By embracing the wrong framework, the Fed has difficulty understanding low inflation

Low inflation has bothered the Fed no end. Two years ago, Yellen "crunched" inflation in a speech titled *Inflation Dynamics and Monetary Policy*. She concludes:

> ***I expect that inflation will return to 2 percent over the next few years as the temporary factors*** that are currently weighing on inflation wane, provided that economic growth continues to be strong enough to complete the return to maximum employment and long-run inflation expectations remain well anchored.
>
> Most FOMC participants, including myself, ***currently anticipate*** that achieving these conditions will likely entail an initial increase in the federal funds rate later this year, followed by a gradual pace of tightening thereafter. ***But if the economy surprises us, our judgments about appropriate monetary policy will change***.

Last week she discussed inflation again in *Inflation, Uncertainty, and Monetary Policy*. She´s still a "believer", although it shows some "cracks":

> Based on analyses of this sort, my colleagues and I currently think that this year's low inflation is ***probably temporary***, so we ***continue to anticipate*** that inflation is likely to stabilize around 2 percent over the next few years.
>
> ***But our understanding of the forces driving inflation is imperfect***, and we ***recognize that something more persistent may be responsible for the current undershooting of our longer-run objective***. Accordingly, we will monitor incoming data closely and ***stand ready to modify our views based on what we learn.***

Concluding:

> To conclude, standard empirical analyses ***support the FOMC's***

> ***outlook that, with gradual adjustments in monetary policy, inflation will stabilize at around the FOMC's 2 percent objective over the next few years***, accompanied by some further strengthening in labor market conditions.

Neel Kashkari, reacting, has introduced "position papers" in the FOMC, writing [My take on inflation]:

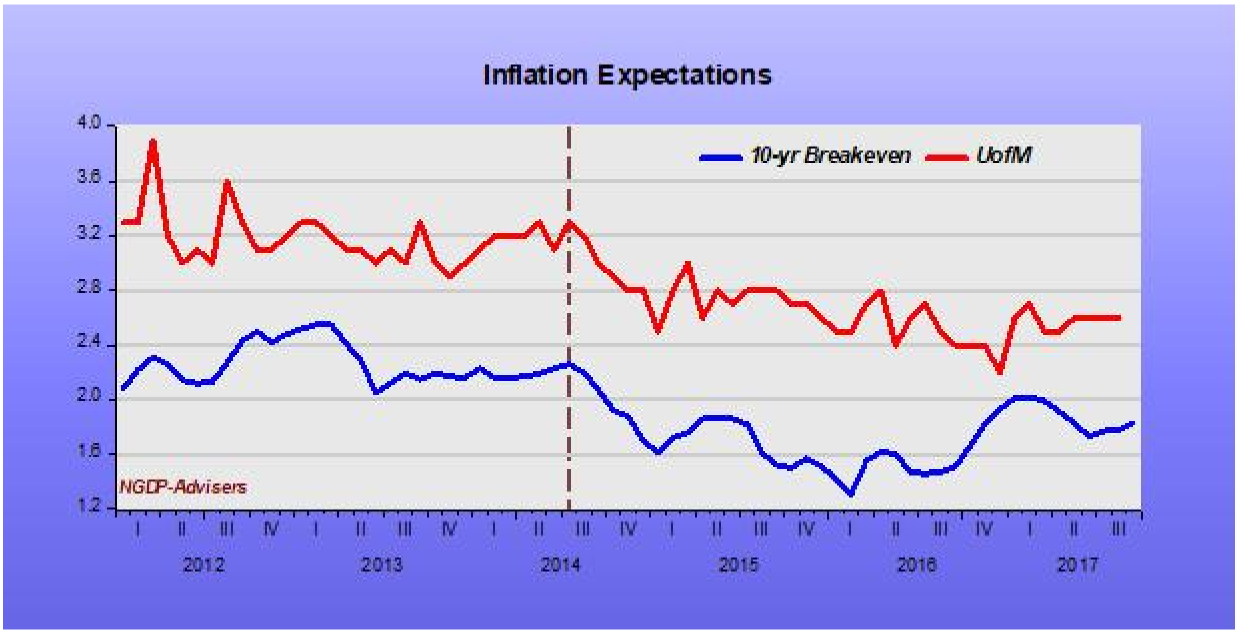
> Members of the Federal Open Market Committee (FOMC) are ***trying to understand*** why inflation and wage growth are low, ***despite the headline unemployment rate having fallen from a peak of 10 percent during the Great Recession to 4.4 percent today***.
>
> ***We would have expected a strong job market to lead to stronger wage growth and <u>then</u> higher inflation*** as businesses passed their increased costs on to customers. Yet that hasn't happened.

