MarketWatch

The Fed knows how to hit its inflation target — it just refuses to do so

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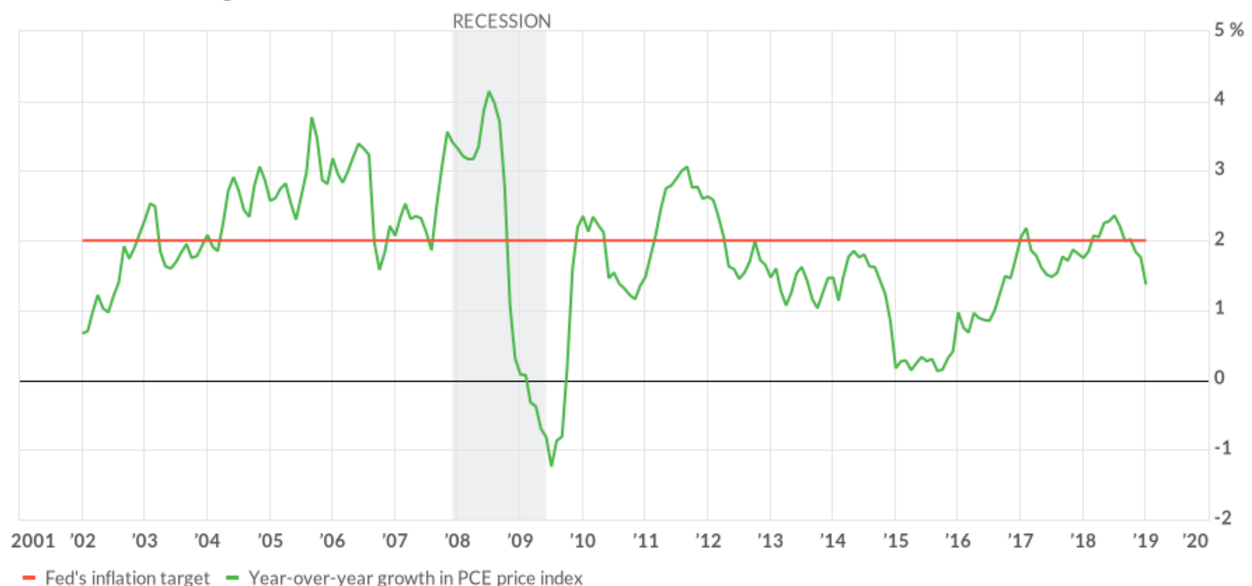
It’s time to put money back into the equation of monetary policy

Inflation miss

Actual inflation vs. target



Source: BEA/Federal Reserve/Haver Analytics

The Fed has consistently undershoot it’s 2% inflation target since the Great Recession. Maybe it’s not really trying.

The Federal Reserve has consistently undershot its 2% inflation target ever since it adopted an explicit target in 2012. Policy makers, desperate to find a culprit outside of themselves, have settled on the public’s subdued inflation expectations as the likely suspect.

In order to get the public on board, the Fed has considered, or is considering, various options, including raising the target inflation rate (nixed) and switching to a system of price-level or average-inflation targeting.

Hasn't anyone at the Fed thought of the obvious solution? If you really want to boost the public's inflation expectations, try giving them a little more actual inflation!

Central banks know how to do this. History is littered with examples, including present-day Venezuela, of governments availing themselves of the central bank's printing press, only to watch any short-term benefit succumb to the dire long-term cost (hyperinflation).

The Fed seems reluctant to orchestrate even modestly higher inflation.

After working hard to establish its credibility following the Great Inflation of the 1970s, the central bank presided over an extended period known as the Great Moderation. (”Great” was clearly in vogue before Donald Trump came along.) Inflation plummeted and stabilized. The public came to expect only modest increases in its cost of living and adjusted its behavior accordingly. Bond markets gradually re-priced for a world in which the risk of future inflation was minimal.

Because credibility is hard-won and easily lost, the Fed seems content to drum up excuses for missing its inflation target rather than take action to hit it.

"The Fed has become a victim of its own success," says David Beckworth, senior research fellow at George Mason University's Mercatus Center. "The Great Recession lowered inflation even more," a case of "opportunistic disinflation." Since then, "the Fed has chosen to err on the side of low inflation."

