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Fed Debates Radical Policy Shift to Lift Inflation

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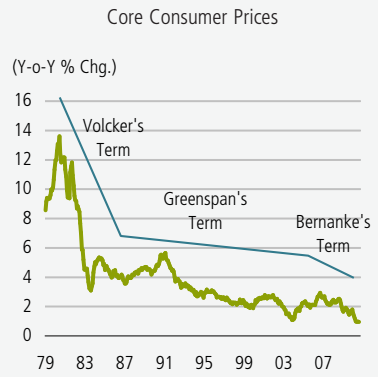
Several Fed officials appear to be pushing for a new round of quantitative easing explicitly aimed at boosting inflation from current low rates. We believe this strategy would further weaken the US dollar, lift commodity prices and is not a good way to promote a sustainable economic cycle.

Display
Distinct Inflation Challenges for Fed Chiefs



As of September 2010
Source: Bureau of Labor Statistics and Haver Analytics

Low Inflation Prompts Policy Rethink

In the corridors of the US Federal Reserve, policymakers are contemplating changes aimed specifically at raising the underlying inflation rate. With inflation slowing and at low levels, as described in last week's *US Economic Perspectives* report, central bankers are growing increasingly worried that underlying price trends **(Display)** are inconsistent with the Fed's historical mandate of maintaining price stability.

Some have even raised the possibility that the Fed should briefly tolerate inflation above its so-called price stability range to offset the period when inflation has been running below the desired target. Their rationale is to prevent the US economy from falling into a deflationary cycle like the one that has plagued Japan since the 1990s.

The most prominent option on the table today is another round of quantitative easing, which aims to boost the money supply by increasing banking reserves. Quantitative easing was deployed in 2008 as an emergency response to an extreme situation, in order to prevent the economy from sliding into depression. Now, however, the Fed may use this measure with the explicit intention of lifting inflation, which would be a very risky strategy at a sensitive moment for the US economic recovery, in our view.

Several officials are dropping hints about another round of quantitative easing. William Dudley, Federal Reserve Vice Chairman, is the most outspoken of the group. He recently said that the current economic situation was "wholly unsatisfactory." In particular, he pointed to projections showing that unemployment and inflation might take years to return to levels consistent with the Fed's dual mandate of full employment and price stability.

Is Phillips Curve Practical for Policy?

The Fed's current thinking and its forecasts are based on the economic theory known as the Phillips Curve, which argues that there is an inverse relationship between unemployment and inflation in an economy. According to this theory, in its most basic form, sustained and high levels of unemployment will lead to lower inflation over time, and vice versa.

But the Phillips Curve theory has its flaws as a guide for monetary policy. For example, estimating the natural rate of unemployment is a very difficult task. In addition, movements in inflation cannot always be explained by a simple model like the Phillips Curve.

Indeed, in 2004, there was a noticeable increase in US inflation even though the jobless rate lingered near its peak for several quarters. Economists do not have a good explanation for why this bout of

inflation struck during a long period of high unemployment.

Volcker Set Inflation as Main Target

For decades, the Fed has grappled with similar questions. Nearly 30 years ago, Federal Reserve Chairman Paul Volcker set out to reduce the US economy's inflation rate, which at the time was higher than 10%. Volcker had the support of Congress as well as the US public, but financial markets were skeptical at first. Investors in the 1970s had seen promises to tackle high inflation repeatedly broken when unemployment began to rise.

Volcker was not deterred. In the summer of 1981, in the face of high and rising unemployment, he raised interest rates—and gained credibility. In an interview in 1980 Volcker said that the "basic philosophy is [that] over time we had no choice but to deal with the inflationary situation because over time inflation and unemployment go together."

In addition, Volcker explained the flaws of sticking rigidly to the Phillips Curve model. The problem was, he said, that attempts to trade off inflation for employment did not create a stable platform for dealing with rising prices, conducting monetary policy or enabling the US economy to reach its maximum growth potential. In fact, said Volcker, the best way the Fed could achieve its dual mandate of full employment and price stability was to eliminate sharp inflation cycles, and with it, to eradicate all the uncertainty that inflation brings to businesses.

Greenspan Kept Inflation in Center

This conceptual framework for monetary policy was largely continued by Volcker's successor Alan Greenspan, who became Fed chairman in 1986. Greenspan's basic policy was that less inflation is better than more, although he never put a specific number or range to define the parameters of price stability. In February 1994, Greenspan stated in testimony before Congress "that over the long run, there is no evident trade-off between inflation and unemployment."

According to Greenspan, US and international experience clearly suggested that lower levels of inflation were conducive to greater productivity and higher standards of living. He also argued that low inflation and low inflationary expectations reduced uncertainty in economic planning and lowered risk premiums for capital investment—the lifeblood of economic growth and wealth creation.

What Will Bernanke Do?

With this historical context in mind, we find it unusual that policymakers today think a move to higher inflation will improve the current economic environment and thereby lead to a more sustainable economic recovery. Of course, inflation triggered by a surge in demand would be a welcome development. But Fed Chairman Ben Bernanke should beware of using quantitative easing to prompt a quick move to higher inflation. In our view, this strategy would further weaken the US dollar, lift commodity prices and is not a good way to promote a sustainable economic cycle.

The logic behind our doubts is simple. In the current environment, with workers' wages and incomes stagnant, higher inflation without higher demand would compel consumers to spend less on certain items in order to cover higher costs for many necessities. For US companies, rising commodity costs in a low growth environment could prove counterproductive by forcing management to cut other costs in order to offset the added expense incurred by inflation.

Remember Lessons from 2001 Crash

There's a good lesson to be learned from the economic recovery following the equity market crash and recession of 2001. At the time, the Fed dramatically eased monetary policy by slashing official interest rates to 1% and keeping rates at very low levels for an extended period. Their goal was to cushion the blow from the sharp loss of wealth caused by the bursting of the technology bubble, and to help jump-start the recovery through increased risk-taking in the real estate markets.

In the short term, it looked like the policy was working. But we all know what happened next. Low interest rates enticed millions of people to buy homes before jobs and incomes had recovered. It was a recovery built on a house of cards, and it ended in a catastrophic collapse. We believe that a policy designed to spark inflation before demand and jobs have recovered is a recipe for disaster again.

The US economy is currently in the early stages of a modest recovery. If handled properly and with patience, we expect economic growth to gain strength and breadth as consumers continue to deleverage and banks become better capitalized and more eager to lend again. In our view, using monetary policy to fuel an acceleration of nominal (not real) growth before the fundamentals are secure is a misguided approach, and risks creating more price imbalances that could undermine the fragile foundations of the US economic recovery. ■