Will a “couple”, a “few” continue into “several”, “most”?

It appears the view that “low” inflation is transitory is losing adherents. In the November FOMC, a couple of participants brought up the idea of alternative monetary frameworks. In the December FOMC, a “couple” became a “few” and two frameworks – PLT and NGDPT – were mentioned.

November FOMC

In view of the persistent shortfall of inflation from the Committee’s 2 percent objective and questions about whether longer-term inflation expectations were consistent with achievement of that objective, a ***couple*** of participants discussed the possibility that potential ***alternative frameworks*** for the conduct of monetary policy could be helpful in fulfilling the Committee’s statutory mandate.

December FOMC

> Due to the persistent shortfall of inflation from the Committee’s 2 percent objective, or the risk that monetary policy could again become constrained by the zero lower bound, a ***few*** participants suggested that further study of potential ***alternative frameworks*** for the conduct of monetary policy such as price-level targeting or ***nominal GDP targeting could be useful***.

At least they didn´t mention changing to a higher inflation target. That idea, however, will feature prominently in today´s (Jan 08) Brookings “**Should the Fed stick with the 2 percent inflation target or rethink it?**”

The point to note, I think, is that the “need for an alternative framework for monetary policy” is gaining momentum.

However, to devise an appropriate monetary policy framework, the Fed has to “get its act together”. Now, they are at a loss. That becomes clear when you read the most recent press conference statements:

Yellen on Press Conference September 17

> For quite some time, inflation has been running below the Committee's 2 percent longer-run objective. However, ***we believe this year's shortfall in inflation primarily reflects developments that are largely unrelated to broader economic conditions***. For example, one-off reductions earlier this year in certain categories of prices, such as wireless telephone services, are currently holding down inflation, ***but these effects should be transitory***. Such developments are not uncommon and, as long as inflation expectations remain reasonably well anchored, are not of great concern from a policy perspective because their effects fade away.

Yellen on Press conference Dec 17

> We continue to believe that this year's surprising softness in inflation ***primarily reflects transitory developments that are largely unrelated to broader economic conditions***. As a result, we still expect inflation will move up and stabilize around 2 percent over the next couple of years. Nonetheless, as I've noted previously***, our understanding of the forces driving inflation is imperfect.***

When someone charged with responsibility for monetary policy states the "our understanding of the forces driving inflation is uncertain", it makes me tremble.

If an economics major wrote that in an exam, the teacher would surely give him a failing grade.

That is, however, not a new view. In his recent presentation on Allan Meltzer, James Bullard mentions that, concerning the Committees of the 1960s and 1970s:

> Meltzer states that the Committee had no ***common baseline even for fundamental questions, such as the causes of inflation***.

Just as Yellen now says that today´s **low** inflation reflects one-off reductions earlier this year in certain categories of prices, in the 1970s Arthur Burns would say that **high** inflation reflected increases in oil prices and the behavior of labor unions and oligopolies.

If they don´t know what drives or causes inflation, how, then, can they discuss alternative monetary frameworks?

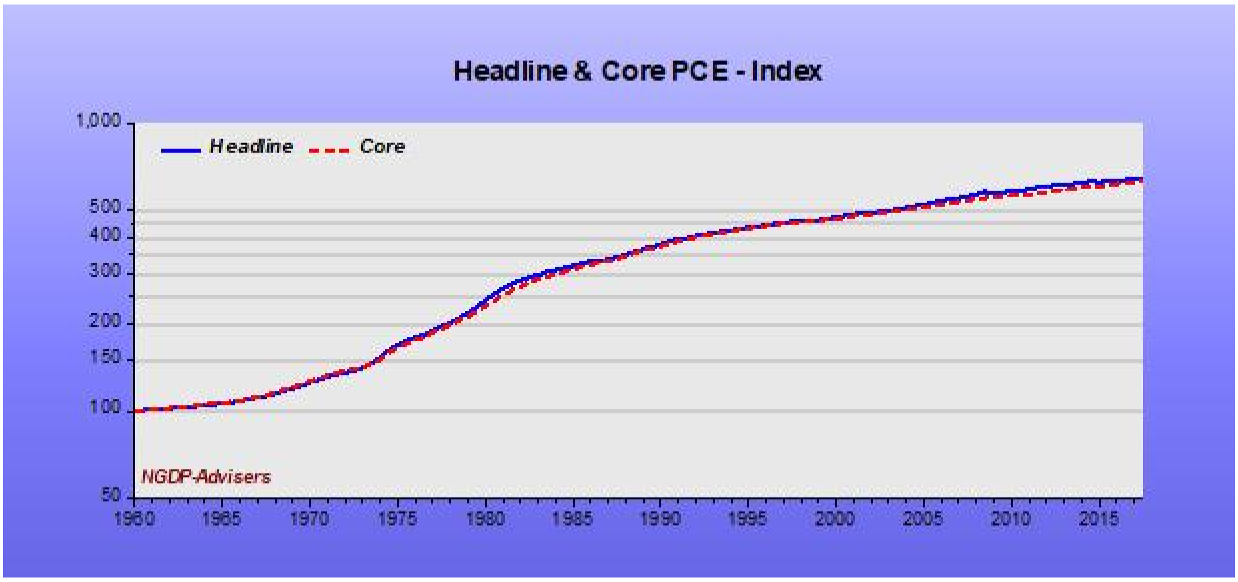
For the past six years, the monetary framework has been inflation targeting (IT) at 2%. Before that, the framework was one of "low and stable" inflation. In practice that´s the same thing, without a precise number attached.