He also writes:

> I believe the most likely causes of persistently low inflation are ***additional domestic labor market slack*** and ***falling inflation expectations***. This essay will explore the causes of the latter, falling inflation expectations, and ***I will argue that the FOMC's policy to remove monetary accommodation over the past few years is likely an important factor driving inflation expectations lower***.

While Yellen believes "gradual adjustments should continue", Kashkari believes the policy to "remove accommodation" is to blame for the fall in inflation expectations.

As Kashkari shows, at least some measures of inflation expectations have fallen since the Fed began to signal a reduction in monetary accommodation three years ago.

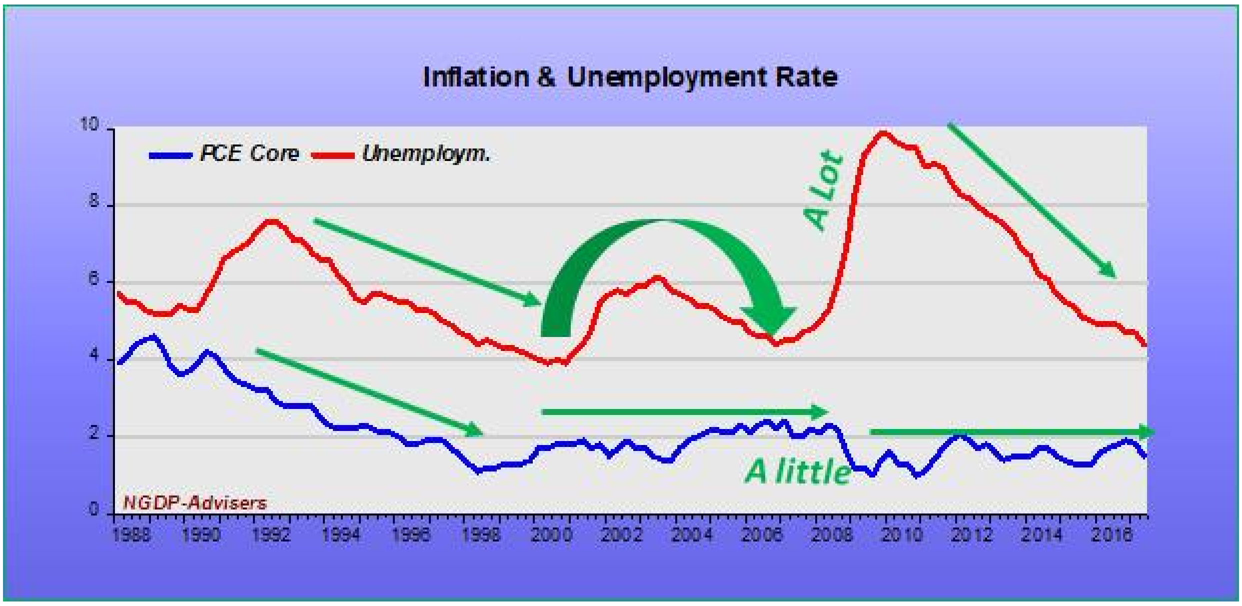


Kashkari does not subscribe to the temporary/transitory view of low inflation, even though he embraces the same Phillips Curve/Cost/Gap framework as Yellen and much of the FOMC. The framework, however, is wrong and misleading.

These are the two ‘strands’ to the framework:

1. Members of the Federal Open Market Committee (FOMC) are ***trying to understand*** why inflation and wage growth are low, ***despite the headline unemployment rate having fallen from a peak of 10 percent during the Great Recession to 4.4 percent today***.
2. ***We would have expected a strong job market to lead to stronger wage growth and then higher inflation*** as businesses passed their increased costs on to customers.

