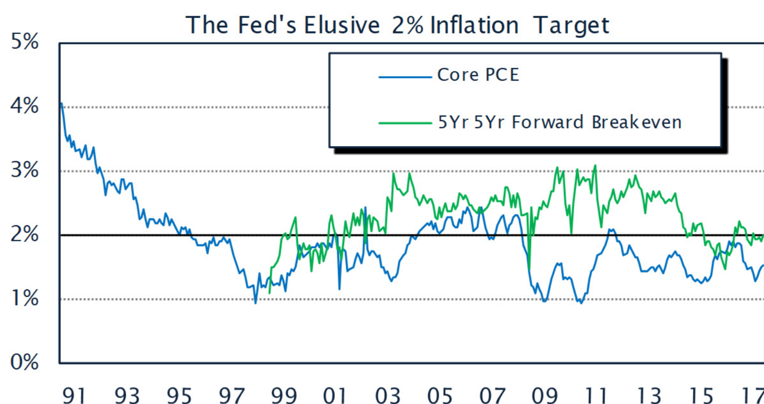
FEBRUARY 2018

INVESTMENT UPDATE

Back in the good old days, inflation was a bad word. Around the time that the Vietnam War was winding down, the US economy was growing at a rapid clip as baby boomers were buying houses, cars, durable household goods—everything their growing families needed in the era of The Mod Squad and The Brady Bunch. But the flip side of this happy story was that all this household demand was spurring higher prices for consumers. Then-President Nixon implemented wage and price controls in August 1971 for a 90-day period in an attempt to strong-arm inflation. Weirdly, inflation was declining when this announcement came, having dropped to an annual rate of 4.6% from more than 6% a year earlier.

Things did not work out for Nixon's inflation fighting scheme. As we now know, that 6% annual inflation rate in 1970 would nearly double by the time Nixon left office in 1974. Both of Nixon's successors, Presidents Ford and Carter, tried their hand at enacting similar anti-inflation policies, with predictably poor results. The oil embargo, the steel crisis and the Iranian Revolution all played a part in marking the 1970s the decade of stagflation—high inflation and weak economic growth.



Things didn't really improve until 1979, when Federal Reserve Chair Paul Volcker instituted his own version of harsh medicine. By managing the volume of bank reserves in the Federal Reserve System, the Fed could more closely control the nation's money supply. Forget the wage and price controls, which didn't fool consumers into slowing down their purchases; Volcker was serious about squashing out inflation for good. So much so that he, not just once, but twice, sent the US economy into recession, which helped knock Jimmy Carter out of the White House and put his successor, Ronald Reagan, in hot water from his first day in office.

Volcker & Co provided the Fed something it had failed to achieve in its previous seven-plus decades of existence: He gave the Fed credibility. Soon after taking the helm at the Fed in August 1979, US inflation peaked at 14.85%. Volcker's monetary clampdown sent the Fed funds rate to 20% by late 1980, and he and his Fed colleagues came under withering criticism from both the legislative and executive branches of government as interest rates skyrocketed. But, little by little, inflation started falling, and by mid-1983 the CPI had dropped to less than 2.5%. Rates stayed elevated for another year or so, as shell-shocked bond traders, after decades of losses from rising rates, were in no hurry to start buying, even at severely discounted prices (if only they knew!).

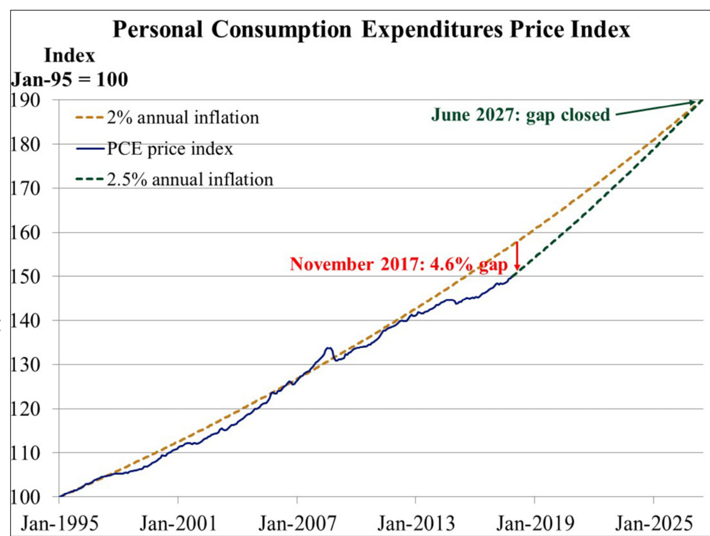
After Volcker came Greenspan, Bernanke and Yellen, all of whom bought into the Fed orthodoxy that the central bank's dual mandate—stable prices and full employment—would call for rate hikes and monetary restraint at the first sign of creeping inflation. This policy has meant that in recent decades the Fed has occasionally engineered recessions by making borrowing more difficult and more expensive when the economy was running at full tilt, believing that failing to do so would result in a return to the dark days of crippling inflation. In fact, this policy has worked so well that not only has inflation been tamed, but expectations of future inflation have also dropped to low single-digits.

