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# Could America Soon Have An *Inflation Problem?*

Economist Marty Feldstein argues that because short-term unemployment is so low, the result could be that "inflation could soon begin to rise year after year without any further decline in overall unemployment." Others argue that inflation will accelerate for a different reason: because of the increased size of the monetary base. Other economists, including Brad DeLong, argue that the inflation worry is vastly overblown.

Is the United States flirting with an inflation problem? Moreover, what are the risks of policy error on the inflation issue? In the 1990s, for example, after a period of low interest rates, the Federal Reserve raised short-term rates with significant unintended consequences, including the outbreak of the Asian crisis and the Russian default. Today the risk would be the unwinding of the global carry trade and dangerous loss of liquidity throughout emerging markets.

Are Fed policymakers today behind the curve on the inflation front? Or is all this talk of monetary tightening playing with fire?

**Over a dozen noted experts offer their predictions.**

***Let's cross inflation off our list of worries and get back to the real world.***

**ALICE RIVLIN**
***Senior Fellow in Economic Studies, Brookings Institution, and former Vice Chair, Federal Reserve Board***

It would be really nice to have to worry about inflation again. If the economic outlook were for robust growth, tight labor markets, rising wages, even a few shortages of skilled workers, economic policymakers would feel more cheerful. The Federal Reserve could then confidently raise interest rates to what used to be considered "normal" levels.

Alas, that is not the situation policymakers are facing in 2015. The optimistic view is that the U.S. economy has enough positive momentum to keep the recovery going, push unemployment down a tad more, encourage stronger labor force participation, and nudge inflation back up to the Fed's 2 percent target. The pessimistic view is that weakness in the rest of the world and the strong dollar will cut our exports and make the momentum hard to maintain.

The longer-run outlook is not encouraging, either. Labor force growth will be slow, estimates of potential growth are being revised downward, and our gridlocked politics precludes the bold public investments that could help the economy grow more strongly. The situation in Europe, the United Kingdom, and Japan is hardly more cheerful. Inflation is not on the horizon in any major developed country. Indeed, potential deflation is higher on the list of potential threats.

Moreover, even if some unforeseen set of shocks were to accelerate price increases, there would be little risk of inflation getting quickly out of hand. The U.S. economy is much less inflation-prone than it was in the 1970s and 1980s, when central bankers felt they had to keep a wary eye on the inflationary beast lest it leap out of its cage and get away from them. Our economy is far more competitive than it was in those days, supply chains are more responsive, unions are a disappearing force for wage increases, multi-year wage contracts with escalator clauses are a thing of the past, and outsourcing has become the norm. Most importantly, inflationary expectations have gone dormant and are unlikely to revive quickly. The robust growth and tight labor markets of the late 1990s did not produce worrisome inflation. The following decade's run-up to the financial crisis produced a housing price bubble without general inflation. A whole generation has grown up reading about some vague thing called inflation without experiencing it. They are not likely to take the self-protective actions that used turn a little inflation into a serious threat.

So let's cross inflation off our list of worries and get back to the real world of the twenty-first century. We need to figure out how to grow the economy faster and share the prosperity more widely. If we are really successful, we might earn the luxury of worrying about inflation once again.

***America has an inflation problem. Limiting future inflation increases could destabilize financial markets.***

**MARTIN FELDSTEIN**
***George F. Baker Professor of Economics, Harvard University, President Emeritus, National Bureau of Economic Research, and former Chairman, Council of Economic Advisors***

The American economy is at or near the inflation threshold level of employment: the overall unemployment rate is 5.5 percent, the unemployment rate among college graduates is just 2.5 percent, and the unemployment rate among those who have been out of work for less than six months is less than 4 percent. Based on past experience, these unemployment rates imply that the core inflation rate will soon be rising past the 2 percent level that the Fed has set as its target.

