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Why Jeffrey Lacker Is Worried About Inflation

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Jeffrey Lacker, the president of the Federal Reserve Bank of Richmond, was the only member of the Fed's policy-making committee who voted to raise interest rates in September, and again in October. Mr. Lacker has long expressed skepticism about the benefits of the Fed's stimulus campaign, and he has been concerned that inflation will begin to rise more quickly as the economy gains strength.

Mr. 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 monetary 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," Mr. Lacker said Thursday in a speech at the Cato Institute.

John Williams, president of the Federal Reserve Bank of San Francisco, in 2013. He said that the economy's Monetary Policy: Q. and A. With the Fed's John Williams: Timing of Rate Rise Is OverratedAPRIL 16, 2015

Eric Rosengren, president of the Federal Reserve Bank of Boston, in 2012. He still expects the Fed to raise interest rates before too long.Monetary Policy: Q. and A. With Fed's Eric Rosengren: Still Bullish on EconomyOCT. 5, 2015

Charles Plosser, president of the Federal Reserve Bank of Philadelphia.Monetary Policy: Q. and A. With Charles Plosser of the Fed: Raise Rates Sooner Rather Than LaterJAN. 30, 2015

Charles Evans, president of the Federal Reserve Bank of Chicago, in 2012. He has been one of the most forceful advocates of the Fed's stimulus campaignMonetary Policy: Q. and A. With Charles Evans of the Fed: Low Inflation Is the Primary Concern DEC. 3, 2014

In an interview Wednesday night, Mr. Lacker also talked about being the only Fed president who has raised rates, why the gold standard was a bad idea and how to improve the Fed's communications. The answers are lightly edited for clarity.

Jeffrey Lacker, president of the Richmond Federal Reserve, has long expressed skepticism about the benefits of the Fed's stimulus campaign. Credit Chuck Burton/Associated Press

It's looking like you won't need to dissent again in December. After all these years, the Fed seems poised to raise rates.

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.

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?

It's been a long time. There has been this sort of generational change on the F.O.M.C. 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.

But this time is different. Are you confident the Fed can make rates go up?

Yeah.

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

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.

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

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.

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?

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.

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

I just don't see a strong case for there being much left. [Broader 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. But there's definitely a notable increase in the extent of anecdotal reports of wage pressure. So that's another piece of the puzzle.

So why haven't we seen faster inflation?

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. In 1966-67, we had unemployment at 5 percent, we pushed it to 4, and it was 1967 and 1968 when inflation took off. So there was a significant lag in the way that relationship seems to have worked in the past.

Do you think things might catch fire? Do you see a real upside?

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.

Is there an upside for economic growth, too?

It’s a possibility. It’s hard to see. It would take a few things lining up. The sluggishness of productivity growth is going to hold us back, combined with the lower growth of the working-age population. I think those two things are going to tie you to fairly low growth numbers, so I’m not quite sure I can see where growth is going to get to 4 percent without some shift in the productivity numbers.

The Fed claims that its decisions are data-dependent. There is nothing data dependent about Fed members having trapped themselves in a...

Jack512 38 minutes ago

Lacker has been crying wolf about inflation for some 6 years now.

Is there an upside for economic growth, too?"... The sluggishness of productivity growth is going to hold us back, combined with the lower...

Some of your colleagues see a significant risk that the weakness of the global economy will weigh on domestic growth. How worried are you?

One always has to be mindful of economic developments in our trading partners, but we’ve fallen prey to overestimating those risks in the past. 1998-99 is a classic example where we eased three times in response to what we thought were the domestic implications of financial turmoil abroad, difficulties abroad, and ended up behind the curve in ’99 and too slow to take it back.

It’s true that you need to look beyond the direct effect of trade with China. Other emerging markets are weakening as well. But if you look at the fundamentals of U.S. economic growth, they seem tied closely to growth in real income here and growth in consumer spending here. Manufacturing and our export trade is kind of a small part of our economy. It’s not the major chunk of activity. You got to take a balanced view, but I think what we’ve seen since September is the downside risks seem to have moderated substantially.

Senator Ted Cruz called for a resumption of the gold standard during the Republican presidential debate Tuesday night. Defend the Fed.

The historical record on the gold standard is pretty clear, that the automatic adjustment mechanism that it provides for rectifying monetary imbalances is blunt and crude and involves relatively costly adjustments. Moreover, it doesn’t really promise price stability, because the relative price of gold can vary over time.

What I sense is motivating proponents of the gold standard is a desire for a more predictable, less discretionary central bank. And that’s fair. That’s perfectly fair. But that’s difficult for any central bank to provide because the future is uncertain and appropriate policy is going to vary with future circumstances, and providing clarity about the way in which future circumstances are likely to affect policy is very difficult. What central banks are limited to is committing to certain principles and a commitment to exercise discretion in a way that is consistent with those principles. That’s in between an algebraic rule and pure discretion. And the closer we can get to being predictable the better, I think. And I think that’s where central banks have focused: to try and make themselves more accountable and predictable.

But I think abolishing central banks is a nonstarter. I take the historical evolution of central banks to be an adaptation to the way that market economies work. The need for some conscious management of the supply of monetary assets, because the demand for those assets fluctuates with a wide variety of factors, and a gold standard or other schemes just don’t look as if they provide the right flexibility of adapting supply to changes in demand.

I assume for the same reasons you do not favor the House bill requiring the Fed to publish a policy rule and justify any subsequent deviations?

When we discuss policy, we make reference to algebraic rules and what they recommend because those rules summarize in a convenient form the past pattern of our reactions to economic data. They’re a benchmark against which we can gauge whether we’re departing in substantial ways. It shouldn’t determine what we do, but they embody past behavior in a way we need to keep in mind. I think we could probably do more to share the rules we do consult and to discuss the relationship between our current policy settings and the predictions of those rules.

Several Republican candidates also suggested the government has not done enough to address the risk of large bank failures during a future crisis. This is a view shared by a fair number of Democrats, too.

I think our preparations for another crisis are incomplete. We’ve done a substantial amount of work. We’re a long way down the road toward where we need to be, but I don’t think we’re there yet.

I’ve said before that I think the living wills – the resolution planning process — is the linchpin. Without credible plans – credible to us and credible to markets and credible to investors – we’re going to be in a box again, we’re going to be in a bind should one of these companies experience financial distress that requires contemplating a rescue or resolution. The plans are getting more robust with each submission, but there’s still work that remains to be done.