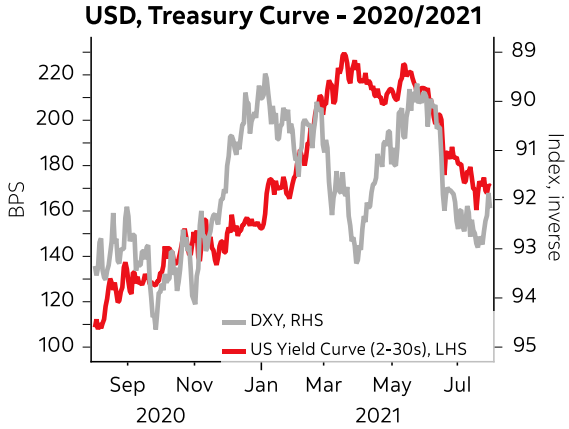

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