The Federal Open Market Committee has nevertheless signaled that it will keep the real federal funds rate below zero for the rest of 2015 and will approach a zero real level of the federal funds rate only at the end of 2016. Those low federal funds rates and the Fed's continued large balance sheet imply an easy money condition that will cause unemployment rates to decline further and the rate of inflation to rise more rapidly. This rise in the inflation rate will be reinforced by the current reversal of the oil price decline and by the end of the very rapid rise of the dollar against the euro and Japanese yen.

Short-term interest rates are therefore too low and are rising too slowly. Getting interest rates back to an appropriate "normal" level might require a more rapid increase in the federal funds rate than the Fed is projecting. That could trigger destabilizing shifts in the behavior of investors and lenders who have been driven by the Fed's low interest rate policy to reach for yield with high-risk strategies.

Investors have bid up the prices of equities and long-term bonds. Their search for yield has also led to narrower spreads between Treasuries and lower grade bonds and emerging market debt. The rapid rise in market interest rates that the Fed might have to bring about in order to limit the increase in inflation would cause a flight from these higher-risk assets with a resulting sharp increase in their yields.

Banks and other lenders have increased their lending to higher-risk borrowers and have made more covenant-light loans that provide less protection to creditors. The rise in interest rates could create problems for these borrowers and therefore for the lenders.

In short, the Fed's pursuit of an even lower unemployment rate and its willingness to accept rising inflation and negative real interest rates creates broader risks of instability for the U.S. economy. America has an inflation problem because limiting future inflation increases could destabilize financial markets and the economy.

***No one knows the inflation answer. What's clear is that the Fed is not prepared.***


**LAWRENCE B. LINDSEY**
*President and Chief Executive Officer, The Lindsey Group, former Director, National Economic Council, and former Governor, Federal Reserve System*


Monetary policy is inherently plagued with the twin problems of forecast uncertainty and long and variable lags between the implementation of policy and the point at which it would have an effect on economic activity. Worse, risks can emerge on either side of desired policy targets requiring either a tightening or a loosening of policy in response to incoming data. To work through this problem, the Federal Open Market Committee has traditionally endeavored not to position itself too far off "center court," following a monetary policy that neither runs too much in the restrictive direction or too far in the accommodative direction, and thus can be adjusted quickly as times change.

This is not the case today. The FOMC has a near-zero short-term interest rate in place coupled with a massive position of almost $4 trillion in longer-dated securities. This portfolio was accumulated with the express purpose of pushing the effective stance of monetary policy below the "zero bound," in effect running a policy with a negative interest rate. One could make the case for such a policy in the dark days following the financial crisis. But no one should imagine that current policy is anywhere close to "center court."

Amazingly, this emergency policy which even its supporters describe as "highly accommodative" is in place as the economy reaches an unemployment rate which is at or close to what has traditionally been considered full employment. When quantitative easing was begun, Fed Chairman Ben Bernanke predicted that it would be wrapped up by the time the unemployment rate came down to 7 percent. In fact, tapering wasn't even begun until that point. Lift-off was to happen within a period that Fed Chair Janet Yellen originally described as six months after tapering was completed. That was March. Moreover, repeated Fed statements noted that the removal of accommodation would happen sooner if progress toward full employment was faster than what the Fed expected. It happened much faster, yet the removal of accommodation did not follow.

Keep the idea of "long and variable lags" in mind when evaluating this policy by considering the following thought experiment. Monetary policy lags are roughly a year and policy will not go into restrictive mode until the Fed funds rate becomes positive in real terms. Until then, monetary policy is a tail wind, not a head wind. Even if the FOMC should raise rates at the June meeting by 25 basis points and then raise them by 25 basis points every other meeting thereafter, a positive real Fed funds rate will not occur until December 2016, and that will not become an economic headwind until December 2017. If the unemployment rate continues to fall at the same rate as in the last two years, it would (mathematically, but not realistically) be 2.2 percent by the time a positive real Fed funds would begin to slow the economy!

The sheer absurdity of this situation points to just how far off center court the FOMC currently is. Is inflation just around the corner? We don't know. But is the FOMC prepared to combat inflation should it appear in a way that would allow a non-disruptive change in the stance of monetary policy? Absolutely not.