That´s how Greenspan wanted it to be. In July 1996, the FOMC had a long discussion on inflation targeting. On concluding the discussion (page 72), Greenspan says:

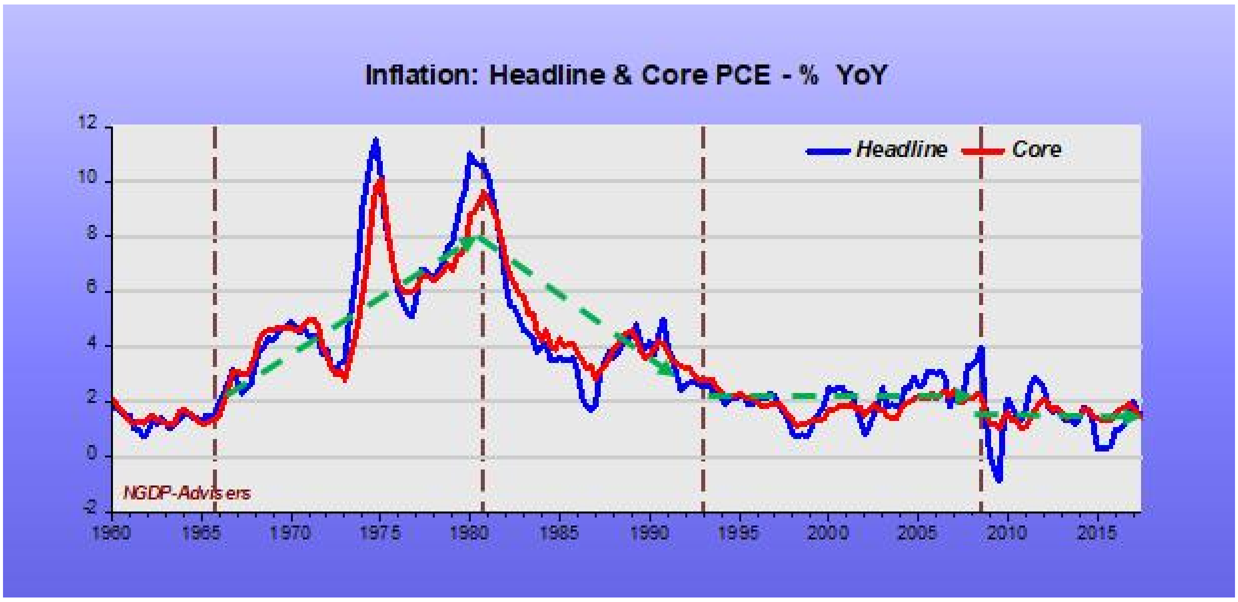
The discussion we had yesterday was exceptionally interesting and important. ***I will tell you that if the 2 percent inflation figure gets out of this room, it is going to create more problems for us than I think any of you might anticipate***.

A few years before that FOMC meeting, the Greenspan Fed had managed to get inflation down to what Greenspan considered "low & stable". Before going forward, let me say that when I say inflation I mean that given by the core PCE.

As the chart indicates, over a long span of time, both the headline PCE and core PCE tell the same inflation story. Over that 57-year period, while the headline PCE went up by a factor of 6.5, the core measure rose by a factor of 6.3.



Over shorter periods, however, the two measures can diverge significantly.