But that orthodoxy may be changing. Part of this shift has come as a result of what happened during and just after the financial crisis of the last decade. Post-crisis, the fear was not a return of inflation, but rather, the greater fear of deflation. Not even short-term interest rates at near-zero were sufficient to induce households and businesses to borrow, and the Fed, fearing a repeat of the moribund Japanese economy (where deflation had set in, consigning its economy to a decade-long recession), pulled out tools it had never tried before .

These quantitative easing (QE) programs put the US economy on a more stable growth path by lowering longer-term interest rates and stabilizing the crippled housing market. What they did not do was re-ignite inflation and only briefly boosted longer-term US inflation expectations. That is shown clearly on the chart on this page, which plots the most common market proxy for future inflation—the five-year forward rate of infla-

tion expectations, five years out. For nearly 20 years, investors have been expecting inflation to pick up, but actual inflation has consistently undershot inflation expectations. What we have, then, is a situation where, for various reasons (including tighter monetary controls and global economies that efficiently allocate resources) both inflation and inflation expectations have been effectively nullified.

So where's the problem, you ask? Why doesn't the Fed just declare victory and get on to worrying about something else? The answer is somewhat complicated. In thinking about what happens in the next recession (much less the next financial crisis), the Fed and other central banks don't want to have to go back into their QE toolboxes; they would much prefer to use conventional monetary policy tools to spur the economy—namely, lowering short-term rates and, if necessary, easing up on the terms of lending to Fed member banks. But in order to be able to lower the Fed funds rate enough to kick-start an economy at the bottom of the economic cycle, it's likely that the Fed will have to implement multiple rate cuts over an extended period of time. And in order to be able to do that, you need to have a funds rate well above 2%, otherwise, you will bump into the dreaded "zero lower bound" (ZLB). Again, once you lower the funds rate to zero, you're "out of bullets," and you have to resort to unconventional policies, or else resign the economy to years of moribund growth and possible deflation. And that is, to put it mildly, suboptimal.



Former Fed Chair Ben Bernanke, now a Distinguished Fellow at the Brookings Institution (where he will soon be reunited with Janet Yellen), has been writing a blog over the past few months, sharing his thoughts on how the Fed can avoid this ZLB problem in the future. His prescription, in short, is for the Fed to begin considering policies that allow the economy to "run hot" for a period of time, allowing inflation to rise enough to lift long-term inflation expectations. That's right, the former head of the US central bank wants the Fed to stop fighting inflation. Let that sink in for a minute.

In the current environment, where we've had inflation stuck below 2% for more than two decades and inflation expectations barely above that level, Bernanke's policy would advocate for no hikes in the Fed funds rate until we get inflation back above the target. Only then will we get the general level of prices in the economy moving back to the level that they've undershot for years. There is an important distinction (obvious only to economists, we suppose) that this is not inflation rate targeting (which is what we have been doing since Volcker), but rather "price level targeting." Temporary price level targeting ("temporary," because it would only be in place after a period of low inflation) would mean that the economy would see price inflation rise and remain above target for a period of time roughly equal to the time it spent below target (again, in order to get prices back to their trend).

If this policy were in place today, we would still not have seen a single rate hike from the Fed in this recovery (we've had five since December 2015). Inflation would likely be running above 2% and inflation expectations would be rising as well. Obviously, Bernanke says, this lower-for-longer rates policy would need to be communicated carefully, with the expectation that it would remain in place only as long as needed to get prices back up to trend; rate hikes would come later, once the price level target was in sight.

St. Louis Fed President James Bullard has taken up the cause as well, and last month laid out how this policy might be implemented. As shown on the chart on this page (which we lifted from the St. Louis Fed's website), we currently have a large gap in the growth trend of consumer prices after years of below-trend inflation. He estimates that it would take approximately ten years of 2.5% inflation, from today, for price levels to get back to trend. Obviously, a period of even higher inflation would close the gap more quickly, assuming the Fed (and the public) would be willing to tolerate it.

Bullard is convinced that the Fed can get the inflation rate up to 2.5%, since we saw levels close to that in the 2004-2007 period. We should point out, however, that the US economy in this period was running on the high-octane fuel of easy credit and poor underwriting, which led directly to the housing meltdown and the global financial crisis. Would the Fed, even a more inflation-tolerant Fed, be willing to let the US economy run at that pace—and for ten years?

It's also important to point out that no central bank is currently using price-level targeting; the entire discussion is still somewhat theoretical. But we give the Fed credit for realizing that the tools and models that they've used in the past may no longer be working; new policies will be needed to deal with a changing, more globalized financial system.