## *The Fed has no strategy.*

**ALLAN H. MELTZER**
***Allan H. Meltzer Professor of Political Economy, Tepper School of Business, Carnegie Mellon University, and Distinguished Visiting Fellow, Hoover Institution***

Can anyone find an example of a time when all major currencies tried to depreciate by printing money that was not followed by inflation? Can anyone recall a time when the Federal Reserve allowed excess bank reserves to reach $3 trillion dollars that banks can use to print money, expand credit, and inflate? Can you think of a country with enormous debt and even greater unfunded liabilities that didn't print money to help finance at reduced interest rates?

The United States and most other governments have enormous debt service. Higher interest rates would increase the U.S. (and other) budget deficits. Won't the Treasury, the President, and the liberal left lean hard on the Fed members to go slow? Has the Fed shown the strength to resist? Not this Fed.

Growth of the broad money stock, M2, remains at about a 6 percent annual rate, too low to be a cause for concern about near-term inflation. The threat comes from the idle reserves that are capable of producing a monetary explosion. Since the Fed ignores money growth, the risk is high. High money growth and inflation are kissing cousins.

It has taken the Fed more than two years to decide whether to raise the federal funds rate a trivial one-quarter percent. It is repeating its long history of being slow to anticipate inflation and slower still to act. The chair of the Open Market Committee is far more concerned about unemployment than the harm she is doing by pushing pensioners to take much more risk instead of rolling over their relatively safe bank CDs and inducing borrowers to take on debt at interest rates that will impose big losses on the buyers of that debt. These are big risks. We will find out more about these and other mistakes when the next crisis comes.

Those who cite confidence in the Fed's willingness to control inflation should pause to consider this. In the early postwar years, a Swiss franc was worth twenty American cents. It is now worth $1.04, more than a five-fold increase. The difference represents mainly differences in inflation rates. The Swiss National Bank, unlike the Fed, doesn't react to noisy short-term data. It pursues a successful medium-term strategy. Has it paid a high price in growth and employment? Not at all. It has benefited from its sustained commitment to a strategy.

Does the Fed have a strategy for controlling the huge stock of idle reserves at banks? None that they told us about, and probably none at all. Their plan is to hold their mortgage debt to maturity and induce banks to hold excess reserves by paying higher interest rates to increase the amount they willingly hold. How high will that be? No one knows, and that includes the Fed. Will it get the banks to hold most of the $3 trillion of current excess reserves? No one can possibly know.

Could we escape with little or no inflation? Sure, it's not impossible. A miracle may happen. A better choice would be for Congress to impose a strategy, a rule for monetary policy. The Fed is the agent of Congress. It doesn't have a strategy, so Congress should impose one.

## *At present there are few warnings or indicators of inflation.*

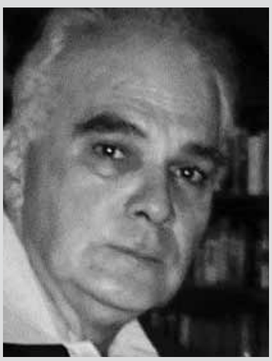
**RICHARD N. COOPER**
***Maurits C. Boas Professor of International Economics, Harvard University***

Inflation is always a potential danger. That is why we charge central banks with keeping it under control. Is it a real danger to the U.S. economy in mid-2015? We have many indicators and warnings, to use a term from the intelligence community, to alert us to any imminent threat; unlike in the intelligence community, none of them are secret. The information available to the Federal Reserve is available to everyone else, sometimes with a slight lag.

At present there are few warnings or indicators of inflation. The actual increase in the consumer price index was actually negative early in the year, thanks mainly to declines in prices of oil products. "Core" inflation, excluding food and fuel, was running well under 2 percent. Excess capacity in manufacturing seems to be ample. Unit labor costs are restrained. The sharp appreciation of the dollar against most other currencies over the past nine months will lower some import prices and put competitive pressure on American producers of tradable goods to restrain their prices.

