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Why Fed’s Lacker is worried about inflation

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Jeffrey Lacker, president of the Federal Reserve Bank of Richmond, was the only member of the Fed’s policymaking committee who voted to raise interest rates in September, and again in October.

Lacker has long expressed skepticism on the benefits of the Fed’s stimulus campaign, and has been concerned that inflation will begin to rise more quickly as the economy gains strength.

Lacker refers to his views as “old-fashioned,” emphasizing he sees little new in the current environment. He does not think that the relationship between employment and inflation has changed; that the Fed should consider other issues, like financial stability, in setting mon- etary policy; or that the economic health of other countries should play a larger role in the Fed’s deliberations.

“A central bank’s ability to influence inflation and how it does so is essentially unchanged,” Lacker said Thursday in a speech at the Cato Institute.

In an interview, Lacker, whose district includes South Carolina, also talked about being the only Fed president who has raised rates. The answers are lightly edited for clarity.

Q: It’s looking like you won’t need to dissent again in December. After seven years, the Fed seems poised to raise rates.

A: I can’t predict the meeting and what my colleagues will do, but it does look like the recent data, and particularly the October employment report, has strengthened the case for raising rates. I’ve thought the case was strong for over six months now. I’m hoping I can be more persuasive in December.

Q: You and Janet Yellen are the only members of the Federal Open Market Committee who were there the last time the Fed raised rates, way back in 2006. Are you telling the new folks how it works?

A: It’s been a long time. There has been this sort of generational change on the FOMC since I’ve been there. But I don’t think people forget how. I think it’s pretty clear. You just write the statement and send it to New York.

Q: You've said you were ready to raise rates six months ago. Do you think the Fed will need to raise rates more quickly?

A: It's too soon to tell. I think there's a chance we are behind the curve, but it will be a year or two before we figure that out. With the anticipation that we're likely to raise rates gradually and the committee having signaled that expectation, I think we have room to accelerate if we find out that we wish we'd started earlier.

Q: Yellen has suggested the Fed is likely to raise rates by about 1 percentage point per year. Is that fast enough?

A: That's a plausible pace for me, but if I picked a number it might be a little higher than that, a little more rapid than that.

Q: Both Democrats and Republicans have been lashing the Fed lately. Democrats want rates to stay low; Republicans think you're dragging your feet. Surely you can't ignore the noise entirely?

A: I think everyone at the Fed reads the paper. But in my experience there's an extremely strong culture of putting aside nonanalytical considerations and letting the economic analysis lead us to what we think is right for the U.S. economy given our mandates. Everyone is entitled to a view and we welcome the scrutiny, as we should in a democracy, but at the end of the day you have to let the economics of the decision you are facing guide you.

Q: You've said for months that in your judgment there is no significant slack remaining in the labor market.

A: I just don't see a strong case for there being much left. (Broad- er measures of unemployment) have fallen pretty sharply in the last couple of months. There is always more slack than is represented by the unemployment rate. The question is whether there is more than is usually present where unemployment is right now, which is 5 percent. And if you look at the data, the answer is no. It's right in line with where it usually is when the unemployment rate is right here.

And we're hearing widespread reports of wage pressures, and it's increased notably over the last year or year and a half. And it's not just the high-skilled areas where you'd expect. Building trades, hotel workers, hospitality sector in some areas where they're having to pay 4 or 5 or 6 percent more to keep people. So we're hearing a striking increase in the extent of reports of wage pressures, across occupational categories. It's not uniform but it's pretty broad. Are things on fire? Not yet.

Q: So why haven't we seen faster inflation?

A: There's a couple of things about the relationship between slack and inflation that are important to bear in mind:

The first is that monetary policy is capable of inducing an acceleration of inflation whether slack is large or small.

Second, there's this confusion about real and nominal that I think infects the discussion, particularly of wages and slack. Real wages have accelerated over the last year because inflation has fallen and the rate of gain in nominal wages hasn't changed much. The wage pressures we've been hearing about, they show up in the macro data as real wage pressures.

And the historical evidence suggests that there's some lag before things accelerate as you reduce slack significantly.

Q: Do you think things might catch fire? Do you see an upside?

A: Consumer spending is pretty strong right now. We've had two years of over 3 percent real spending growth, which is a notable step up. Earlier in the recovery we were doing under 2 percent. This is an important macroeconomic development.

Could the overall tenor of conditions change? I think it could. I think the inflation picture has the potential to change relatively quickly. It's done that in the past where over the course of 6 to 12 months a picture in which inflation looked on the soft side changed to the opposite, and I think we have to be prepared to respond strongly if that takes place.