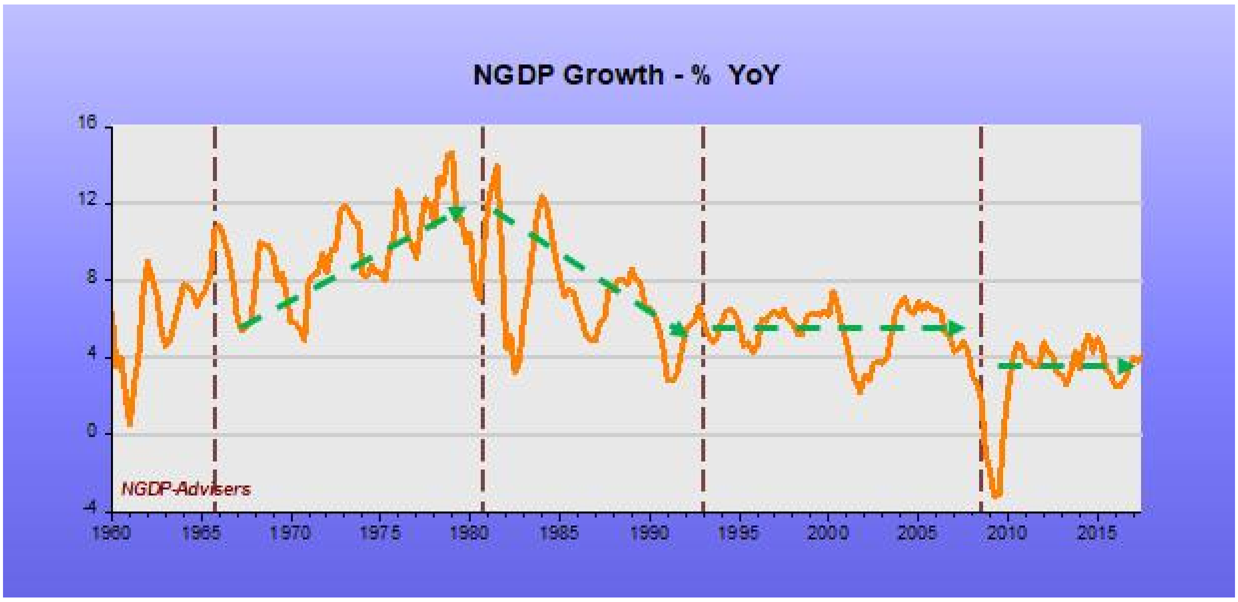
In the chart, note that from the mid-1960s to the early 1980s, inflation (of both varieties) was on an upward trend. That´s true even if you look through the spikes associated with the two oil shocks of the decade.

That´s the definition of inflation; a sustained rise in **all** prices. Note, however, that once inflation was "conquered", becoming "low & stable", oil shocks, no matter how strong, mostly cause fluctuations in the headline measure. Note the word "fluctuations", not "trend".

What better explains the pattern of first stable, and then rising, and then falling, and finally stable and low inflation?

A few economists have had the gall to say it was mostly "luck". Sometimes "bad luck", when oil shocks came in strong in the 1970s, followed by "good luck" due to the paucity of supply shocks in the 1990s.

We feel monetary policy, the stance of which is best indicated by what´s happening with nominal spending (NGDP) growth path (not the level or direction of interest rates) provides the best explanation.

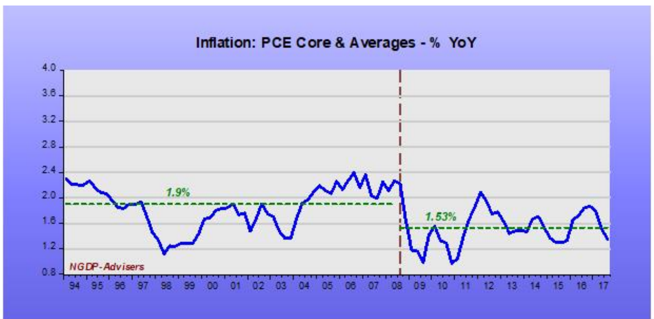


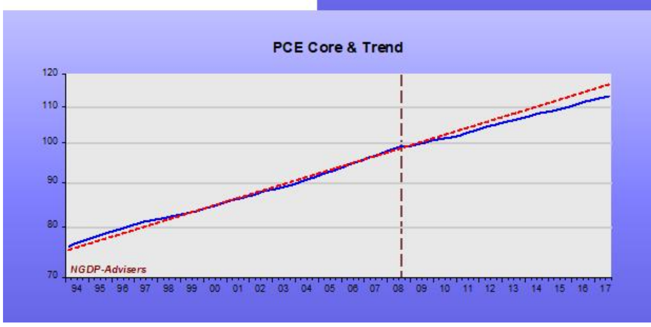
Once the rising growth in nominal spending, which began in the early 1960s brought forth an “update” in inflation expectations; the system was “doomed”. Things only began to change with the “[Volcker moment]()” that kicked-in in the early 1980s.