Worldwide, there has been a slowdown of growth in many emerging markets, including Brazil, China, and Russia, and only weak recoveries in Europe and Japan. Prices of most primary products have weakened as a result (also of new capacity coming on line in the case of some minerals). Long-term interest rates are at all-time lows in many countries, even negative in Germany and Switzerland; futures markets expect only modest increases.

All this does not sound like an economic environment in which inflation is likely to erupt unexpectedly. Why then the concerns? Some attach more importance to inflation than to other economic outcomes, and always fear inflation. Others attach more weight to some indicators than to others. U.S. unemployment has fallen to 5.5 percent, which some see as entering the danger zone. Most importantly, Federal Reserve liabilities (the basis for monetary expansion) have grown enormously since 2008, from under $1 trillion to over $4 trillion. But commercial banks, concerned with repairing their balance sheets and raising capital since the 2008 crisis, have not used the lending capacity that this creates. The potential for credit creation is there—many wish that more of it had been used. The Federal Reserve is well aware of this potential, and when lending picks up strongly has both the time and the tools to restrain it if it becomes too exuberant (including if necessary raising reserve requirements, a tool that has not been used in many years). The danger of future inflation calls for alertness, but not for immediate action.



## *Inflation? Not a chance.*

**CRITON M. ZOAKOS**
***President (1994-2014), Leto Research LLC***

Will America soon have an inflation problem? Not a chance. Fed policy since 2008 has been to tilt against powerful deflationary forces that have yet to abate. How powerful are those forces? Consider this: from September 2008 to date, the monetary base has increased by 336 percent, from $0.94 trillion to $4.1 trillion, yet the annual CPI growth declined from 5 percent in September 2008 to -0.1 percent in February 2015. So we are talking about quite powerful underlying deflationary forces that will not go away.

But deflation is not necessarily anti-growth. During the second industrial revolution, in the twenty years from 1873 to 1892, the average annual GDP growth was 4.23 percent and the average annual inflation rate was -2.41 percent. Over that twenty-year period, real GDP grew 145 percent and the CPI level declined by 43 percent. This growth-friendly deflation was driven by persistent productivity growth as a result of the economy absorbing the cost-saving effects of railroads, telecommunications, electricity, and revolutionary new-materials manufacturing such as the Bessemer process.

The causes of this current underlying deflation have not yet been studied precisely because it is "underlying," that is, it is masked by the massive growth of monetary aggregates and not measured by the monthly CPI reports. My best guess is that the current bout of growth-friendly deflation in the United States (as distinct from the rest of the world) is due to similar technology-driven productivity gains as seen in the Gilded Age, but also due to cheap foreign labor and competitive devaluations. Proliferating new materials technologies, 3-D printing, rapid advances in robotics, rationalization of processes based on internet-of-things applications, automation, and so forth are cutting costs as they penetrate deeper into economic activities, improving some, eliminating others and creating brand-new ones.

The Fed's accommodative policies of the last six years were aimed at stabilizing the financial system, not at achieving the traditional targets of employment and price level. Therefore, a return to normal policies need not be argued on the basis of whether or not America will soon have an inflation problem. No such problem is likely to materialize, and yet the Fed should tighten its policy rate and perhaps do so sooner than Yellen's stated timetable.

The reason is that the existing accommodative policies are distorting the resource allocation process and in this sense inhibiting growth. By aiming to stabilize the financial system during and in the aftermath of the 2008 crisis, the Fed's accommodative policies had no choice but to prop up traditional assets that were under threat by the challenging new technologies. This is a policy that has to end if resources are to be freed up and applied to the emerging technological possibilities. By having given ample advance notice, the Fed is attempting to execute the shift without reviving the fears of systemic collapse. At this particular time and instance, the Fed's immediate task is to transform the resource allocation system without collapsing it—not to fine-tune the price level and unemployment rate.