Beckworth points to evidence to support his assertion. First, the Fed's median inflation forecast one-to-two years out, reflected in its quarterly Summary of Economic Projections, has consistently been below 2%. (It wasn't until 2018, when the unemployment rate pierced 4%, that the inflation forecast rose to 2%.) That hardly sounds like a "symmetric" target, as the Fed insists.

The second piece of evidence suggesting that the Fed is erring on the side of caution is "the fact that it hasn't hit its target," Beckworth says. "Either the Fed is the most unlucky institution in the history of humanity, or it is getting what it wants."

The Fed's persistent, sub-2% inflation projections may reflect policy makers' entrenched Phillips curve view of the world: the idea that there is an inverse correlation between unemployment and inflation. The experience of recent decades — the stagflation of the 1970s and the low-unemployment/low-inflation decades that followed — may have challenged that view, but for many members of the Federal Open Market Committee, old habits die hard.

Or maybe inflation is being constrained by the Fed's current operating system.

"In terms of basic economics, interest on reserves increases the demand for reserves, so even very large increases in the supply of reserves have little effect on inflation," writes Peter Ireland, professor of economics at Boston College. "Quantitative easing would have been more effective without interest on reserves."

If the Fed were to determine that inflation expectations were constraining actual inflation and decided to do something about it, how would it proceed?

The Fed could always lower interest rates under its current "floor" system of setting an administered rate, known as IOER (interest on excess reserves), in order to reduce the funds rate.

Or perhaps the Fed should reconsider its stated commitment to a floor system and try to hit its inflation target the old-fashioned way, by realigning the stance of monetary policy with the size of its balance sheet?

Some background is in order. In 2008, the Fed started paying banks interest on excess reserves — the reserves that banks elect to hold over and above what they are required to hold against demand deposits — in conjunction with its large-scale asset purchases in order to retain control of the federal funds rate.

In effect, the Fed was paying banks not to lend, suppressing the money multiplier, constraining the increase in aggregate demand and putting a damper on the recovery from the 2007-2009 recession. (Another event designated as "Great" in the history books.)

Prior to 2008, the Fed manipulated the supply of reserves in the banking system by buying or selling Treasury securities to produce the desired level for the funds rate. With a so-called corridor system, the funds rate was bounded by the IOER rate (zero) on the bottom and the Fed's discount rate on the top.

With the introduction of LSAPs, or quantitative easing, the Fed's balance sheet swelled from a pre-crisis $900 billion to $4.5 trillion. Excess reserves soared from less than $2 billion before the crisis to $2.7 trillion in 2014.

How would the Fed revert to a corridor system, given its $2.5 trillion portfolio of federal debt and the massive amounts of reserves it is holding for depository institutions?

The Fed officially announced last month that it would terminate its balance-sheet normalization at the end of September and maintain "an ample supply of reserves," relying on "administered rates" instead of active reserve management in the conduct of monetary policy.

The ostensible reason for maintaining such a large balance sheet is that banks tell the Fed they have an increased demand for reserves, which qualify as "high-quality liquid assets" needed to meet their liquidity coverage ratio as required by regulators.

"Of course banks tell the Fed they need reserves," says George Selgin, director of the Center for Monetary and Financial Alternatives at the Cato Institute. "They're attractive. The Fed has to make them less attractive."

U.S. Treasuries are also designated as HQLA, so in theory the Fed could encourage banks to swap out their reserves for Treasuries by removing the incentive to hold reserves, shrinking the size of its balance sheet in the process.

How would it work in practice?

“First the Fed would lower IOER below the constellation of other overnight rates,” including the funds rate, Beckworth explains.

“Banks will start converting from reserves to other items.”

“Second, the Fed would have to mop up the reserves — sell securities — pulling in reserves as the banks are dumping them,” he says. “It would get messy as the rush for the door could overwhelm the system.”

The process might even serve as a form of target practice, allowing the Fed to perfect its aim so that it can hit the 2% inflation bulls-eye.

The Fed is adamant that it cannot return to the old system.

“The Fed created the demand for reserves, and now it says we can’t fix it?” Beckworth asks. “It’s not as if there’s a dearth of Treasuries.”

The excuses are wearing thin. It’s time to put some of the “M,” or money, back in monetary policy.