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The quandary on inflation

Dr Robert Gay | Fenwick Advisers | 27 July 2017

In recent congressional testimony, Chair Janet Yellen expressed dismay that inflation has remained persistently below the Fed's target of 2% despite years of monetary stimulus and a decline in joblessness to its lowest level in more than 50 years. Granted, all data have anomalies and measurement issues, yet the recent shortfall in US inflation (Figure 1) seems strikingly "abnormal" relative to that of recent years, especially in the context of a tighter domestic labor market. And it comes at an awkward time, as the Fed has set course for an historic unwinding of its extraordinary policies of the past eight years. Will low inflation derail the Fed's exit strategy? If not, where are they headed?

Figure 1: US core inflation rate

Source: Tradingeconomics.com | U.S. Bureau of Labor Statistics.

Notwithstanding the fascination of market observers with the quandary presented by the latest undershooting, the Fed is not likely to give up on the notion that inflation will begin to rise now that the economy has reached its potential – at least not yet.

One of the most enduring relationships in macroeconomics has been the link between the so-called output gap and inflation, depicted in Figure 2.

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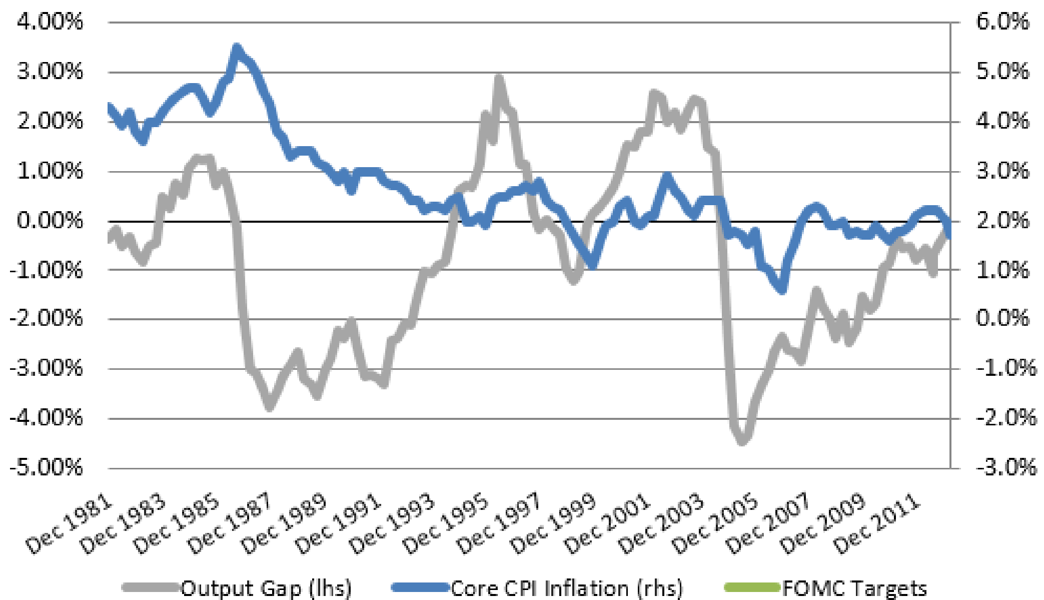
Figure 2: US output gap and inflation



Source: Tradingeconomics.com | U.S. Bureau of Labor Statistics.

Note, however, the delayed response of core inflation **even after** real GDP exceeds its inflation-stable potential (i.e., the output gap measured on the left-hand scale crosses its target of zero.) This seemingly perverse lag can be seen during the late 1990s and again in 2003 when inflation actually declined after output had already surpassed potential. On average, the delayed reactions can last for one year, so this latest undershoot is not yet cause for FOMC members to lose faith in this relationship.