**STEPHEN G. CECCHETTI**
***Professor of International Economics, Brandeis International Business School, and former Economic Adviser and Head of the Monetary and Economic Department, Bank for International Settlements***

**KERMIT L. SCHOENHOLTZ**
***Professor of Management Practice and Director of the Center for Global Economy and Business, Stern School of Business, New York University, and former Chief Global Economist, Citigroup***


***Will inflation rise soon? The truth is we don't know.***

Policymakers always have to balance a multitude of risks. If the Fed keeps rates too low for too long, it could push inflation above the 2 percent long-run objective or encourage an asset price bubble. If it tightens too early, it could lock in a period of subpar growth without conventional policy tools to address new adverse shocks to aggregate demand.

Moderate inflation is like an infection that has a known treatment. We have the tools and the experience to manage bursts of inflation. So, if inflation were to start to rise, we know what to do. And, somewhat reassuringly, we would be back in a world that we understand.

Will inflation rise soon? The truth is that we don't know. Simple models of the inflation process have performed poorly over the past few years, so we are hesitant to put much stock in their predictions. Wages have shown little response to falling unemployment. At the same time, the combination of weak growth abroad, the drop in commodity prices, and the rising U.S. dollar has imparted a new disinflationary shock to the U.S. economy.

Won't the large Federal Reserve balance sheet and the massive monetary base translate into inflation? Provided that the Fed uses its policy tools appropriately, we are not concerned. The size of a central bank's balance sheet depends on things like the nature of a country's financial system and the means by which policymakers choose to carry out their operations. The crisis has left us with a different financial system than the one we had in 2007. Importantly, the payment of interest on excess reserves—combined with tougher regulatory requirements and more prudent management—means that banks are going to hold substantially higher quantities of liquid assets in the future. In the decade before the crisis, total reserves were regularly below $10 billion in the decade before the crisis. We are not headed back to that simple world.

Perhaps most important, the Fed's authority to pay interest on reserves—a power granted to it in the emergency TARP legislation of 2008—allows it to tighten monetary policy without altering its balance sheet. The reason is that no bank will make loans at an interest rate below the riskless rate paid on its reserves at the Fed. As a consequence, the Fed retains control over the supply of bank credit and the stock of money.

That still leaves us concerned about the risks to financial stability associated with continued low interest rates. Yet we also share the doubts of many current and former Fed officials about using interest rate policy to secure financial stability. The response of first resort should be regulatory. That should focus the attention of U.S. policymakers—not just the Fed—on making the U.S. financial system significantly more resilient, and on organizing a coherent macro-prudential framework to keep it so.

***We run very few immediate inflation risks, but persisting very low rates have raised financial risks.***


**W. BOWMAN CUTTER**
***Senior Fellow and Director, Economic Policy Initiative, Roosevelt Institute***


In the short run, I come down (mostly) on Brad DeLong's side. Almost all the numbers show a labor market with a fair amount of slack and very few impending big pressures. Labor force participation is still about 3 percentage points lower than in 2009; there are still two million people not in the labor force but interested in working; there remain 2.5 million people in the labor force but unemployed for less than five weeks; and 3.8 million workers unemployed for more than fifteen weeks. Both the consumer and producer price indices remain tame. Most forecasters see GDP growth of about 3 percent for the remainder of this year, enough to keep the labor market improving but hardly a growth run-away. (And the very early first quarter 2015 growth reports are well below this rate.) And corporate earnings reports have been mixed to low.

After the last several years, it would seem to me that we should want to see more employment gains and that we run very few immediate inflation risks with a continuation of the current Fed policy for awhile longer. We do not face an immediate inflation problem; and the Fed should not abruptly (not that it does anything abruptly) change policy. The Fed should do what I expect it will do at the upcoming meeting: not change policy, and remain a bit vague.

But longer run, I agree with Marty Feldstein that the Fed has to remain extremely cautious. All the numbers I mentioned above are showing steady labor market improvement. The labor compensation index is rising. The inflation risks, correspondingly, begin to rise.

