Yellen Should Go Slow

There's no need to rush to "normalize" U.S. monetary policy.

By John M. Berry

Unless there is some unexpected slump in the U.S. economy, it's clear the Federal Reserve will continue to trim its monthly purchases of Treasury and mortgage-backed securities—which were down to $45 billion in May from $85 billion at the end of 2013—and wrap up its quantitative easing program by the end of the year. In congressional testimony in May, however, Federal Reserve Chair Janet Yellen made it equally clear that she does not intend to rush to normalize monetary policy.

Normalization, historically, Yellen said, would be moving back to a short-term interest rate target of around 4 percent when the economy is close to full employment. But that is not a targeted commitment from the Federal Open Market Committee, she stressed. "We anticipate that even after employment and inflation are near mandate-consistent levels, economic and financial conditions may, for some time, warrant keeping the target federal funds rate below levels the committee views as normal in the longer run."

The Fed official target for inflation, as measured by the personal consumption expenditure price index rather than the narrower consumer price index, is 2 percent. In the twelve months ended in March, the PCE price index rose just 1.1 percent. After

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a 0.3 percent increase in April, the CPI was up 2.2 percent over the past year.

Conservative Fed critics were undoubtedly appalled by such a bold statement from Yellen. Many of them were already complaining that the Fed's easy money policies over the past six years—a policy that has caused the central bank's balance sheet to balloon to $4.4 trillion—have made a burst of high inflation unavoidable. For instance, Allan Meltzer of Carnegie Mellon University, a leading Fed historian, warned in a May *Wall Street Journal* op-ed column, "Never in history has a country that financed big budget deficits with large amounts of central bank money avoided inflation. Yet the United States has been printing money—and in a reckless fashion—for years."

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At a hearing of Congress's Joint Economic Committee, the chairman, Rep. Kevin Brody, a Texas Republican, asked Yellen to respond to Meltzer's complaint. She said, in so many words, that he was wrong. The "formative years" professionally for many of the FOMC members were the 1970s when overly easy Fed policies allowed inflation to skyrocket, and they won't let that happen again. "I do believe that we have the tools and absolutely the will and the determination to remove monetary accommodation at an appropriate time to avoid overshooting our inflation objective," Yellen declared.

Without a doubt, the increase in so-called base money has been enormous. As Meltzer noted, there are "more than $2.5 trillion of idle reserves on bank balance sheets" which could provide "fuel for greater inflation once lending and money growth rises."

But having tinder doesn't always mean there's going to be a fire, and so far few of those idle bank reserves have been used to fund loans. Without that lending to cause the monetary aggregates to grow rapidly, the reserves won't trigger more inflation. In fact, some analysts, such as John Makin at the American Enterprise Institute, fear that with the fall in the velocity of money, the danger isn't more inflation but deflation. In a recent article, "Now Is the Time to Preempt Deflation," Makin argued that deflation, not inflation, was a risk not just in the United States but also in Europe and China. Japan, of course, has been wrestling with deflation for years.

With prices rising so slowly in so much of the world, "deflation is no longer a hypothetical possibility—rather, it is a threat that should be taken seriously," Makin said. "Once deflation takes hold, its self-reinforcing nature makes it hard to reverse."

Yellen doesn't really quarrel with either of Makin's points. In an April speech to the New York Economic Club, she said the FOMC doesn't want inflation to slip too far below 2 percent because "at very low inflation rates, adverse economic developments could more easily push the economy into deflation. The limited historical experience with deflation shows that, once it starts, deflation can become entrenched and associated with prolonged periods of very weak economic performance."

Furthermore, with the overnight interest rate target stuck close to the so-called zero lower bound, she continued, "Lower inflation translates into a higher real value for the federal funds rate, limiting the capacity of monetary policy to support the economy." And it also "increases the real burden of debt for households and firms, which may put a drag on economic activity," she added.

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The Big Bet

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Like AEI's Makin, European Central Bank President Mario Draghi and the ECB's Governing Council are seriously concerned about the possibility of deflation in Europe. To reduce that risk and to spur lagging eurozone growth, Draghi has been using some of the same tools as the Fed: guidance that the ECB will keep its interest rate targets low for an extended period of time. He also said at his May press conference that in June the Council will authorize use of "unconventional instruments"—probably some form of quantitative easing—"in order to cope effectively with risks of a too-prolonged period of low inflation."

