U.S. Inflation Is Not Too Low

Michael Bordo
Rutgers University and Hoover Institution Stanford University

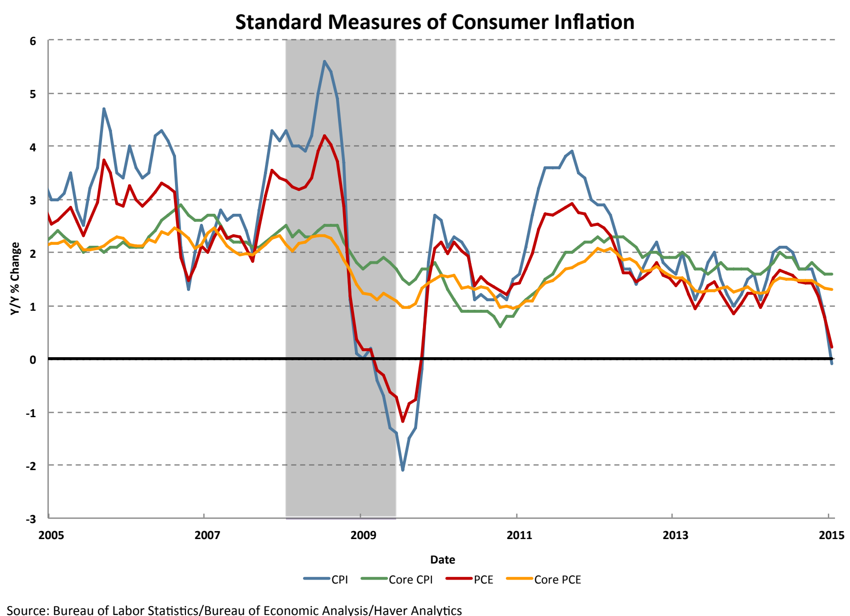
Shadow Open Market Committee Meeting

New York, New York
March 20, 2015

U.S. Inflation Is Not Too Low

The Federal Reserve is preparing to normalize monetary policy and has plans to raise its policy rate from zero in the very near future. Economic conditions have improved markedly in the past year. This is seen in respectable economic growth and the unemployment rate has been falling below 5.5%, the Fed's estimate of the natural rate. Until earlier this year the FOMC has been reluctant to normalize monetary policy and raise the federal funds rate because it felt that labor market conditions were still too soft. That reason is vanishing very quickly. Since then the FOMC has focused on the other component of its dual mandate—inflation and has argued that inflation is still too low to justify tightening. Indeed some officials have expressed concern that there is a risk of deflation which could augur Japan style stagnation or even worse the conditions of the 1930s.
This concern over low deflation and deflation is way overblown. The latest data for the U. S. does not justify it. Figure 1 shows some standard measures of inflation.