Second, the combination of the Great Recession and the very rapid structural changes occurring in our economy has probably raised the NAIRU at least somewhat. Between fall 2008 and fall 2010, the number of long-term unemployed more than doubled while labor force participation declined. These data represent a large number of people not receiving on-the-job training in all the new technologies.

And finally, separate from inflation concerns, persisting very low rates—as Feldstein has also noted—have raised financial risks. Narrowing spreads, declines in junk bond rates, high equity levels, increases in covenant light loans, and the return of some of the more questionable mortgage lending practices are all signs of rising risk. The Fed will have to begin a slow, delicate process of moving us back to a more normal rate environment.

***It's highly unlikely inflation will become a problem.***

**JAMES E. GLASSMAN**
***Head Economist, Chase Commercial Bank, JPMorgan Chase***

There's little danger of the Fed "falling behind the curve." Such assertions are likely based on the boom-bust cycles of a long-ago era that were partly caused by poor monetary policy management—but that era bears little resemblance to today's realities. Recent business cycles have been more the result of financial shocks, rather than inflationary excesses.

Sure, the Fed must work to keep inflation in check. But it would be equally undesirable if inflation remained below the central bank's 2 percent long-run goal, where it is stuck right now. In that case, the Federal Reserve would discover—as the Bank of Japan did—that its reliance on pegging short-term interest rates to manage the economy would be limited in the event of a crisis, given the zero lower bound on interest rates.

Why are inflation concerns misplaced? The economy remains underemployed, even though the official unemployment rate has fallen close to conventional assumptions of the NAIRU—the non-accelerating inflation rate of unemployment, or the ideal level of unemployment that's consistent with stable inflation—and short-term unemployment is back to normal. Even so, inflation remains tame.

But this shouldn't be surprising.

For one, it took six to nine years for the economy to recover from the last three recessions. There's little reason to assume that the economy has already recovered from one of the worst recessions after only six years.

Second, the distinction between short- and long-term unemployment and the assertion that short-term unemployment is a better indicator of cyclical slack is far-fetched. The number of people unemployed for long spells is falling rapidly. Long-term unemployment appears to be a cyclical issue as well.

Third, many underemployed or unemployed have not been included in the official unemployment figures. An unemployment metric that included them would be closer to 8 percent, rather than the current 5.5 percent rate. Many are working part-time involuntarily, meaning they are not classified as unemployed, but underemployed. And unemployment figures do not count the three million young adults who, in the face of limited job opportunities, temporarily exited the job market.

Fourth, the level of the NAIRU is uncertain. Empirical estimates of the NAIRU range from 4.5 percent to 5.5 percent, but if anything, the NAIRU might be even lower than that, because the young adults who have exited from the labor force tend to have a higher natural rate of unemployment.

It's also worth noting that the reserves the Fed created as a byproduct of its large-scale asset purchases pose no inflation threat, because they remain as excess reserves—effectively, they're in quarantine. Such reserves are aiding banks to meet their new liquid cash requirements.

Ultimately, it's highly unlikely that inflation will become a problem for America, and the Fed's critics would do well to understand that the central bank's challenge is analogous to asking a quarterback to develop a strategy without knowing where on the football field the ball has been placed, and then warning him that the rules are going to be changed by moving the end zone further out.

***The U.S. economy is now a house of cards. The Fed is condemned to make a policy error in one direction or another.***

**BERNARD CONNOLLY**
***CEO, Connolly Insight, LP***

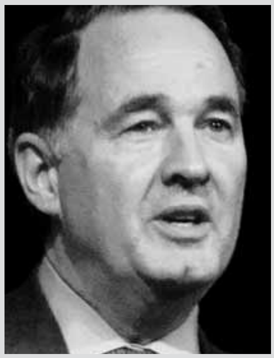
If consensus forecasts for U.S. growth over the next twelve months prove correct, the United States would face a choice between above-target inflation and a "liquidation" crisis in the economy.

