The myth of “low inflation” debunked

Yellen and the Fed seem surprised that inflation remains below target even with unemployment at historically low levels.

With that view coming from the Fed we get pieces with “novel” titles such as

- The New Fed Team Will Inherit Inflation Miss That’s Mystifying Yellen
- Nobody seems to know why there’s no US inflation

Even absurdly titled papers as one recently presented by former Board Member Tarullo:

- Monetary Policy Without a Working Theory of Inflation

The list is almost endless…

Why is that a concern today? Why wasn´t it a concern in the eleven years from 1994 to 2005.

In the eleven years from 1994 to 2005, PCE Core inflation averaged 1.8% annualized. Over the past 11 years from 2006 to 2017, the average has been 1.7%! What a difference one basis point makes.

One explanation that jumps out is that now the Fed has an explicit 2% inflation target. Before it was just “low and stable inflation”.

The Fed´s obsession with “price stability” is dangerous. James Meade said it explicitly is his Nobel Lecture 40 years ago:

> Earlier I spoke of ‘price stability’ as being one of the components of ‘internal balance’. Yet in the outline which I have just given of a possible distribution of responsibilities no one is directly responsible for price stability.
>
> **To make price stability itself the objective of demand management would be very *dangerous*. If there were an upward pressure on prices because the prices of imports had risen or because indirect taxes had been raised, the maintenance of price stability would require an offsetting absolute reduction in domestic money wage costs; and who knows what levels of depression and unemployment it might be necessary**

> **consciously to engineer in order to achieve such a result?**

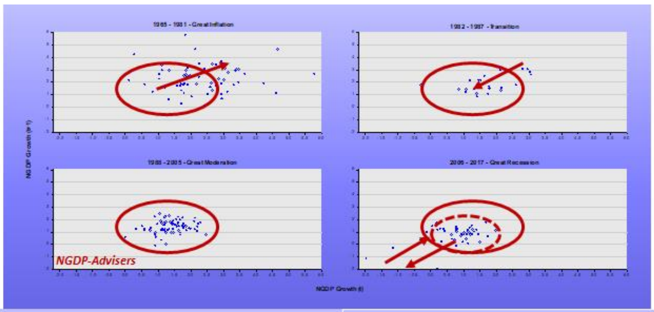
He proposed instead that the Fed pursue nominal (NGDP) growth stability:

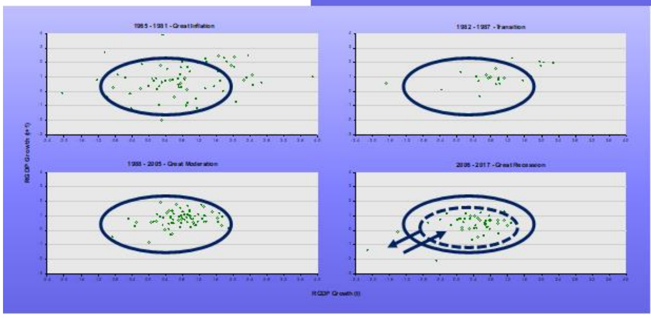
> I have told this particular story simply to make the point that the choice between fiscal action and monetary action must often depend upon basic policy issues, which should certainly be the responsibility of the government rather than of any independent monetary authority.
>
> **Perhaps the best compromise is an independent monetary authority charged so to manage the money supply and the market rate of interest as to maintain the growth of total money income on its 5-per-cent-per-annum target path, after taking into account whatever fiscal policies the government may adopt**.

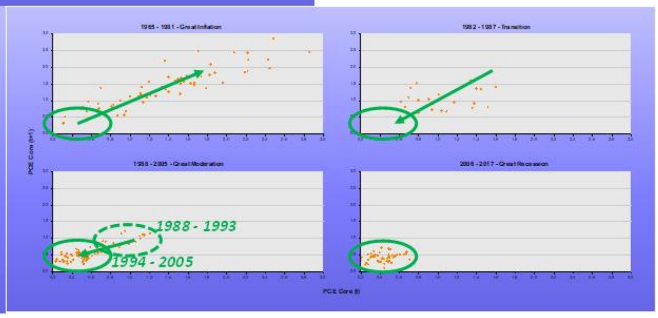
The charts below provide compelling evidence for the pursuit of nominal stability by the Fed, with one proviso: it has to be a stable LEVEL path at an adequate level.

The charts are constructed to give a visual idea of the volatility of the different aggregates. The horizontal axis shows growth (quarter-on quarter) in quarter t, while the vertical axis shows growth in quarter (t+1).

During the so-called Great Moderation period, NGDP growth stability resulted in both RGDP growth stability and inflation stability. Note that inflation keeps falling until the economy adjusts to the stable level path of NGDP growth.