The Fed should be concerned, however, about the **strength** of this relationship. Figure 2 gives the clear impression that fluctuations in inflation have narrowed sharply over the past 30 years, even though real GDP has continued to overshoot and undershoot its optimal full-employment level by as much as ever. Globalisation of production and supply chains coupled with rapid technology transfer and outsourcing of services undoubtedly have played a major role in weakening the link between inflation and domestic output. Whatever the cause, the Fed no longer presumes that monetary stimulus alone will generate either a quick or pronounced response on the inflation front.

The story on wages is similar – namely, tight labor markets no longer make much difference when employers set their pay scales. In economists' lingo, the Phillips curve – a relic of the postwar era – is dead. Indeed, simple neoclassical notions about labor supply and demand determining prices, including wage rates, that you see in textbooks never applied very well to labor markets. A better framework is that product market conditions including productivity trends, bargaining power, peer comparisons and the degree of oligopoly pricing are more important determinants of pay scales than the number of unemployed persons *per se*. During most of the postwar period until the early 1980s, a typical pay formula called for

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real wage increases in line with productivity trends. In an industry with strong unions, that target was 3% and whatever ground was lost to inflation would be made up at the beginning of the next contract.[1] Weaker unions and industries with less favorable productivity had to settle for less generous real wage gains. Nonunion tried to emulate those pay gains but began to fall short during the inflationary 1970s. Employers with good-paying jobs acquiesced because they could cherry pick employees and sustain profits through steady advances in efficiency.

That cozy framework began to unravel in the 1980s with the rise in import completion. Now technology is having a similar effect. A striking example comes from the service sector. Employers of retail trade establishments, for example, once had to adjust wages upward during periods of low unemployment.[2] Now, online retailers are driving many mainstream and Main Street retailers out of business and workers have no leverage in setting their wage. On an economy-wide basis, aggregate productivity trends have slowed to a crawl and workers leverage in wage bargaining has waned dramatically as companies have outsourced less skilled jobs to lower wage locales abroad. Corporate negotiating power has strengthened with increased concentration of business in an ever smaller group of controlling companies. Rather than thinking of labor shortages pushing up wages – which is relevant for a shrinking number of skilled occupations – envision a framework in which companies target a markup over wages that limits the upside for workers when growth in the business is slow and when competition is constraining their pricing power.

What are the implications for monetary policy?

The efficacy of any monetary policy strategy depends critically on the transmission mechanism from interest rates and credit creation, to output and inflation. In an ideal world, there would be a direct path from the Fed's policy rate to the end goals of stable inflation and full employment. Unfortunately, that path has become riddled with diversions and detours that are weakening the effectiveness of monetary policy initiatives. Troubled banks do not necessarily lend more because their cost of funding from the central bank is low or even zero. Even when credit is readily available and inexpensive, households and businesses do not necessarily rush to borrow more money (only governments seems to do so). Too much borrowing is devoted to unproductive activities that do not raise potential GDP but rather are squandered on mergers, acquisitions and real estate development that hollow out existing structures. And now the transmission from output to inflation has diminished to the point where monetary stimulus has become less potent. To compound the dilemma of central banks, liquidity increasingly is seeping into asset prices instead of working through the preferred and direct path to output.

At full employment, these impaired transmission mechanisms take on great significance. For one thing, "trying harder" to stimulate demand no longer makes good economic sense. An example of this convoluted line of thinking is the proposal to raise the inflation target to, say, 3% in a futile attempt to push output far above its potential. That strategy is a

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prescription for wasteful investments, overconsumption and, eventually, an even worse debt bubble than we already have.

A second implication is that the extraordinary policies including asset purchases and negative real interest rates have little redeeming value at full employment. They now are no longer contributing to the efficacy of monetary policy and, indeed, were never intended to be permanent fixtures on the monetary landscape but rather a temporary expedient to stabilise a global financial system in crisis.[3] At the center of the maelstrom were global banks with too much leverage, sketchy derivative products and unknown counterparty risks. Now all major US banks have passed stress tests that give the Fed some comfort that the financial system can stay afloat without the aid of a life support. Absent immediate concerns about the safety and soundness of the financial system, the FOMC has charted a course to unwind both its bloated balance sheet and negative interest rates. In my opinion, the Board would like to set that course on automatic pilot in quarter three, so that it stays on course regardless of whoever is appointed to be the Chairperson in January. Hitting the inflation target is not a prerequisite.