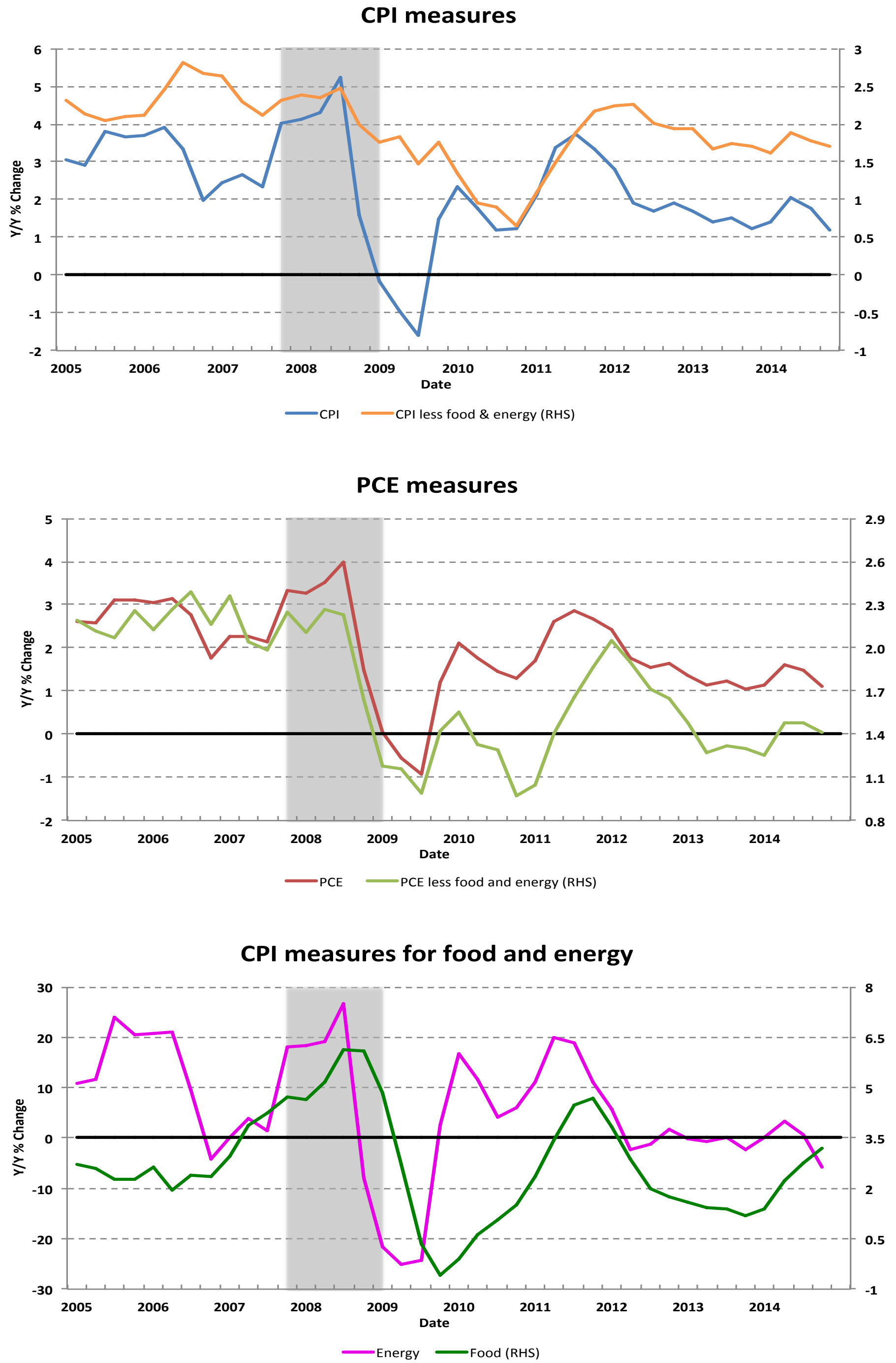
Figure 1



Source: Bureau of Labor Statistics/Bureau of Economic Analysis/Haver Analytics

As can be seen, the source of the concern is the CPI and the PCE (the index the Fed prefers) which until very recently was declining towards zero. However almost all of this decline reflects a decline in the price of energy. See Figure 2.