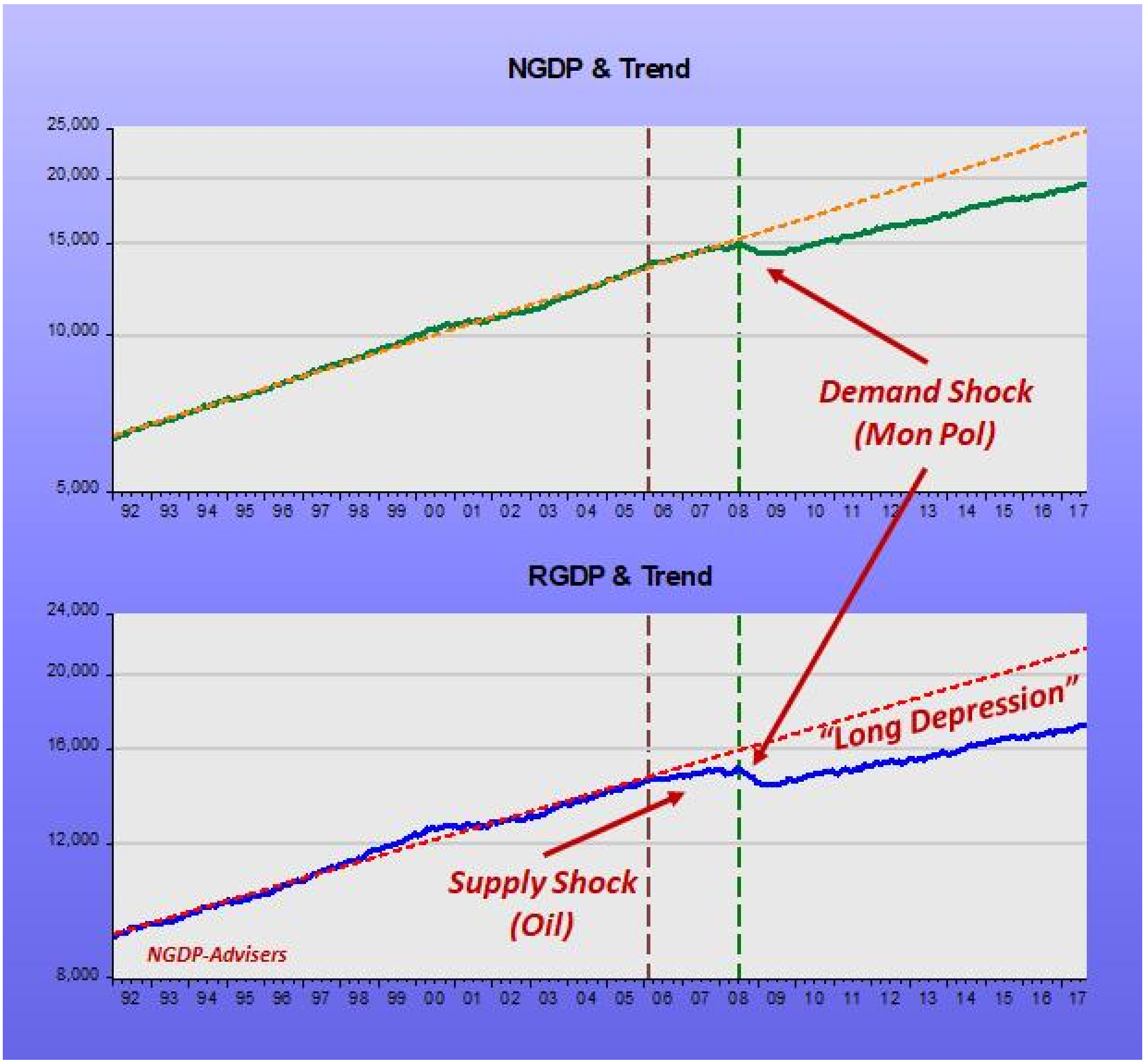
The importance of the “level” requirement becomes clear from looking at what has happened in the last seven years, after the crisis abated.

Nominal stability is once again the norm. NGDP growth (and RGDP growth) are even more stable than during the Great Moderation (their volatility is contained within a smaller circle). Notice, however, that the trend level and trend growth rate of both NGDP and RGDP are significantly lower at present.

Average inflation has been a bit below the 2% target for the past 23 years, both when it was implicit and after it became explicit. That´s a fixture of nominal stability. What the Fed got wrong in 2008 was to lose that stability and then not engineering an economic recovery to put the economy back on (or near to) the previous trend level.

Inflation will be low and stable if NGDP growth is stable. Real growth will be the “victim” of too low NGDP growth. Just as the “Great Moderation” was the outcome of “appropriate monetary policy”, the “Long Depression” is the outcome of “misguided monetary policy”.

Endnote: Take a peek at what a “Long Depression” looks like and how it´s brought about.



NGDP & Trend
25,000
20,000
15,000
10,000
5,000
92 93 94 95 96 97 98 99 00 01 02 03 04 05 06 07 08 09 10 11 12 13 14 15 16 17
Demand Shock
(Mon Pol)
RGDP & Trend
24,000
20,000
16,000
12,000
8,000
"Long Depression"
Supply Shock
(Oil)
NGDP-Advisers
92 93 94 95 96 97 98 99 00 01 02 03 04 05 06 07 08 09 10 11 12 13 14 15 16 17