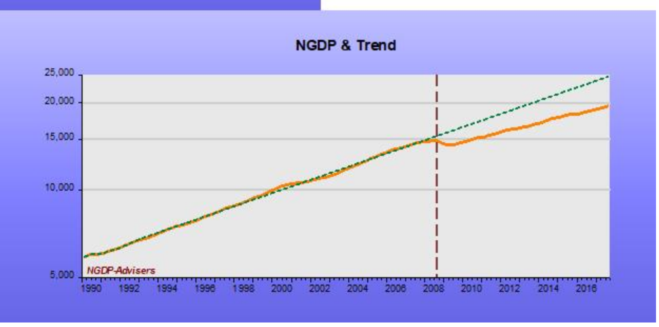
It appears that monetary policy, gauged by the NGDP growth path explains the pattern observed for inflation.

Once the FOMC realizes this, it will “naturally” accept the view that the “ideal monetary policy framework” is that which level targets an NGDP growth path.

It is interesting to note that until monetary policy unraveled in 2008, inflation targeting (low & stable inflation), price level targeting (PLT) or NGDP level targeting (NGDPLT) were observationally equivalent.





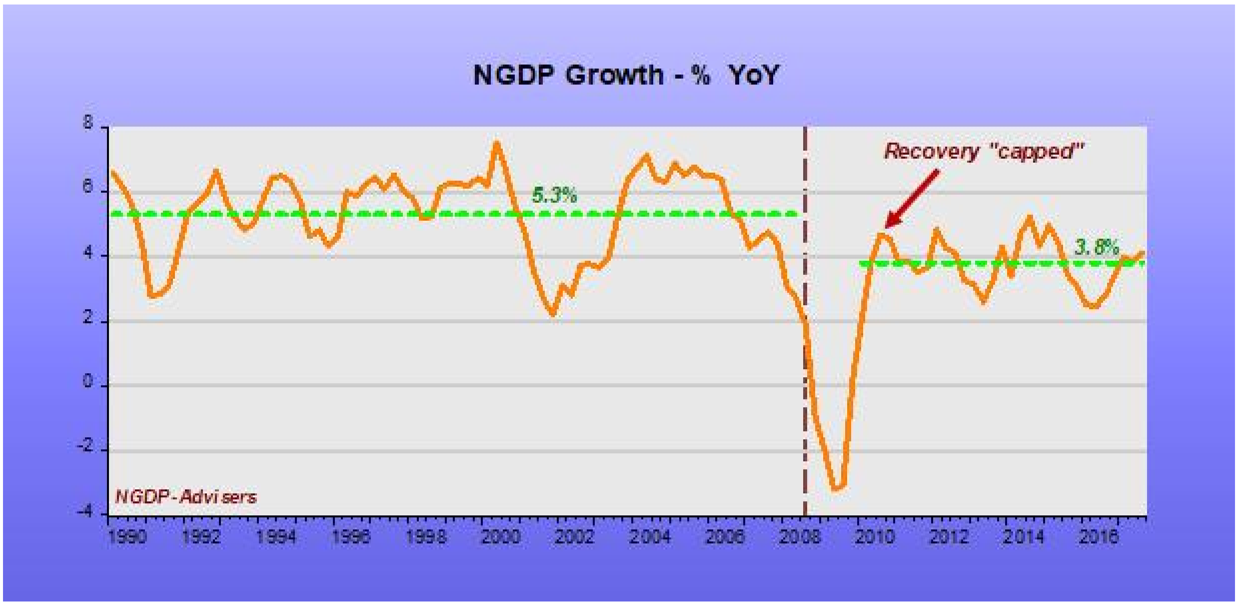


When the Fed let NGDP tank in 2008, and inhibited a recovery, inflation went lower, the price level fell from the trend path, as did NGDP (with average NGDP growth falling from 5.3% to less than 4%).

In January 2012, Bernanke did what Greenspan advised against: he let the 2% "get out of the room". Although inflation remains low (even if a bit lower) and stable, it is not 2%, therefore we have to keep talking about inflation!