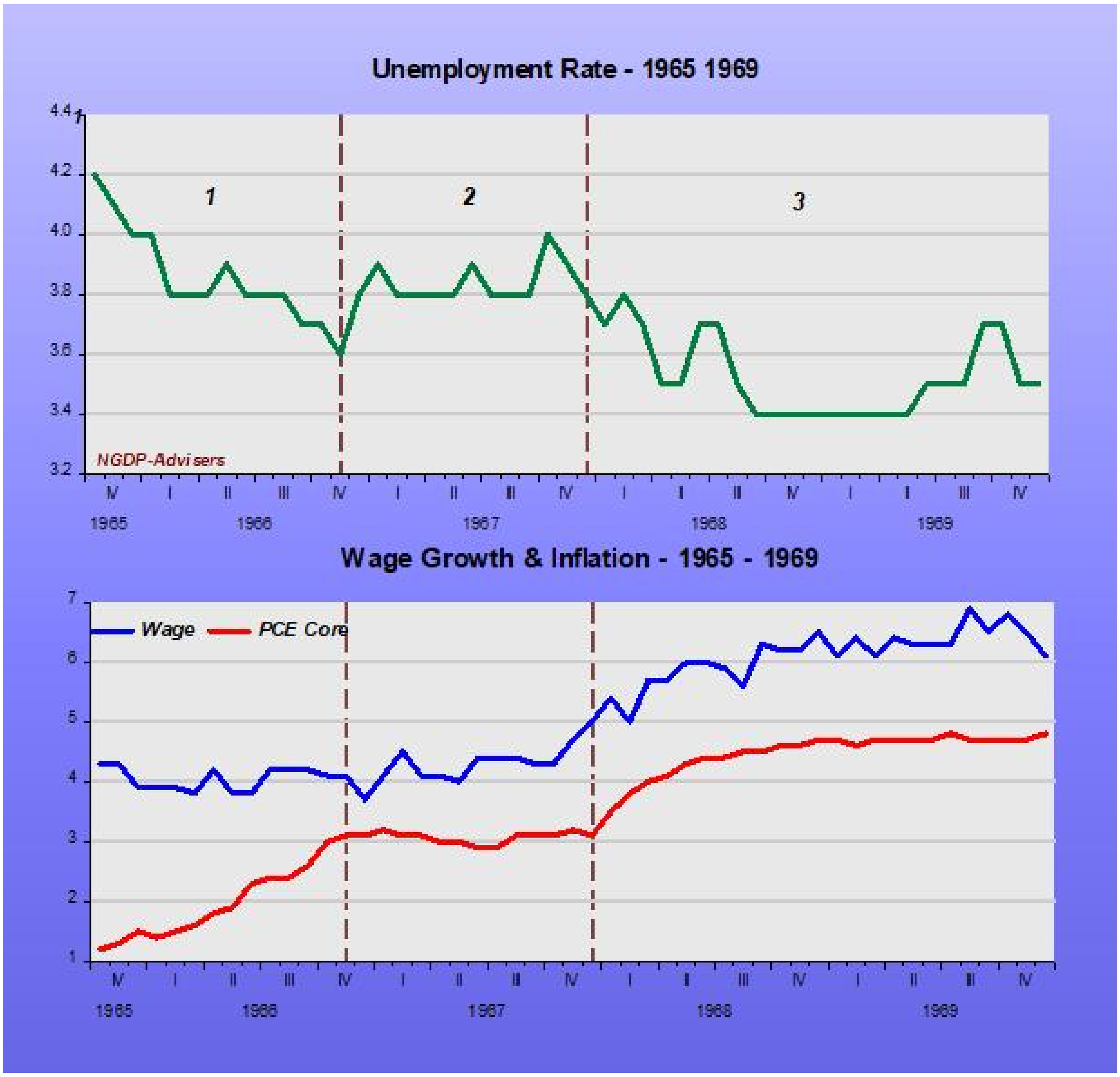
Regarding the first ‘strand’, the chart indicates that falling/low unemployment has no implication for inflation.



In words, all combinations of unemployment and inflation are possible. You can have falling unemployment and inflation, rise & fall in unemployment alongside stable inflation, strongly rising unemployment with weak fall in inflation and strong drop in unemployment with stable inflation.

