The Noisy Debate

So far there is little reason for the Federal Reserve to raise interest rates.

BY JOHN M. BERRY

As the nation's jobless rate fell below 6 percent this fall, the good news intensified an already noisy public debate among some Federal Reserve officials over when to begin raising interest rates to keep inflation from jumping past the central bank's 2 percent target. After all, the central bank's policymaking group, the Federal Open Market Committee, said a year ago, when the jobless rate was 7.2 percent, that it would keep its overnight interest rate target close to zero "at least as long as the unemployment rate remains above 6.5 percent, inflation between one and two years ahead is projected to be no more than a half percentage point above the Committee's 2 percent longer-run goal, and longer-term inflation expectations continue to be well-anchored."

The two inflation metrics are still being met, but the falling unemployment rate has encouraged the band of inflation hawks on the FOMC to argue their points more vociferously than ever and to give a more moderate group some pause.

All the seventeen FOMC participants agree that eventually the Fed will need to tighten policy to withdraw the stimulus that has helped fuel the economic recovery. They have different opinions on when that should happen, and once it does, how fast interest rates should be increased and what might be their eventual top level. However, in September, fourteen of the seventeen said that by the end of next year the target should be roughly between 1 percent and 2 percent. At the

John M. Berry has covered the economy for four decades for the Washington Post, Bloomberg News, *and other publications.*

THE INTERNATIONAL ECONOMY
THE MAGAZINE OF INTERNATIONAL ECONOMIC POLICY
220 I Street, N.E., Suite 200
Washington, D.C. 20002
Phone: 202-861-0791
Fax: 202-861-0790
www.international-economy.com
editor@international-economy.com

extremes, two said rates should not be raised at all next year and one said the target should be close to 3 percent.

Most of these rate projections actually show an aggressive path for rates that is not likely to be justified by developments in either the U.S. or the world economy. To get overnight rates to 2 percent by the end of 2015, the FOMC would have to start that process with a quarter-point increase at its late January meeting and do the same at its other seven sessions during the rest of the year. Alternatively, if the first move were to come in midyear, as a number of officials have suggested, getting to 2 percent would take four consecutive half-point steps.

Again, based on their September appropriate policy projections, a majority of the committee said the rate target should be close to 1.5 percent or higher by next year's end. Thus, they want at least quarter-point increases beginning in the spring.

FOMC statements and numerous public comments by Fed Chair Janet L. Yellen have stressed that decisions on withdrawing stimulus are "data dependent." So far, data on inflation and other indicators that might be considered precursors of inflation, such as increases in wages, certainly do not support such rapid rate hikes.

The reason for using the jobless rate as an important indicator in setting interest rate policy is the concept of the natural rate of unemployment, and the related measure known as the NAIRU—the non-accelerating inflation rate of unemployment. That is, there is a jobless rate at which inflation would be neither increasing nor falling. Some therefore regard it as, effectively, a measure of sustainable full employment. If the unemployment rate falls below this natural rate, employers will find it necessary to boost workers' pay more rapidly in order to fill vacancies and increase the production of goods and services—and in the process generate more inflation.

Unfortunately, the natural rate can't be measured directly, it changes over time, and it's hard even to estimate, certainly with any precision. A couple of decades ago at one of the Kansas City Federal Reserve Bank's annual seminars in Jackson Hole, Wyoming, economist Edmund S. Phelps of Columbia University, later a Nobel Prize winner, announced that his research showed that "the natural rate has climbed from around 5 percent in 1964 to around 6.45 percent in 1993." The conference room exploded with laughter at that second decimal point.

Last year the Congressional Budget Office estimated the natural rate currently to be about 6 percent but that in the longer run it is about 5.5 percent. Various Fed officials have also pegged it at between 5 percent and 6 percent while acknowledging the lack of precision.

Under current circumstances, the impact of the falling jobless rate is far from clear. For one thing, millions of workers dropped out of the labor force during and after the financial crisis. The share of the population with a job now is down to 59 percent from about 63 percent prior to the financial crisis. Some of the drop is likely due to changing demographics, but that's a difference of ten million jobs. If the economy continues to create jobs at a healthy rate, more potential workers may be enticed back into the labor force. If a substantial number again seek jobs, it could slow the decline in the jobless rate and hold back any impact on wages.

So far, extremely low interest rates have not produced either a surge of inflation or significant asset bubbles that threaten financial stability.

There are other key uncertainties as well, including the meaning of the natural rate in a very low inflation rate environment when employers know it is likely to be difficult to increase their selling prices if their costs rise. Thus, in recent years firms have concentrated on holding down costs, including limiting pay increases, as a way to increase profits.

Some economists at the San Francisco Federal Reserve Bank, however, argue that firms were reluctant to cut nominal wages during the recession, and in a sense therefore overpaid their workers relative to what the state of the labor market required. As a result, as the economy has recovered, employers have increased workers' pay less than they normally would have. Now pay is likely to rise more rapidly, the economists argue.

