The Inflation Debate

Why Team Yellen will move cautiously.

BY JOHN M. BERRY

By every measure, inflation in the United States is well under control. The Federal Reserve's inflation goal is for an annual increase of 2 percent in the core personal consumption expenditure price index, which excludes often-volatile food and energy items. In the twelve months ended in March, that index was up only 1.3 percent and shows few signs of accelerating.

Nevertheless, some Fed critics are warning that the central bank needs to quickly and aggressively raise interest rates to head off a surge in inflation. One of them, Harvard University economist Martin Feldstein, warned in a *Wall Street Journal* article in late March that the Fed needs to act because the nation's unemployment rate had fallen to 5.5 percent, which "has historically been regarded as about the lowest rate that can be sustained without starting an inflation spiral."

Other critics focus on the enormous build-up in commercial bank reserves that historically would have led to a massive expansion of credit for both business and consumer spending and fueled inflation. That risk also demands an immediate increase in interest rates, the monetarist critics insist.

But most top Fed officials, including Chair Janet L. Yellen, maintain that the old rubrics are not applicable given the current state of the U.S. economy. After all, the Fed's target for overnight interest rates has been between zero and a quarter-percentage point for more than six years. Some

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economists and politicians predicted as far back as five years ago that the low interest rate policy would cause a surge in prices, but that didn't happen.

Now, with economic growth solid enough to bring unemployment down to 5.5 percent from a peak of 10 percent, Yellen and most of the other members of the Federal Open Market Committee have indicated they expect to begin to raise the near-zero target sometime later this year. However, both Yellen and Vice Chairman Stanley Fischer have stressed they plan a "shallow" trajectory for rates, not a rapid series of increases.

Feldstein and other critics say raising rates slowly would heighten the risk of both too much inflation and financial market instability. "The Fed should accelerate its projected rate increases and communicate the new projections explicitly to markets. Unless this is done, the combination of rising inflation and increasing real interest rates may expose the economy to an unnecessary risk of financial instability," Feldstein wrote.

Professor John Taylor of Stanford University, a recognized scholar of monetary policy and the author of the so-called Taylor Rule as a guide for setting interest rate targets, said in a recent *USA Today* interview that the Fed target today should be somewhere between 1.25 percent and 2 percent. He cautioned, however, that "you have to move there gradually. I mean they're not there now. So going from 0.25 percent to 1.25 percent overnight would not be a good idea."

In response to Feldstein's *Journal* piece, J. Bradford DeLong, an economist at the University of California at Berkeley, wrote in his blog, "Yellen projects and wishes for unemployment to fall further, and is confident that when it falls further wage growth will reemerge and inflation climb back to target. But she is not at all confident that if she raises interest rates as fast as Feldstein wishes and the economy weakens that she will then be able to strengthen it."

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That is what the current fundamental disagreement is all about: If the U.S. economy were to turn out to be more fragile than expected and interest rate increases caused it to weaken noticeably, the Fed would have precious little room to bring rates down again. The zero lower bound—that is, that interest rates cannot go below zero under normal circumstances—seriously limits what the Fed can do to bolster growth. That is why, after hitting the zero lower bound, the central bank turned to purchasing longer-term Treasury and mortgage-backed securities, so-called quantitative easing, to bring down longer-term interest rates to give the economy a boost.

In a speech during a research conference at the San Francisco Federal Reserve Bank a few days before Feldstein's piece appeared, Yellen laid out in unusual detail her thinking about the issues the FOMC faces in making its policy choices over the next couple of years.

First, Yellen said, there is still slack in the labor market, with 5 percent or 5.2 percent a more likely long-term rate consistent with a stable inflation rate, not 5.5 percent. Moreover, wage growth "continues to be quite subdued."

Second, getting this far in the recovery from the Great Recession that followed the financial crisis has "required exceptionally low levels of short- and longer-term interest rates, reflecting a highly accommodative stance of monetary policy… If underlying conditions had truly returned to normal, the economy should be booming," Yellen said.

Third, there are often long lags before changes in monetary policy affect the economy, so the Fed cannot wait for inflation to get to the 2 percent goal before raising interest rates. On the other hand, she said, "I would be

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uncomfortable raising the federal funds rate if readings on wage growth, core consumer prices, and other indicators of underlying inflation pressures were to weaken."

