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The Federal Reserve needs someone who understands inflation

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A worrying trend has developed among Federal Reserve officials in the past month: They claim to no longer have a working theory of inflation in the economy. This began at the September FOMC press conference when Fed Chair Janet Yellen admitted, "The shortfall of inflation from 2 percent … is more of a mystery." This is problematic.

It absolves the Fed from achieving one of their goals mandated by Congress. Furthermore, a central bank that is both charged with managing inflation and admits that inflation is a mystery has the potential to lead to damaging policy decisions. As the president considers a successor for Yellen, he should ensure the nominee possesses a complete understanding of inflation dynamics and how the Fed can and cannot affect them.

Maintaining stable prices — keeping inflation manageable — is part of the Fed's mandate. And in January 2012 the Fed explicitly announced a 2 percent symmetric inflation target saying it "is most consistent over the longer run with the Federal Reserve's statutory mandate." Since then, however, the Fed has consistently undershot that target.

The reasons for this undershooting have changed, but the Fed's performance has not. First, the Fed argued inflation was low due to temporary factors that the central bank felt would not materially affect the longer run. Then the Fed offered more exotic explanations, citing lower cost wireless plans and decreasing prescription drug prices, as forces holding down inflationary pressures. Yellen has also discussed the so-called "Amazon effect" in which the growing share of online shopping holds inflation low.

The Fed technically could change this by injecting more money into the economy, allowing that money to circulate and raise inflation. Basic monetary economics says that the monopoly supplier of currency is capable of generating nearly any amount of inflation.

But excess money creation is dangerous. In the old operating framework it led to uncomfortably high inflation throughout the 1970s. Society was forced to endure a good deal of pain as then-Fed Chair Paul Volcker was forced to significantly raise interest rates, thereby substantially increasing the price of credit, to drain that excess money from the system.

Today, Fed officials are making the mistake of relying on the Phillips Curve to guide policy decisions, and that is leading to their confusion about inflation. The Phillips Curve says that when the unemployment rate drops the inflation rate ought to increase, and raise prices along with it. But this relationship is absent in the data, something even Yellen has admitted.

Clinging to this outdated model is causing Fed officials to say they're without a working theory of inflation. To explain this inflation "puzzle" they have cited supply-side driven price changes. But trying to explain inflation with these kinds of price changes may lead to the Fed inadvertently harming the economy.

Here's how that could play out: Were the economy to undergo a boom in productivity, a welcome development, the drop in prices would be a benefit to consumers. A positive supply shock of this type would see a decline in measured inflation. Under inflation targeting, falling prices would be a signal to the Fed to cut interest rates. But excessive monetary stimulus creates its own inflationary problems. It would be far better to let the price change pass through and have consumers enjoy the lower prices.

Without properly understanding inflation, negative supply shocks can cause even more problems than positive shocks. If prices rise due to an oil shortage, this puts pressure on consumer budgets. However, the inflation targeting central bank sees rising prices as elevated inflation, and thus engages in tightening monetary policy. This puts additional downward pressure on the economy.

Properly understood inflation is a monetary phenomenon and one that the Fed can affect. This understanding of inflation is different than supply-side effects on prices, which the Fed has far less, if any, control over. And contrary to recent remarks from Fed officials, understanding these differences does form a working theory of inflation dynamics. In particular, such an understanding highlights the dangers of reacting to all inflation and price changes in the same way.

As he makes his selection, the president would be well advised to ask potential nominees for their views on inflation, with a special emphasis on how they would respond differently to different shocks as Fed chair. Treating all inflationary pressures the same can harm the economy, and the president needs a chair who's aware of this. A central bank that claims to be without a theory of inflation dynamics runs the risk of becoming a further destabilizing force when a shock hits the economy.

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