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Will Fed's Reliance On Archaic Economic Models Doom The Economy?

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Monetary Policy: Fed Chair Janet Yellen repeated Tuesday that the Fed wouldn't let current low inflation keep it from raising rates later this year, saying the central bank should be "wary of moving (interest rates) too gradually." But moving gradually to where, we wonder?

No, we're not being flip with that question. Yellen now concedes that the Fed has been wrong for nearly 5 years in its inflation expectations. Inflation today remains below 2%, the Fed's target rate. Theoretically, this shouldn't be happening. Indeed, with unemployment now at 4.4%, the Yellen and the Fed thought inflation would be running at 3% to 4%.

That's why Yellen believes current low inflation is "probably temporary," and that "over the next few years" inflation is likely to go higher.

Based on the Fed's inflation model, it's not hard to understand why Yellen believes that. Many economists and policymakers, including those at the Fed, are wedded to what is called the "Phillips curve," which posits that employment and inflation are trade-offs — as unemployment falls, inflation ramps up. The basic argument is that low unemployment means labor is scarce, so employers raise wages sharply to attract qualified workers. That fuels inflation across the board.

The only problem is, that's not how the real world works. For at least the last quarter of a century, the global economy has been swept by major disinflationary forces, ranging from freer trade and lower taxes, to an aging global population, life-changing new technologies, and tech-driven business models that have made old models obsolete.

Wall Street economist Ed Yardeni knows this. He's been talking about it for decades.

"I have been making the case for structural disinflation for almost all 40 years that I've been in the forecasting business," Yardeni wrote Tuesday in his Yardeni Research, Inc. Morning Briefing. "I've discussed how globalization, technological innovation, demographic changes, and Amazon have subdued inflation and continue to do so."

You can add Wal-Mart to that list. The discount retailing giant's era of super-rapid expansion may be done, but it still has a systematic, and powerful, disinflationary impact on pricing for virtually all goods sold anywhere in America, especially in brick-and-mortar stores.

Meanwhile, as part of the "technological innovation" Yardeni talks about, oilfield fracking has had an enormous influence on moderating inflation by bringing the per-barrel price of oil down from over $100 to a current level of just above $50.

And this is why the Fed, even with 0% interest rates for nearly 8 years, has been unable to get the inflation needle to move up to its target rate.

So the question arises: Why should the Fed be worried about the current level of inflation at all? Even if inflation is below 2% but higher than 0%, isn't that the inflation sweet spot? Why is the Fed worried that inflation isn't at *precisely* 2%? Is current price stability below 2% bad? We would argue the answer is no.

More troubling to us is that our monetary policymakers seem to believe that interest rates should be pre-emptively raised to quell imaginary inflation pressures. Prices and interest rates should be set by supply and demand in an ever-changing, dynamic market. Not by a group of people sitting in a room, arguing about the correct level of interest rates and basing their decisions on an inaccurate model.

As James Dorn, vice president of monetary studies at the Cato Institute argues in IBD's Commentary section today, the Fed's Phillips curve-based inflation model is archaic and, worse, wrong. It has led to repeated judgment errors in the conduct of U.S. monetary policy, in particular in relation to the pace and magnitude of interest rate changes, and is a major reason why the Fed's overzealous moves have repeatedly ended in U.S. recession.

That's why we're a bit concerned about Yellen wanting so desperately to "move" rates higher. Does she really know exactly where interest rates need to be right now? Or how fast they need to rise? Does anyone at the Fed? Given past performance, we seriously doubt it. Virtually every recession since World War II has been a result of the Fed's overzealous raising of rates to kill inflation pressures.

That's why, as we've argued here before, interest rates should no longer simply be a matter of Fed discretion. That creates too much room for human error. Far better to have reliable, stable rules to follow. Rules aren't perfect, but at least they are transparent and use past experience to guide the future.