Maybe, maybe not. Something significant seems to have shifted in the market for labor that has allowed profits to surge at the expense of workers' pay, and the shift began before the crisis struck.

The Commerce Department's Bureau of Economic Analysis, which calculates the gross domestic product and other national income estimates, provides figures for what it calls the gross value added by U.S. domestic nonfinancial corporate business. The figures include estimates of those business's labor and non-labor costs and profits. From the 1950s through the 1990s, labor's share of the

A Myriad of Voices

Federal Reserve Chair **Janet Yellen:** Decisions on withdrawing stimulus are "data dependent." So far, data on inflation and other indicators that might be considered precursors of inflation, such as the increases in wages, do not support rapid rate hikes.

Narayana Kocherlakota, *President, Federal Reserve Bank of Minneapolis:* "In light of continued sluggishness in the inflation outlook and the recent slide in market-based measures of longer-term inflation expectations, the Committee should commit to keeping the current target range for the federal funds rate at least until the one-to-two-year ahead inflation outlook has returned to 2 percent."

Richard W. Fisher, *President, Federal Reserve Bank of Dallas:* Asked the Fed Board to raise the discount rate.

Charles I. Plosser, *President, Federal Reserve Bank of Philadelphia:* Continuing to say that it will be appropriate to maintain the current extremely low target range for "a considerable time" is a mistake because an earlier reduction in monetary accommodation will be needed.

Esther George, *President, Federal Reserve Bank of Kansas City:* "The continued high level of monetary accommodation increased the risks of future economic and financial imbalances and, over time, could cause an increase in long-term inflation expectations."

Charles Evans, *President, Federal Reserve Bank of Chicago:* "The decision to lift the funds rate from zero should be made only when we have a great deal of confidence that growth has enough momentum to reach full employment and that inflation will return to a sustainable 2 percent rate."

value of what was produced ranged between 62 and 65 percent. With the turn of the century, that share began to fall, particularly after 2004. In the first half of this year, it was down to 58 percent. As the labor share has dropped, non-labor costs have increased but the profit share has gone up much more. Last year and this, the profit share was 14.6 percent, up from around 11 percent or 12 percent during the 1970s through the 1990s. Only in the 1950s and 1960s were profits higher, around 17 percent.

Just why this has happened isn't clear at all. But it could be that in a low-inflation environment in which businesses have been hard-pressed to increase their top line results by raising prices, companies have been forced to hold down costs to increase their bottom lines. Fed policymakers should take this significant shift into consideration as they ponder to what degree the falling unemployment rate is likely to add to inflationary pressures.

Undoubtedly they should take the International Monetary Fund's latest world economic outlook into consideration. That forecast showed growth slowing in most of the world, including Europe, China, Russia, and many emerging market countries such as Brazil. That slowdown already has brought down a host of commodity prices. Oil prices in particular have plunged as demand has softened and U.S. production has surged, with regular gasoline now selling for less than $3 a gallon in most of this country.

The impact of the falling jobless rate is far from clear.

This is hardly a context in which inflation is going to flourish. Europe continues to flirt with recession and deflation, with consumer prices in the eurozone up only 0.3 percent in the last twelve months. In this country, the Fed has a 2 percent target for the personal consumption expenditure price index, a broader measure than the more well-known consumer price index. The CPI rose 1.7 percent in the twelve months ended in September while the PCE price index increased only 1.4 percent. The latter has been less than the targeted 2 percent on a year-over-year basis for two and a half years.

The reasons the indices are up even that much have nothing to do with the economy pressing against any sort of production capacity limits or with labor cost pressures. The two large portions of the index where prices are rising rapidly are food and shelter, which together account for 46 percent of the CPI, and both rose 3 percent in the last twelve months. Food is up so much primarily because of meat prices that have risen because the U.S. cattle herd is at a historically low level as a result of droughts and the high cost of corn for feedlots due to its use to make ethanol. Shelter prices, on the other hand, are a matter of rising rents that are an artifact of the significant drop in the share of American households owning their own homes, which is the result of several forces. Many people lost homes to foreclosures during the financial crisis, others who might like to buy now can't get a mortgage because of far tighter lending standards, and many younger couples are now renting because a heavy load of student debt makes them ineligible for loans.

Neither of these current sources of inflation would be reduced by an increase in interest rates engineered by the Fed. To the contrary, higher rates would make mortgages even harder to obtain.

Meanwhile, there is no indication that the 1.4 percentage point drop in the jobless rate—from 7.2 percent to 5.8 percent for the year ended in October—has had much impact on wages. For instance, the employment cost index for private industry workers, a quarterly measure that includes employers' costs for wages and benefits, rose a modest 2.2 percent in the twelve months ended in September, compared to 1.9 percent for the year ended in September 2013. However, monthly data for average hourly earnings for employees on private payrolls rose only 2 percent in the year ended in October, down from a 2.2 percent increase over the previous twelve-month period. In other words, so far it's early but no reason to think employers are about to spring for a sudden, potentially inflationary bump in wages. And lots of reasons to think the opposite.