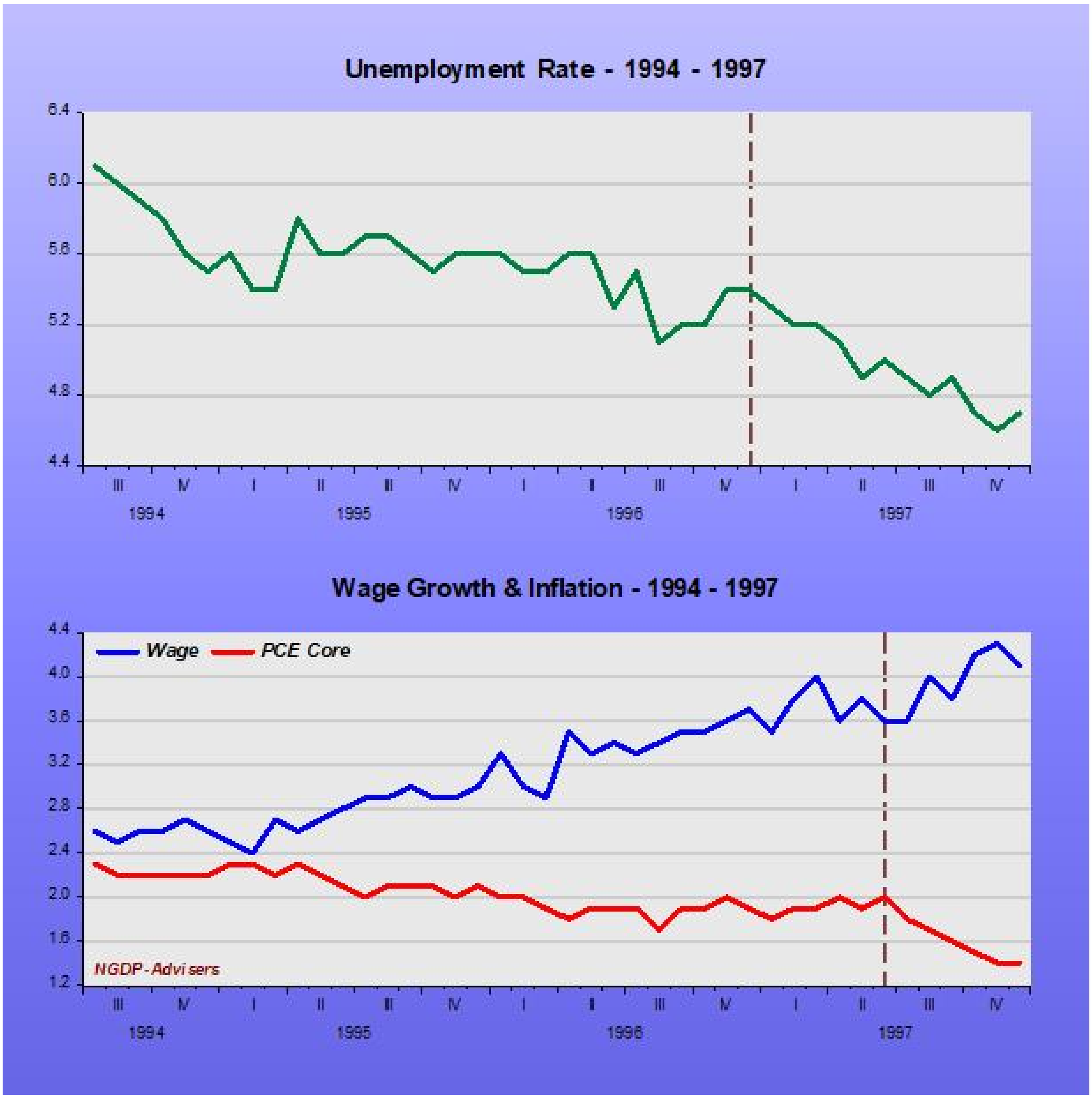
The second ‘strand’ reflects the cost-push view of inflation held by adepts to the Phillips Curve framework.

The chart below indicates that view is quite wrong. Look at the second half of the 1960s, the moment when inflation in the US began to travel up. In ‘region 1’, you have a strengthening labor market alongside rising inflation (what the P-C predicts). However, there´s ***no*** increase in wage growth.