Draghi has good reason to be worried. Recently the twelve-month rise in the eurozone consumer price index has fallen from nearly 3 percent two and a half years ago to only half a percent. In some countries, such as Germany with stronger economic growth, prices are rising more rapidly. In others, including Cyprus, Greece, Slovakia, Spain, and Portugal, deflation is already a fact. A recent survey of economists at several British institutions, including the Bank of England, found that roughly half thought there was a significant danger of a broad deflation in the eurozone, but that prompt action by the ECB could prevent it.

One thing contributing to persistent low inflation, Draghi noted, is the fairly steady rise in the euro relative to the U.S. dollar over the past few months. What the ECB might do to cheapen the euro isn't clear, but reducing interest rates one way or another might have such an impact.

The possibility of deflation aside, there are other reasons Yellen and a majority of the FOMC participants should move slowly in raising their interest rate target: the damage to the U.S. economy and financial markets from the financial crisis and its aftermath may well have changed some aspects of what used to be "normal."

In the years before the crisis, as Yellen said, an overnight interest rate of around 4 percent was regarded as about right when the economy was operating close to full employment and with little upward pressure on inflation. In that context, a 4 percent nominal interest rate and a 2 percent inflation rate meant a real interest rate of 2 percent was thought to be consistent with an economic equilibrium at full employment. (The FOMC had lowered the Fed funds target to only 1 percent in 2003 when Fed staff economists said the chances of a period of deflation had reached one in three. The committee began raising the funds target again in mid-2004 and continued to do so in steady quarter-point steps until it reached 5.25 percent in mid-2006 to counter inflationary pressures.)

The financial crisis, however, may have changed the calculations for that equilibrium. Some economists, including Lawrence Summers of Harvard University, the former Treasury secretary who was also a key adviser to President Obama, now believe a better estimate of the equilibrium real interest rate may be zero rather than 2 percent.

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If that were correct, the FOMC should be setting an interest rate target of only 2 percent, not 4 percent, in a world with full employment and an inflation rate of 2 percent. Obviously at this point, the FOMC hardly needs to make such a choice.

Summers laid out his thinking in a presentation at a policy meeting of the National Association for Business Economics in March.

First of all, Summers said, in the wake of the huge expansion of credit that led to the crisis, there has been an enormous drop in debt-financed investment. The excessive leverage of the pre-crisis period has vanished as banks lost money, and regulators, with both more powers and new mandates under the Dodd-Frank financial reform legislation, began to clamp down on financial intermediation. In addition, many corporations, including Google and Apple, are "swimming in cash" while they offer products that may require little capital investment in manufacturing facilities.

Meanwhile, U.S. population growth has slowed to only about three-quarters of a percentage point a year, down roughly a quarter compared to what it was during the boom. That suggests over time slower growth of demand and thus less need for private investment.

Changes in the distribution of income—both between labor and capital and among individuals—have also played a role, Summers said. Corporate profits as a share of GDP are significantly higher than at any time since World War II. Last year, for example, non-financial corporations earned 14.9 percent of each dollar received from current production, half again as much as they earned a decade ago. Over the same period labor's income share fell by almost 6 percentage points, from 62.8 percent to 57 percent. As a result of those profits and other factors, gross savings by domestic non-financial businesses last year exceeded their gross investment outlays by more than $250 billion, according to the Commerce Department. In other words, businesses became net lenders rather than borrowers.

Still another indicator of a possibly lower equilibrium real interest rate is the continuing decline in the cost of capital goods relative to other goods and services. Summers noted that capital goods prices—including those of consumer durables such as autos—have been rising only about three-fourths as fast as other goods and services. "Consumer capital goods can be bought with less borrowing and less investment" just the same as for businesses, he said.

Finally, in a world of low inflation, investors obviously are willing to accept a lower nominal rate of return, and that effect is amplified when taxes are taken into account, Summers said. He gave an example of an investor in a 40 percent tax bracket at a time of 3 percent inflation. An investment with a 5 percent return would receive a 2 percent pre-tax real return and after tax a zero real rate. But if inflation is only 1 percent, a nominal rate of return of 1.67 percent would give a pre-tax real rate of 0.67 percent and again, a zero real rate.