It is currently true that there is still slack in the labor market. The number of people working part-time for economic reasons (PTER) remains high by historical standards. Part of the reason for this is structural, notably the negative effects of Obama's New Deal-style policies. But part of PTER represents a pool of already-employed labor which is restraining wage growth. However, PTER has been declining quite rapidly. By early 2016 it would, if the Fed's growth forecasts proved accurate, be back to levels historically consistent with full employment. But by then short-term unemployment would be below such a level: the labor market would be overheating, despite a still-high level of long-term unemployment, the result of a long process of replacing education with indoctrination in political correctness and of New Deal-style policies in conjunction with heavy illegal immigration.

No one has great confidence in the existing models of the relationship between unemployment and wage increases; and the relationship between wage increases, even relative to miserable productivity growth, and price inflation is similarly uncertain. The long trend of a rising share of profits in national income might reverse; the surge in rents might be moderated by increased supply (actual and imputed rent makes up around 30 percent of the consumer price index); other prices not directly related to marginal cost can vary in unexpected ways. Moreover, inflation, even core inflation, is presently below target, so that a period of tight labor markets might simply help return inflation to target. Nonetheless, an overheated labor market could probably not persist for long without sparking above-target inflation (even a further collapse in oil prices would only defer that development, still assuming Fed growth forecasts to be correct).

This implies that the Fed probably is behind the curve if its growth forecasts are right: a central bank would "normally" seek to have interest rates fully "normalized" before full employment is reached, and the Fed has repeatedly and explicitly said that it has no intention of doing that. Why? The key Fed figures seem to feel intuitively, even if they are reluctant to admit it, that the U.S. economy simply could not withstand anything like "normalization." The point of maximum danger for the U.S. economy will thus come if labor market overheating forces the Fed's hand. The U.S. economy—like most other economies—is now a house of cards sustained by a combination of ultra-low real rates and asset bubbles. Anything that undermined the carry trade and asset bubbles would have severe consequences for the United States and for the global economy.

Thus, the Fed is condemned to make a policy error in one direction or another. It can be saved from such an error only if its near-term forecasts prove too optimistic. But that would merely put off the evil day and make that day all the more horrible when it finally comes.



***There will clearly be a risk of rising inflation in 2016 and 2017.***

**DAVID HALE**
***Chairman, David Hale Global Economics, Inc.***

The United States currently has a two-tier inflation rate. Commodities have declined 3.3 percent year-on-year and at a 5.4 percent annual rate during the past three months. The prices of services *ex* energy have increased 2.4 percent year-on-year and 2.6 percent during the past three months. The major factor depressing commodity prices is energy, which has fallen 18 percent year-on-year and at a 44 percent annual rate during the past three months. The major factor bolstering service prices is rent. It has increased at a 2.7 percent rate year-on-year and at an annual rate of 3 percent during the past three months.

Oil prices have recently stabilized, but if Iran increases exports by one million barrels per day after sanctions are lifted, prices could plunge to $40 per barrel next year. Such a development could hold headline inflation close to zero during the first half of 2016 while core inflation could remain close to 1.8 percent. There is likely to be more upward pressure on wages later this year. There was a 3.9 percent wage gain at annual rates in March. Recently, some prominent retailers such as Walmart, Target, and Starbucks have announced they will increase their basic wages. This decision reflects tighter labor markets and competition for competent people. This wage pressure could push inflation above 2 percent once oil prices stabilize again. As productivity growth is very subdued, rising wages will force companies to raise prices.

Monetary factors also suggest inflation is poised to increase. The growth rate of M3 during the past three months has been 7.4 percent compared to 5.4 percent year-on-year. As the consumer price index is very low, real money growth is robust and should help to promote faster gains in output.

There is little risk of deflation in the U.S. economy. There will clearly be a risk of rising inflation in 2016 and 2017 when oil prices stabilize and wage growth accelerates. The Fed will have to increase the funds rate to 2 percent late next year to hold these price pressures in check.

