Playing with matches

Dr Robert Gay | Fenwick Advisers | 23 April 2015

Do you recall the childhood game of burning a match in your fingers and trying to blow it out just before your fingers were scorched? It was a risky business because your fingers didn't feel the burning sensation until you already had suffered injury. Inflation follows a similar course. Recoveries tend to push the economy beyond its inflation-stable potential without any immediate signs of rising inflation. History shows a delay of at least a year and sometimes longer after when the economy passes "full employment" and when more inflation becomes obvious. Once inflation gets on a roll it, however, it can be hard to get the genie back in the bottle - much the way your burnt fingers take time to heal. The trick is to snuff out the fire before it causes some serious damage. In their recent projections and speeches, FOMC members have made it clear that they believe inflation pressures are sufficiently benign to warrant taking those chances.

This is a world turned upside down from the Volcker era when the wage-price nexus - that is, cost-push inflation - was the scourge of monetary policy. Now, low-wage competition is the scourge of effective monetary stimulus and Yellen wants to use tight domestic labor markets to remedy the lack of wage growth, in the hopes that the US can do so without losing its competitive edge. It is a large bet on the ability of US businesses to sustain productivity with technology and on the flexibility of the labor force. Yet, the risks seem worth taking in a world in which deflation, stagnation and inequality overshadow inflation as the foremost challenges to economic policies.

RUNNING HOT

The US Federal Reserve is setting the stage to run the economy "hot" - that is, above its potential in the years ahead in order to return inflation to the 2% target. We already are getting close to that threshold. According to Fed research, the so-called NAIRU (Non Accelerating Inflation Rate of Unemployment) is in the range of 5% to 5.25%, compared with the actual reading of 5.5% in March.[1] That would put the output gap - the difference between real GDP and its inflation-stable potential - at one percentage point, a slim margin indeed. The first indication that this intent had become the majority view became evident in the projections of FOMC members released at the 18 March meetings. The central tendency of forecasts called for unemployment to drop below 5% in 2016 and 2017, before returning to a "longer run" level consistent with the staff view of the natural rate. No one paid much attention, but in Fed circles the fractional difference is significant and was meant to send a signal.

Chair Yellen made to clearest statement of the FOMC's intent in a subsequent speech on 27 March at a research conference sponsored by the Federal Reserve Bank of San Francisco, appropriately titled "The New Normal Monetary Policy". She discussed why the federal funds rate needed to return to a more normal rate - and, yet, stressed why board members believed that follow-on rate adjustments will happen very gradually, in contrast with the belated lurches of the Greenspan era. In the context of the current small output gap, that means monetary policy would remain expansionary long after the point at which the central bank should be removing the punch bowl. And, as a result, the unemployment likely would fall below the natural rate.

> "A final argument for gradually adjusting policy relates to the desirability of achieving a prompt return of inflation to the FOMC's 2% goal, an objective that would be advanced by allowing the unemployment rate to decline for a time somewhat below estimates of its longer-run sustainable level. To a limited degree, such an outcome is envisioned in many participants' most recent SEP projections. A tight labor market may also work to reverse some of the adverse supply-side developments resulting from the financial crisis. The deep recession and slow recovery likely have held back investment in physical and human capital, restrained the rate of new business formation, prompted discouraged workers to leave the labor force, and eroded the skills of the long-term unemployed. Some of these effects might be reversed in a tight labor market, yielding long-term benefits associated with a more productive economy. That said, the quantitative importance of these supply-side mechanisms are difficult to establish, and the relevant research on this point is quite limited."

In short, "running hot" might benefit in relieving labor market rigidities and inequities that monetary policy alone cannot redress. One of the side-benefits presumably would be upward pressure on wages. I have argued that a sustained rise in real wages is a precondition to escaping deflation and secular stagnation.[2] Some firms - including Walmart, Walgreens, McDonalds and Aetna - already have adjusted upward their minimum thresholds for wages presumably because hiring and retaining good workers is becoming more difficult. In a sense, Yellen's tight labor markets are a US version of Japan's encouragement to employers to raise salaries and the German government's support for a lucrative wage settlement at IG Metall. Real wage gains in western countries in turn depend on normalising wage differentials around the world, notably between China and western industrialised nations.

Whether or not wage adjustments become more widespread depends on employers' response to tight labor market conditions. In the 1970s and 1980s, past inflation and indexation dominated wage negotiations and unemployment had relatively little impact, but those factors began to switch roles during the 2000s. Skill shortages already are apparent for many tech jobs and pay for workers with those skills are rising two to three times as fast as average wages. The key to the success of the Fed's gambit, however, rests on whether employers and workers respond to tight labor markets by investing in requisite education, training and technology that sustains productivity and real incomes.

IMPLICATIONS

Fixed income markets seem to have gotten the correct message, albeit perhaps for the wrong reasons – short term interest rates will stay low for a long time. The Fed's strategy of "running hot" is equivalent, in effect, to an admission that the neutral policy is lower than it was in the past. FOMC members acknowledged as much in lowering their projections for federal funds over the next few, as well as their views on the longer run rate, which in essence is their estimate of the neutral rate. We are likely to see more downward adjustments.

What happens to bond yields, by contrast, will depend on what happens to inflation itself and market expectations of future inflation. In short, the Fed needs to be careful about what it asks for. If financial markets perceive that the Fed is getting behind the curve in controlling inflation, bond yields will rise and the yield curve will steepen. By contrast, as long as the Fed is seen as normalising rates in a timely manner, inflation expectations and bond yields could stay low. This logic implies the Fed should start the normalise rates sooner rather than later, as a sign of conviction to exit quantitative easing and zero rates, as well as a shot across the bow of those who want to persist in using the US dollar as the basis of carry trades. After that, the game with monetary matches is on. The end game could be higher real wages, lower profits and the end of an investment cycle. Let's hope for something better – something closer to Yellen's vision of higher employment, reduced inequality and a sustainable recovery.

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