The willingness of investors to accept low real rates is underscored by the solid demand for U.S. Treasury securities and other "safe" assets. In mid-May, yields on ten-year Treasury notes were only 2.5 percent and those on five-year notes 1.5 percent. Perhaps more striking were returns on ten-year inflation-protected notes, which were at only 28 basis points. That is, an investor would be compensated for any increase in the consumer price index plus just over a quarter of a percentage point. That is awfully close to a zero real rate.

Of course the investor is also buying protection against any surge in inflation, and the economy is hardly at full employment.

Another imponderable on the table for the FOMC is the amount of slack in the economy. In the annual budget and economic outlook report by the Congressional Budget Office released in February, the CBO revised downward both the estimate of slack and the rate of growth of potential GDP. For the next several years, the CBO believes potential output will increase by only 2 percent annually, down from 2.2 percent over the past ten years. About half the drop is due to lower capital investment related to the financial crisis and most of the rest is due to a decline in potential hours worked.

Before the crisis, more than 63 percent of the working age population had jobs. For the past several years, however, that figure has hovered between 58 and 59 percent. Importantly, the ratio for men aged 25 to 54, which had been 87.5 percent, fell to about 81 percent and has rebounded only to less than 83 percent. The question is, will those prime working-age men come back into the labor force if economic growth and job availability improve, or will so-called structural problems, such as out-of-date skills, keep them on the sidelines? With the jobless rate falling faster than expected—it was down to 6.3 percent in April but could bounce back somewhat in May or June—this is a key issue for Fed policymakers as they ponder how much slack there really is at this point.

Forecasts by FOMC participants and many private economists show only a modest increase in U.S. inflation in coming years. The CBO also predicted in its February outlook that the PCE price index favored by the Fed would increase 1.5 percent this year and be up only 1.9 percent in 2017. The consumer price index will rise a few tenths faster, reaching 2.3 percent in 2017, the CBO said.

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According to the latest projection by Fed policymakers released in March, few of them—even the so-called hawks who have been pushing for a higher Fed funds target all along—expect PCE inflation to exceed 2 percent anytime over the next three years. Only one or two said it would reach 2.4 percent in 2015 before dropping back to 2 percent the following year.

In addition to projections of economic growth, unemployment, and inflation in coming years that the FOMC participants provide four times a year, they also offer individual assessments of "appropriate monetary policy"—"appropriate" being entirely in the eye of the beholder. In March one of the sixteen participants—probably Esther George, president of the Kansas City Federal Reserve Bank, though none are identified by name—wanted

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the current 0.25 percent target increased to 1 percent by the end of this year. All but two wanted an increase by the end of 2015. However, another nine wanted the target still to be 1 percent or less at the end of next year. One, again probably George, wanted it to be 3 percent.

By the end of 2016, when most of the FOMC expect the economy to be operating close to or at full employment and inflation to be at or close to 2 percent, the assessments of an appropriate fed funds target were all over the lot. One thought it should be 4.25 percent, another a scant 0.75 percent. However, consistent with Yellen's statement that normalization should not immediately occur under those circumstances, only three of the sixteen participants thought the target should be 3.5 percent or higher. Ten thought it should be between 1.75 percent and 2.75 percent. In the longer run, all 16 pegged the rate at 3.5 percent to 4.25 percent.

This kind of individualism is anathema to many Fed critics who want the FOMC to adopt some sort of rule for setting policy. Among them is John Taylor of Stanford University, a noted authority on central banking. At an International Monetary Fund conference in April, he presented a paper titled, "Re-Normalize, Don't New-Normalize Monetary Policy." Taylor argued that most of the unorthodox policy tools the Fed has used in the aftermath of the crisis, including quantitative easing, have been a mistake and, in fact, may have made things worse.

"I think the distortions caused by these massive interventions and the impossibility of such policy being rule-like indicate that such a new-normalized policy would be a huge mistake," he said.

Yellen certainly disagrees that the use of quantitative easing and far more explicit forward guidance have been mistakes. Like Taylor, however, she also would be more than happy if the economy begins to behave in sufficiently normal fashion that a general policy rule would work well once again. But the U.S. economy, indeed the world economy, is not there yet. ◆

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