TCM INSIGHTS

MOVING INFLATION GOALPOSTS

In the aftermath of the oil crisis and resulting inflation shock of the 1970s, the Federal Reserve settled on the notion that a two percent inflation rate is the correct level to maintain their dual mandates of price stability and maximum employment. However, the rationale for setting an inflation target of two percent is unclear, and the Federal Reserve states on their own website that that this level is a 'judgement' on their part – with no empirical data to back that decision up.

New Math

Additionally, the target is not based on one-year inflation numbers, but since 2012 has been an explicit long-term goal, and in 2016 the Federal Reserve clarified that the target is symmetrical – "the Committee would be concerned if inflation were running persistently above or below this objective."

The problem with their statement is that their very own favored inflation indicator, the PCE deflator, has averaged 1.5% over the past decade. As a result, the Fed now says it could let future inflation run high so that the long-run average rises to 2%. No one knows exactly what this means, but one could infer that the Fed is willing to have inflation run at 2.5% for the next ten years so that the 20-year average is 2%.

However, as the saying goes, "if it ain't broke, don't fix it." Over the last ten years low inflation didn't hurt the economy. Unemployment, the Federal Reserve's other mandate, fell to 3.5% in February – the lowest level since the 1960s.

A Stable Dollar

Some economists believe that there is an unspoken third mandate – to maintain a stable value for the dollar. In an age of globalization, it is a difficult decision to make an investment, build a plant, or sell goods in a foreign country if the value of your currency fluctuates over time, making the forecast revenues from those investments more unpredictable.

It is known that falling prices, deflation, is bad for the economy. As consumers delay purchases, knowing that prices will fall, further price falls are caused as demand is postponed – leading to a negative deflationary feedback loop which is very difficult to unwind using central bank monetary tools.

continued on page 2

The Risks

However, runaway inflation is also not good. By allowing the inflation rate to move higher, the Federal Reserve risks an upward inflation feedback loop where demand outstrips supply as consumers buy goods to avoid price hikes, which in turn raises prices. The most effective monetary tool central banks have to tame inflation is the raising of interest rates to tighten financial conditions - like Paul Volcker did in the late 1970s and early 1980s.

By introducing policy to allow inflation to rise above their target, albeit an arbitrary target, the Fed risks losing control of price stability, the dollar, and ultimately employment.

October 9, 2020

Some information is derived from First Trust Portfolios, Morningstar, Charles Schwab, and Value Line. Reproduction or distribution of this material is prohibited and all rights are reserved.