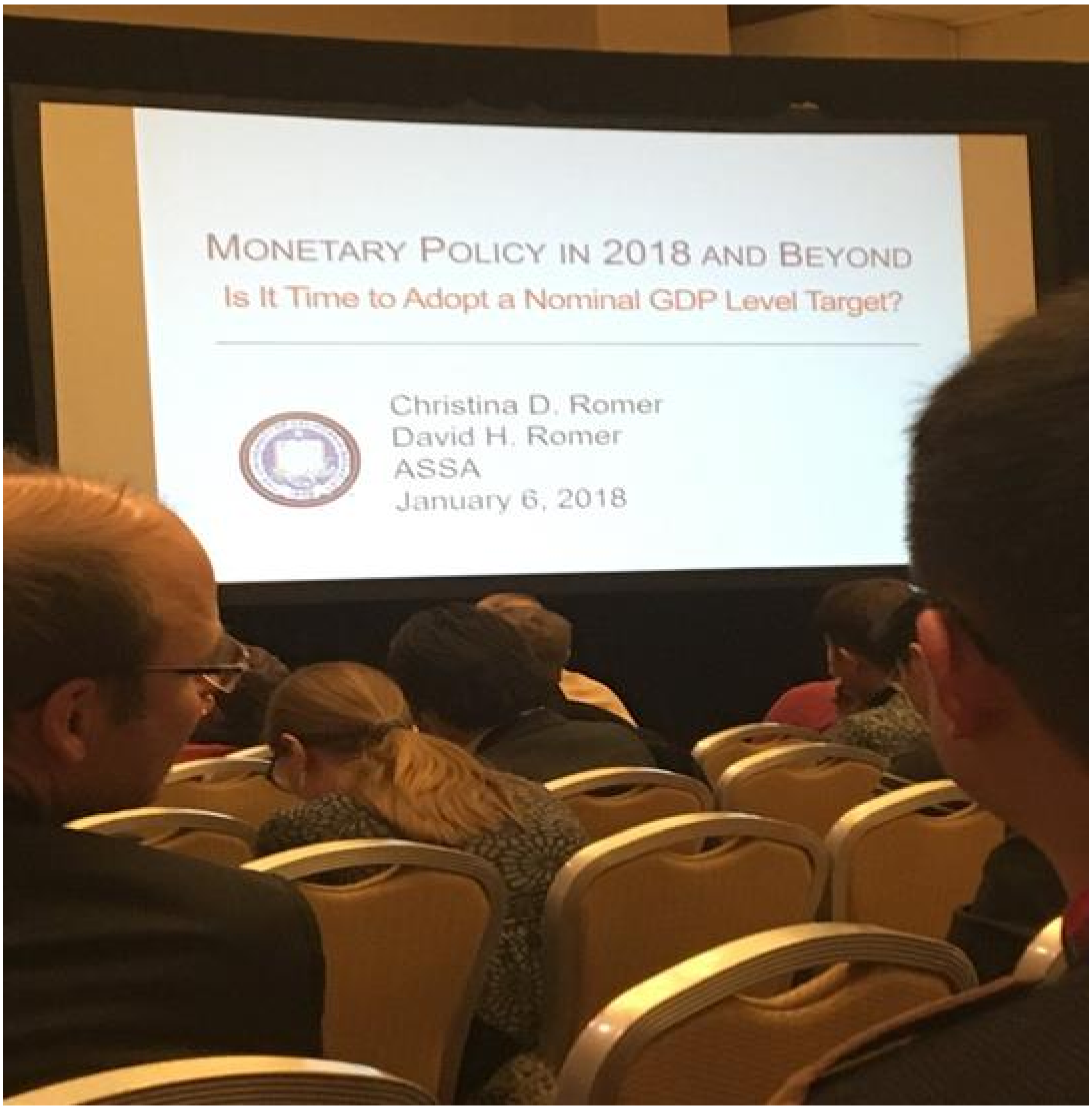
Ironically, while the Fed is "surprised" by the low inflation, and for more than two years has been saying that over the "next two years" it will go back to 2%, all the while, through words and deeds, it has been "tightening" monetary policy. Go figure!

According to our NGDP metric, since the great recession ended, monetary policy has remained tight. A real recovery was held up, with the Fed allowing only a "submerged expansion".



This state of affairs could continue "indefinitely", with this expansion in less than two years becoming the "record breaker", even though the economy has remained, throughout, in a "long depression".

It is heartening, therefore, to see that during the most important economic gathering of the year, NGDP level targeting was presented by a "high level" member of the profession.


MONETARY POLICY IN 2018 AND BEYOND
Is It Time to Adopt a Nominal GDP Level Target?
Christina D. Romer
David H. Romer
ASSA
January 6, 2018