A third implication of shifting economic parameters is that the Fed will need to change its milestones for effective monetary policy. The old norms no longer are valid. Of greatest uncertainties for financial markets are:

1. the neutral policy rate;
2. the ultimate target for the size of the Fed's balance sheet;
3. the rate at which the Fed will approach those new metrics; and,
4. the economy's potential growth rate.

On the neutral rate, FOMC participants are moving slowly but inexorably toward a real rate of 0% to 0.5%, notwithstanding a higher range implicit in their 'dot' forecasts for the policy rate. Since most Board members also are projecting growth in excess of its potential, their forecasts for the policy rate should exceed the new neutral rate – which implies that, at some point, policy actually would become tight and the yield curve may invert. Staff studies support a new neutral in the range of 0% to 1%.[4]

Some FOMC members, including Lael Brainard and John Williamson, place greater emphasis on unwinding the balance sheet rather than reaching the new neutral rate, so as to have less impact on the US dollar. That reasoning seems plausible but presumes carry trades exploiting interest rate differentials would dominate all else, which may prove unlikely if other central banks follow the Fed's lead in normalising policy, as the Bank of England and Bank of Canada are already doing. The ECB will be close behind, in my opinion.

In any event, Chair Yellen will want the pre-announced plan for unwinding the balance sheet to go into effect long before her current term expires in January, so a timetable will likely to set at the September meeting and another rate hike is likely before year end.

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The ultimate target for the size of the balance sheet has not yet been decided. Estimates range from US$2.5 trillion to US$4.2 trillion. The lower number seems sufficient to manage Fed operations; the latter seems excessive. At the runoff rates already announced, the balance sheet will reach a new mid-range norm of US$3.2 trillion by the end of 2021. The market impact of such a gradual withdrawal by the Fed would be almost imperceptible, in my opinion - an increase of about 15 basis points annually on the 10-year Treasury bond yield. Similarly, the federal funds rate is already almost halfway to the new neutral and, at the current rate, would reach that norm by the end of 2018. These glide paths are so shallow that they have elicited characterisations as "boring" and akin to "watching paint dry".

The Fed deserves some kudos for its transparency in preparing markets for unwinding its extraordinary policies of the past eight years. This episode of central bank invention is far from finished. Indeed, it has just begun. In Europe and Japan, the exit will prove to be much more difficult and testing for financial markets, especially now that the US economy has reached that unique tipping point at which output has reached is sustainable potential and, hence, policy blunders - either monetary or fiscal - have serious long term consequences. If the US economy's sustainable growth rate has slowed to less than 2% as most evidence indicates, then the Fed and most everyone else are destined for some major disappointments.

ENDNOTES

1. Cost of living clauses in union contracts provided an automatic indexation mechanism to past inflation, albeit with a lag. Nonunion wages often were adjusted annually with implicit adjustments for past inflation.

2. While on the Fed staff during the 1980s, I maintained an assortment of wage models including ones for major industry grouping. Wages in the retail trade sector were among the few that showed some sensitivity to the unemployment rate.

3. See Robert S Gay, "Rules Versus Discretion: Lessons from Recent History", Fenwick Advisers Commentaries, June 24, 2017.

4. See Gagnon, Etienne, Benjamin K. Johannsen, and David Lopez-Salido (2016), "Understanding the New Normal: The Role of Demographics", Finance and Economics Discussion Series 2016-080. Washington: Board of Governors of the Federal Reserve System, http://dx.doi.org/10.17016/FEDS.2016.080 and from the IMF, Andrea Pescatori and Jarkko Turunen, "Lower for Longer: Neutral Rates in the United States", IMF Working Paper 15-135, June 24, 2015.

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