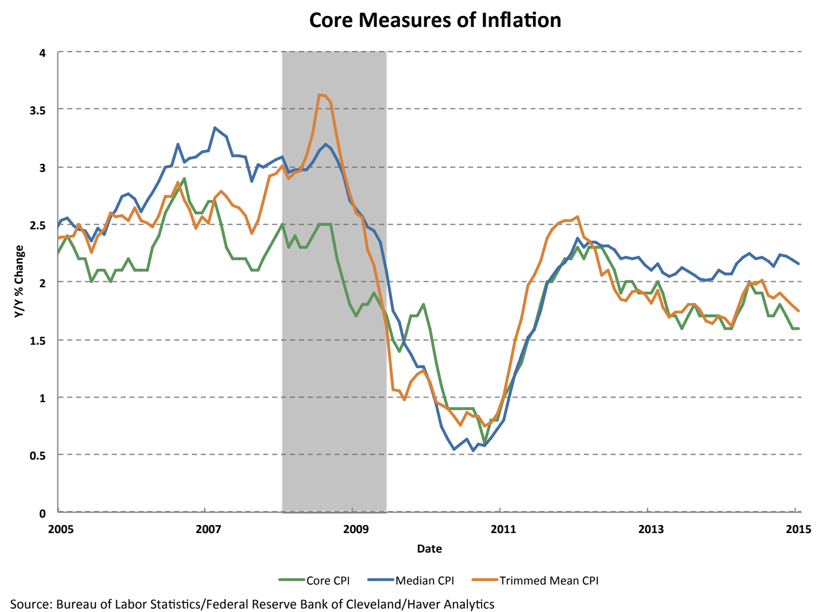
Figure 2



Source: Bureau of Labor Statistics/Haver Analytics

Energy Prices have been declining reflecting the U.S. shale oil boom . When energy prices are subtracted out (as well as food prices) , Core CPI and the Core CPI are much closer to the Fed's two per cent inflation target. Indeed if we examine different measures of the Core CPI index—the Median CPI and the Trimmed Mean, (measures favored by the Federal Reserve Bank of Cleveland), inflation is either above 2% or very close to it. See figure 3.

Figure 3



The decline in oil prices represents a positive supply shock. It changes the price of oil relative to other goods and its negative effects on the CPI will likely be temporary until the economy adjusts. The recent experience has resonance to the negative supply shock that occurred with OPEC I and OPEC II in the 1970s. Then, a rising CPI reflecting a negative supply shock was mistakenly viewed by the Fed and other central banks as a permanent shock. It was accommodated by expansionary monetary policy which made inflation, which had been driven by many years of overly expansionary monetary policy, worse (Bordo and Orphanides 2013).

The concern over deflation by the Fed and other central banks is overblown. The history of deflations for many countries over 200 years suggests that recession associated with a serious deflation is very rare. The only real example of this

"ugly" deflation was the Great Depression of the 1930s and it was associated with other negative forces including an asset price bust and debt deflation (Bordo and Filardo 2005, Borio, Erdem, Hofmann and Filardo 2015). Most historical deflations have been benign/or of the "good" variety. The Japanese case of deflation in the 1990s and early 2000s is often mentioned as a reason to prevent inflation from getting too low. In actual fact, Japan only experienced a few years of deflation and there is very little evidence of Great Depression dynamics developing. The real problem was that Japanese monetary policy, until very recently, was just too timid to deal with the stagnation it faced.

There are strong reasons to believe that the underlying core inflation rate in the U.S. will pick up in the near future. These include considerable improvement in labor market conditions, sustained growth in broad money and a potential bounce back in velocity reflecting increased confidence in the U.S. Economy (Anderson, Bordo and Duca 2014 , Belongia and Ireland 2014). The Fed should stop hesitating in its plans to raise rates and normalize monetary policy.

References

Michael Belongia and Peter Ireland (2014) "Interest Rates and Money in the Measurement of Monetary Policy" NBER Working Paper 20134.

Michael Bordo, John Duca and Richard Anderson (2014) "Money and Velocity During Financial Crises: From the Great Depression to the Great Recession" Federal Reserve Bank of Dallas (mimeo).

Michael Bordo and Athanasios Orphanides (2013) *The Great Inflation; The Rebirth of Modern Central Banking*. Chicago; University of Chicago Press.

Michael Bordo and Andrew Filardo (2005) "Deflation and Monetary Policy in a Historical Perspective: Remembering the Past or Being Condemned to Repeat it?" *Economic Policy*, October.

Claudio Borio, Magdalena Erdem, Andrew Filardo Boris Hofmann (2015) "The Costs of Deflations: an Historical Perspective" BIS *Quarterly Review*. March.