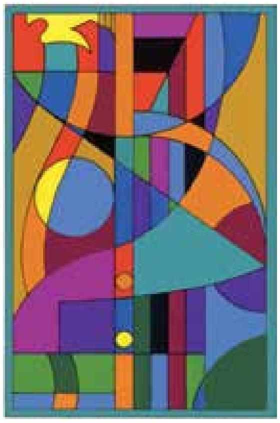

View from the Beltway

The Inflation Enigma

By Owen Ullmann

The Fed's flying with blinders on.

The U.S. economy has been on a tear. Growth is humming along at about 3 percent, unemployment hit a fifty-year low of 3.6 percent in April, stock market gains have goosed consumer spending, and worker wages are finally rising, all as the current expansion became the longest in history this summer.

And inflation? For seven years it has limped along at less than 2 percent.

That's not supposed to happen according to the conventional economic models, particularly when a persistent decline in productivity from the 1990s was expected to spill over into price inflation. Like most private economists, the Federal Reserve anticipated that strong growth—juiced by the 2017 tax cuts—and tightening labor markets would trigger higher inflation. So it hiked interest rates throughout 2018 to combat what has turned out to be a phantom threat.

Low inflation seems embedded in the U.S. economy—indeed, the global economy—and the sharpest minds are stumped as to why. There are many theories to explain the current set of circumstances, but no one is sure whether this period of low inflation is transitional or part of a long-term trend resulting from a combination of factors that include technology, globalization, and demographics.

"We just don't understand inflation," concedes Jeremy C. Stein, chair of the economics department at Harvard University who served two years as a Fed governor during the Obama Administration. The lack of significant wage inflation in view of all the reports of critical labor shortages is hard to explain, he says. "It may just be temporarily asleep and the labor market tightness might show through eventually, but it is still mysterious."

Understanding the underlying causes of our current low-inflation environment is critical for ensuring sound monetary policy and preventing another financial crisis based on flawed inflation expectations. Are we in a period like the 1960s, when the economy was booming, only to run into an ugly period of high inflation and stagnation in the 1970s? Or have we created a new virtuous cycle that keeps inflation well anchored indefinitely? Everyone wins in the latter case except for heavily leveraged borrowers who cannot count on inflation to lessen their debt payments. A review of the many explanations for low inflation may help determine what the future holds.

Mohammed A. El-Erian, chief economic adviser at Allianz, argues that structural forces are sustaining a disinflationary environment worldwide. "They include aging populations, inequality, persistent household economic insecurity, and, of course, technological innovations which reduce barriers to entry for a widening set of economic activities," he explains. "Together they serve as headwinds to consumption, workers' bargaining power, and risk pooling."

Donald Kohn, an astute economist who was a forty-year veteran of the Federal Reserve System, including Board vice chair from 2006 to 2010, also is stumped. "Everyone points to anchored inflation expectations," which encourage disinflationary behavior, he observes. "But I honestly don't have a good answer."

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A 2018 paper, "Why Is Inflation So Low?" by St. Louis Federal Reserve Bank economist Juan M. Sánchez and senior research associate Hee Sung Kim, attributes persistently low inflation throughout the developed world to both technological advancements and aging populations.

The authors note how technology has had a profound impact on lowering prices of many goods, in contrast to continually rising prices for services. "According to the U.S. Bureau of Labor Statistics, prices of general tuition and medical care have risen 29 percent and 25 percent, respectively, while prices of television and photographic equipment have decreased 73 percent and 24 percent, respectively, since 2010," they write.

One puzzle is why inflation would remain low even though productivity growth has decelerated from the 1990s, when Fed Chair Alan Greenspan pushed through accommodative monetary policy over concerns by FOMC skeptics in the belief that it would not lead to a new burst of inflation. (He was right at the time, though the long stretch of easy money contributed to the financial crash of 2007–2008.)

Sánchez and Kim conclude the most likely reason lagging productivity figures have not boosted inflation is the rise of the "sharing economy," namely the private exchange of goods and services such as Airbnb and Uber, which are responsible for significant drops in prices for hotel rooms and transportation. "Although it is not easy to see this in the official productivity statistics, it is clear that the rise of the sharing economy has improved productivity by allowing for the utilization of otherwise idle goods and services, which then has led to the reduction in prices," they write.

The authors do not address other potential technological developments, such as fracking, which has led to a huge boost in oil production by countries such as the United States. The result has been more stable energy prices and less leverage by OPEC to manipulate the market for internal or foreign policy political reasons.

However, they do see a major impact from the aging of populations in the United States, Europe, and, in particular, Japan, where long-term aging has been accompanied by near-zero inflation for decades. The authors' explanation is that as older workers lose their high-skilled jobs, they are forced into entry-level positions which depress wages for young workers starting out. Yet we also know that as people age, they tend to transform from net borrowers to net savers, a disinflationary trend.

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The St. Louis Fed paper also looked at the impact of globalization on inflation and concludes, surprisingly, that it has a negligible impact on inflation. Rather, it notes that inflation expectations also exert a powerful influence on price behavior: "…it is hard to rule out that long periods of near-zero policy rates have implied that only low expected inflation is compatible with the current fundamentals of the economy."

A counterintuitive argument for low inflation is explained in the 2016 paper, "Inflation Dynamics During the Financial Crisis" by Boston University economist Simon Gilchrist, Brandeis University economist Raphael Schoenle, and Fed economists Jae Sim and Egon Zakrajšek. Their research concludes that "liquidity constrained firms increased prices in 2008, while their unconstrained counterparts slashed prices. … Financial distortions create an incentive for firms to raise prices in response to adverse financial or demand shocks."

Or to consider the converse, during times of low interest rates and ample liquidity, firms such as Uber can stay in business with new loans and investment injections and expand their customer base rather than by raising prices because they are desperate for cash.

That raises a fundamental question for Fed Chair Jerome Powell and his colleagues on the Federal Open Market Committee: Does accommodative monetary policy spark inflationary forces during a strong economy or disinflationary forces because of easier financial conditions?

President Donald Trump, obsessed with his reelection prospects in 2020, is prodding the Fed to cut rates and let the economy roar. But so far, the Fed is skirting an answer to the inflationary enigma by sticking to a middle course. It tightened policy last year because of strong growth but is now pausing to see whether the economy can continue to grow above trend (around 2 percent) with inflation still lagging below 2 percent.

"We suspect transitory factors may be at work" in keeping inflation below the Fed's target, Powell said at a news conference on May 1, after the FOMC voted to hold rates steady. Obviously, he does not buy the argument of a structural change in inflationary forces. At the same time, he has been unable to explain why inflation has run below Fed forecasts for so many years now.

Fed Vice Chair Richard Clarida seemed less convinced that inflation will pick up soon when he signaled in a speech in New York on May 30 that the Fed would be prepared to reduce interest rates "if the incoming data were to show a persistent shortfall in inflation below our 2 percent objective." Transitory or sustained? No one really knows yet, and it may take years to find out. Until then, the Fed will be flying with blinders on and can only pray for a smooth landing as it navigates through uncertain inflationary terrain. ◆