Nevertheless, some FOMC participants are convinced interest rates need to be raised quickly, and a few have thought so for years. Esther George, who became president of the Kansas City Federal Reserve Bank three years ago, has been pushing for higher rates all that time, dissenting in that direction at seven of the eight FOMC meetings while she was in the voting rotation for bank presidents in 2013. She has followed in the footsteps of her predecessor, Thomas J. Hoenig, who wanted an increase in the Fed's target for overnight rates to at least 1 percent. Continuing excessively low rates could lead to another financial crisis, Hoenig argued.

The FOMC minutes of the October 2013 meeting said George dissented because she "was concerned that the continued high level of monetary accommodation increased the risks of future economic and financial

Continued on page 71

Continued from page 39

imbalances and, over time, could cause an increase in long-term inflation expectations."

Another less obvious way of dissenting is for a board of directors at the regional Fed banks to seek an increase in the discount rate, the interest rate the banks charge on overnight loans to financial institutions. That rate was raised by the Fed Board from half a percent to three-quarters of a percent in the spring of 2010. Less than three months later, Hoenig's directors in Kansas City asked the Fed Board to raise the rate to 1 percent. So did the board in Dallas, where Richard W. Fisher is president. Thus, more or less consistently for four years, there has been some push for higher rates.

Hoenig wanted higher rates to ward off another financial bubble as investors poured money into risk assets. In fact, as predictions that loose money would generate a major round of inflation proved wrong year after year, financial imbalances—read bubbles—became the new bugaboo. Even the lack of volatility in stock prices became a sign a new catastrophe was around the corner. The big drop and quick rebound in stocks prices in October presumably was reassuring. Certainly volatility soared.

George and Hoenig, who is now vice chairman of the Federal Deposit Insurance Corp., stand at one end of the policy spectrum. At the other is Narayana Kocherlakota, president of the Minneapolis Fed, who was a strong hawk when he took the job and not that long after turned 180 degrees. A former Fed governor said of Kocherlakota, "He is an intellectual and when he became convinced he was wrong, he changed his mind."

At the FOMC's late October meeting, Kocherlakota dissented, the committee statement said, because he "believed that, in light of continued sluggishness in the inflation outlook and the recent slide in market-based measures of longer-term inflation expectations, the Committee should commit to keeping the current target range for the federal funds rate at least until the one-to-two-year ahead inflation outlook has returned to 2 percent." He also disagreed with the committee decision to end its asset purchase program known as quantitative easing or QE.

Evans is right to be cautious.

At the September meeting, Fisher in Dallas and Charles I. Plosser, his counterpart in Philadelphia, dissented on the grounds that continuing to say that it will be appropriate to maintain the current extremely low target range for "a considerable time" is a mistake because an earlier reduction in monetary accommodation will be needed.

Charles Evans, president of the Chicago Fed, another dove but not a voting member of the committee this year, said in mid-October that the Fed has to be wary of moving too soon. "For me, the biggest and costliest downside risk is that in our haste to get back to 'business as usual' monetary policy, we could stall progress and backtrack to the economic circumstances of recent years—an economy mired in the zero lower bound." The ZLB, as he called it, refers to the fact that the target for overnight rates cannot fall below zero.

Evans is right to be cautious. As he said, "The decision to lift the funds rate from zero should be made only when we have a great deal of confidence that growth has

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enough momentum to reach full employment and that inflation will return to a sustainable 2 percent rate. We should also proceed cautiously and keep the path of rate increases relatively shallow for some time after we begin to raise rates. This approach will allow us time to assess how the economy is performing under less accommodative financial conditions and reduce the odds of overaggressive rate hikes choking off progress toward our policy goals."

The decision at the October meeting to end QE was the FOMC's first step of reducing monetary accommodation. QE did its job of reducing long-term interest rates to a degree after overnight rates were pegged close to the zero lower bound. For the moment at least, income from the securities on the Fed's balance sheet and from repayments of mortgages and maturing Treasuries will continue to be reinvested.

So far, extremely low interest rates have not produced either a surge of inflation or significant asset bubbles that threaten financial stability. Neither appears likely in the near term and the Fed should be very cautious about raising interest rates in a world of slowing growth and very low inflation.

Bolstering this point, an analysis published by the San Francisco Fed in mid-November concluded that "inflation is expected to remain low through the end of 2016, and the uncertainty around the forecast is tilted to the downside, that is, the risk of lower inflation. In particular, the probability of low inflation by the end of 2016 is twice as high as the probability of high inflation—the opposite of historical projections." In effect, it said, "the risk of high inflation collapsed in 2008 and has remained well below normal since." ◆