Fourth, the policy guidance from John Taylor's version of the Taylor Rule—as he said in the *USA Today* interview the rule currently indicates that overnight rates should be between 1.25 percent and 2 percent—is wrong in the current circumstances. The prescription offered by the rule "changes significantly if one assumes, as I do, that appreciable slack still remains in the labor market, and that the economy's equilibrium real federal funds rate—that is, the real rate consistent with the economy achieving maximum employment and price stability over the medium term—is quite low by historical standards," Yellen said. "Under assumptions that I consider more realistic under present circumstances, the same rules call for the federal funds rate to be close to zero. Moreover, I would assert that simple rules are, well, too simple, and ignore important complexities of the current situation."

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Fifth, the decision about when "lift off" in rates should occur "should not be overemphasized, because what matters for financial conditions and the broader economy is the entire expected path of short-term interest rates and not the precise time of the first rate increase." The FOMC is not about to embark on any predetermined course of tightening, because that course will depend on how economic conditions evolve, she said.

Sixth, the economy's underlying strength has gradually been improving and the equilibrium real federal funds rate has been rising, and that is likely to continue. If it does, it will be "appropriate to raise the actual level of the real federal funds rate in tandem, all else being equal," she said.

On the other hand, that equilibrium real rate cannot be directly measured, and some financial market participants think that growth in industrial nations may remain low—after all Europe and Japan are hardly growing at all and even China's robust growth has decelerated—and keep the equilibrium rate roughly where it is. If that happened, "monetary policy would need to keep real interest rates persistently quite low relative to historical norms to promote full employment and price stability, absent a highly expansive fiscal policy," Yellen said.

And fiscal policy, of course, is another important deviation from historical experience. One reason economic growth was so slow early in the recovery from the recession was that government spending was cut rather than increased as it usually was during previous slumps. When spending rose again, it helped generate stronger gains in real GDP beginning in 2013. Now, however, with both the House and the Senate under Republican control, budget resolutions in both point again to spending limits that could again put downward pressure on growth. Just one more issue the FOMC should have in mind as it makes its policy decisions.

Yellen and most of the other committee participants have said repeatedly that their policy decisions will depend on the incoming economic data. As of late April, the latest figures have at best been mixed, with the gain in payroll employment in March much weaker than in January and February, industrial production down in three of the four months since last November, and retail sales for the first three months of the year down 1.3 percent from the last three months of last year. Part of the first quarter weakness was probably caused by particularly bad weather in February. But growth has to pick up over the rest of this year if it is to reach the 2 percent to 3 percent increase in real GDP most Fed officials have predicted for this year.

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Jeffrey M. Lacker, president of the Richmond Federal Reserve Bank, who believes the FOMC should begin raising rates as soon as possible, noted recently that "readings on some indicators have been unexpectedly weak in recent weeks, some of which may be attributable to unseasonably adverse weather. It's too soon say how much, however, and the more prudent approach is to look through very short-term fluctuations and assess emerging trends based on a longer run of data." For one thing, the healthy gain in payrolls since the middle of last year will help consumer spending to continue to rise, with overall GDP growth of more than 2 percent this year.

Lacker's counterpart at the New York Fed, William C. Dudley, is more cautious than Lacker about raising rates. "The unemployment rate is still too high and the inflation rate too low," he said late last month. "Because the economic outlook is uncertain, I can't tell you when normalization will occur. The timing is data dependent." Then he used a phrase that caught the attention of many analysts: "When, hopefully, the data support a decision to lift off later this year…".

"Hopefully" means that Dudley, who is also vice chairman of the FOMC and is the only one among the dozen bank presidents who has a vote at every meeting, like Yellen isn't going to rush to raise rates based on some outdated rule of thumb.

Stone & McCarthy Research Associates, a financial markets research firm, surveys its clients shortly before each FOMC meeting about their expectations for policy decisions. Currently the key question was when lift off would occur. The committee earlier said it would not happen at the late April meeting. A few of the SMRA clients thought the action might come at the mid-June or late July meeting, but a solid majority said mid-September is the most likely time.

Former Fed Vice Chairman Donald L. Kohn, who is now at the Brookings Institution, said that Yellen appears to be trying to downplay the timing of the lift off. Correctly so, in his view, because when rates are first increased they "will still be extraordinarily low, and what determines financial conditions is not today's federal funds rate but the expected trajectory out into the future."

The focus on the trajectory also makes it clear that under the leadership of Yellen, Fischer, and Dudley, the Fed will be moving cautiously because of all the uncertainty about the economy and the state of financial markets. And at this point, they all believe that if a mistake is made, the consequences of waiting too long for lift off or moving too slowly thereafter can more easily be corrected than moving too soon or too aggressively. ◆