***Fed policy is too tight.***

**STEVE H. HANKE**
***Professor of Applied Economics, Johns Hopkins University, Senior Fellow, Cato Institute, and Contributing Editor,*** TIE

The Fed remains schizophrenic and tight. In consequence, inflation in the United States is not just around the corner. The CFS Divisia M4—the most important measure of the money supply for those of us who embrace a monetarist approach to national income determination—is growing at an anemic year-over-year rate of 2.8 percent. How could this be? After all, over the past few years, the Fed has been engaged in the largest quantitative easing program in its history.

To find explanations, we must revert to John Maynard Keynes at his best. Specifically, we must look at his two-volume 1930 work, *A Treatise on Money*—a work that Milton Friedman wrote about approvingly in 1997. Keynes separates money into two classes: state money and bank money.

State money is the high-powered money (the so-called monetary base) that is produced by central banks. Bank money is produced by commercial banks through deposit creation. Keynes spends many pages in the *Treatise* dealing with bank money. This isn't surprising because bank money in the United Kingdom was much larger than state money in 1930.

Today, bank money accounts for about 80 percent of the total U.S. money supply, measured by M4. Anything that affects bank money dominates the production of money. So, we have to look at the issue of bank regulations—courtesy of the Basel regulatory procedures and the Dodd-Frank legislation.

These new regulations have been ill-conceived, procyclical, and fraught with danger. Indeed, bank money, the elephant in the room, has been struggling under a very tight monetary policy regime since the financial crisis of 2008–2009. This has forced the Fed to keep state money on an ultra-loose leash. The net result of this schizophrenic policy stance has been a sluggish growth rate in broad money and a continued growth recession, absent inflation, in the United States.

***The Fed is risking a significant medium-term inflation problem.***

**CHARLES W. CALOMIRIS**
***Henry Kaufman Professor of Financial Institutions, Columbia University Graduate School of Business***

The Fed is risking a significant medium-term inflation problem. There is no imminent threat of high inflation, but that is not the proper guidepost for policy. Policymakers must look ahead more than a few weeks or months because monetary policy's impact lasts for much longer and because it is neither wise nor easy to change monetary policy abruptly.

Some policymakers have wrongly argued that past slow wage growth implies little risk of inflation in the future. Behind that interpretation is a popular narrative about the sources of inflation, which sees inflation as a process through which firms pass rising costs associated with higher wages on to their customers via price increases. While that narrative certainly has some intuitive appeal, it receives absolutely no support from actual data. While wage growth and price inflation did move closely together from the mid-1960s through the early 1980s, whatever relation existed in those earlier years has completely disappeared. Recent analysis by Edward Knotek and Saeed Zaman, published in the Cleveland Fed's *Economic Commentary,* shows quite consistently, across a wide range of econometric models, that wage growth lost its ability to forecast future movements in inflation starting in the mid-1980s.

Some have argued that it would be prudent to wait until inflation moves closer to the 2 percent target before taking any deliberate steps toward further tightening. This view not only ignores the predictable effects of past accommodation, it also fails to take account of the transitory influence energy price declines have had on inflation. The relative price decline of oil has a one-time level effect on prices, implying a predictable future acceleration in inflation as the effect of that change dissipates.

The Fed has maintained a zero-interest rate policy for over five years. Historical experience tells us that whenever interest rates are held too low for too long, financial markets and economic behavior become distorted and the resulting excess aggregate demand generates rising inflation. Since the third quarter of 2010, the Taylor Rule guidepost implies that the Fed should have begun to raise interest rates from the zero floor, which implies that FOMC interest rate policy has been more than appropriately accommodative for the past four years. Even with the slowdown in measured inflation in the fourth quarter of 2014, the Taylor Rule now calls for a funds rate target of around 1.25 percent. That rate would imply substantial continuing monetary accommodation (1.25 percent is well below its long-run value of 4 percent). The Fed should begin in June 2015 to raise the funds rate gradually and predictably. ◆