

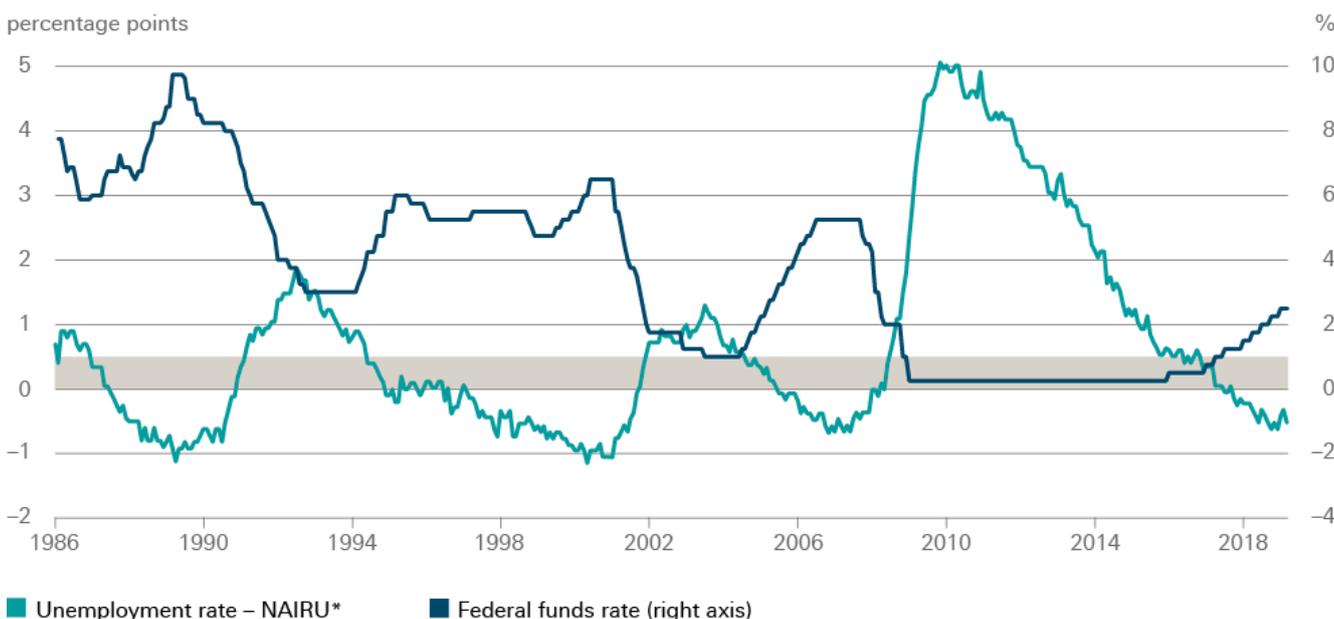
IS THE FED SURPRISING US? PROBABLY NOT.

Looking at U.S. unemployment figures through the Fed's eyes makes its data-dependent policy all too logical

The U.S. Federal Reserve (Fed) is pursuing a dual mandate. On the one hand, it aims to keep prices stable, on the other hand it aims to achieve full employment. Both elements of this mandate, inflation as well as unemployment, are incorporated in the concept of NAIRU, the "non-accelerating inflation rate of unemployment." Hence, NAIRU provides some useful insights into the Fed's behavior. In this week's "Chart of the Week" we look at the relationship between NAIRU vs. actual unemployment rates and the Fed's key-policy rate.

As our chart demonstrates, the Fed used to start hiking rates when the actual unemployment rate dropped to levels close to NAIRU, i.e. when the difference between both rates was shrinking to less than half a percentage point. The Fed kept hiking rates as long as the difference, which at least in the short run is mainly driven by changes in the actual unemployment rate, continued to fall. Once the unemployment rate bottomed out, the Fed ended its hiking cycle. And when the unemployment rate climbed back above NAIRU, the central bank began cutting rates again.

The experience from previous cycles also does a good job in explaining current Fed behavior. When the unemployment rate, which rose to 10% during the great recession, declined to a level not far above NAIRU in December 2015, U.S. central bankers started the hiking cycle. Now, with evidence mounting that the labor market momentum is softening, policy makers have signalled to take a pause and to look at economic data and dynamics in order to assess the path going forward. In other words, the path of the Fed's policy will depend on incoming data. This is not as natural as it sounds. First, just a few months ago, it was investors' worry that the Fed's monetary policy might be too pre-determined, that sent equity markets downward. And second, it means that the Fed will make its decisions virtually at the same time as the market. Stressing "data dependency" is exactly the message we are expecting from next week's Federal Open Market Committee (FOMC) meeting.



Sources: Bloomberg Finance L.P., DWS Investment GmbH as of 3/13/19
 * non-accelerating inflation rate of unemployment

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 Source: DWS Investment GmbH

GLOSSARY

Federal Open Market Committee (FOMC)

The **Federal Open Market Committee (FOMC)** is the committee that oversees the open-market operations (purchases and sales of securities that are intended to steer interest rates and market liquidity) of the U.S. Federal Reserve.

Great Recession

The **Great Recession** refers to the prolonged economic downturn in much of the world after the financial crisis of 2007-08.

Inflation

Inflation is the rate at which the general level of prices for goods and services is rising and, subsequently, purchasing power is falling.

Monetary policy

Monetary policy focuses on controlling the supply of money with the ulterior motive of price stability, reducing unemployment, boosting growth, etc. (depending on the central bank's mandate).

Non-Accelerating Inflation Rate of Unemployment (NAIRU)

The **Non-Accelerating Inflation Rate of Unemployment (NAIRU)** refers to a level of unemployment below which inflation accelerates.

U.S. Federal Reserve (Fed)

The **U.S. Federal Reserve**, often referred to as "**the Fed**", is the central bank of the United States.

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