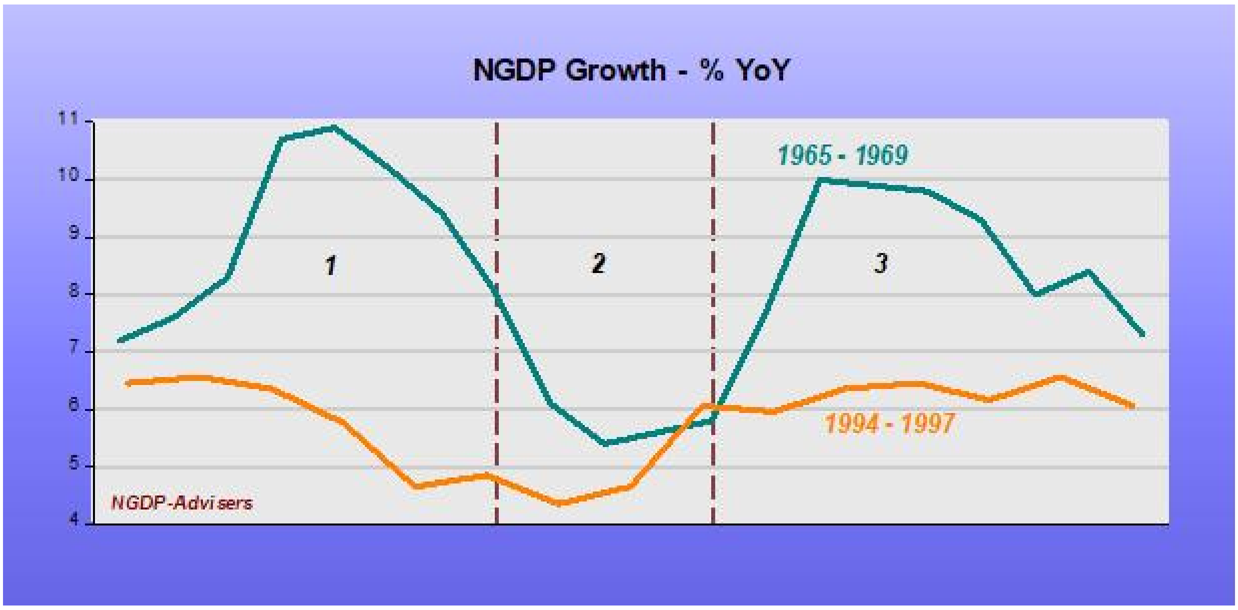
During that period, inflation expectations were "dormant". However, when inflation rises (doubles) and stays high, expectations adjust. When that happens, wages rise alongside inflation ('Region 3) together with a strengthening labor market.

The next chart shows what happened in another period of strengthening labor market.



Throughout, the labor market strengthens. Wage growth also rises throughout but inflation falls. Towards the end of the period, unemployment falls faster. Wages rise more strongly and inflation falls further!

What explains those patterns? The next chart posits that nominal spending (NGDP) growth, a quantity under the Fed´s control, does a much better job of explaining the behavior of inflation.



Regions 1, 2 and 3 in the NGDP growth chart refer to the regions in the 1965 – 1969 chart. The pattern of initially rising then stable and again rising inflation is consistent with the behavior of NGDP growth.

Why, one may ask, does unemployment fall, wages rise and inflation falls in 1994 – 1997, if NGDP growth is lower and relatively stable in that period?

The answer is that the best the Fed can do for the economy is to achieve and maintain ***nominal stability*** (a stable rate of NGDP growth at an **appropriate level**). This will allow the economy to best 'adapt' to different circumstances, some positive, some negative (think, for example of a productivity shock – a positive supply shock like in 1994 – 1997 – or an increase in oil prices – a negative supply shock). Meanwhile, striving to maintain nominal stability, the Fed won´t 'provoke' nominal or demand shocks like in 1965 – 1969.

In summary, to understand inflation the Fed has to jettison its Phillips Curve/Cost/Gap theory of inflation. It misleads and leads to bad policy decisions.

That, however doesn´t seem likely. The framework is too entrenched in the minds of current monetary policymakers. Unless we´re lucky and, as Yellen indicated, they learn something and then ***"stand ready to modify our views based on what we learn."***

I sincerely hope they don´t go the way of the BIS (Bank for International Settlements, the "Central Bank of Central Banks). As recently suggested by Claudio Borio, head of the BIS Monetary & Economic Department:

> Finally, if these hypotheses are correct, we may need to adjust monetary policy frameworks accordingly. As I shall explain, that would mean putting less weight on inflation and ***more weight on the longer-term real effects of monetary policy through its impact on financial stability*** (financial cycles).

If that idea comes to pass, “God help us”!