The Real Mystery About Low Inflation

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Where's that inflation we were promised? That's the question Senators Elizabeth Warren and Sherrod Brown asked economist Marvin Goodfriend during contentious hearings over his nomination to the Federal Reserve Board.

In 2011, Goodfriend had said that inflation would grow more severe. But inflation, as the senators noted, has been relatively low since then.

The Fed says it wants a measure of inflation called the PCE deflator to rise by 2 percent a year. Since the economic recovery began, the measure has almost always been below that target.

While Goodfriend was particularly vocal, he's hardly alone in having expected higher inflation than we have seen. The Fed itself has routinely projected that inflation will soon hit the 2 percent target. It keeps moving the date we are going to hit it into the future.

A lot of financial commentary has puzzled over the "mystery of the missing inflation." Unemployment is low, interest rates are low, and during the early years of the recovery the Fed made large-scale asset purchases to ease credit. Many people associate each of these things with rising inflation. Yet it keeps failing to materialize.

Low inflation may sound like a happy surprise, but economists express concern about it for a number of reasons. Most of all, they worry that if the Fed has lost the ability to raise the inflation rate, it may not be able to take effective action to counter the next recession.

There are convincing explanations for the Fed's failure to hit its 2 percent target: a complicated one and a simple one.

The complicated one observes that monetary policy has not been as accommodative as it might seem. Low interest rates have reflected a low natural rate of interest more than they have reflected Fed easing. The asset purchases were advertised and understood to be temporary, blunting their inflationary impact. Perhaps most important, the Fed has been paying banks interest on excess reserves -- IOER -- that is above the corresponding market interest rate.

George Selgin, a monetary economist at the libertarian Cato Institute, explained the effects of this last policy in recent congressional testimony:

By keeping its IOER rate above corresponding market interest rates, as it has done since November 2008, the Fed has prevented additions to the supply of bank reserves from resulting in any general increases in the supply of credit. Instead, increases in total bank reserves were matched by roughly equal changes in banks' excess reserve holdings.

Even during the early years of the recovery, the Fed's policies have worked at cross purposes with each other, with the interest on excess reserves counteracting the Fed's asset purchases.

The deeper explanation for why the Fed hasn't hit its target is the simpler one: It doesn't really want to hit it. Or, at least, it doesn't want to hit it as much as it wants other things.

It has become easier to see this in recent years, as the Fed has taken multiple steps that unequivocally reduce inflation. From December 2015 onward, the Fed has raised the federal funds rate five times, and it was talking about raising it long before it acted. The Fed has also slowly moved to reduce its asset holdings. The Fed wouldn't have done either of these things if higher inflation were its top priority.

It has given other goals – such as "normalizing" interest rates by bringing them closer to historical averages – precedence over higher inflation. And it has decided that it would rather keep paying interest on excess reserves, a policy that it believes gives it more control over interest rates, than lower its payments in a way that might increase inflation.

Goodfriend overestimated how inflationary the Fed was willing to be. So have a lot of other people. The real mystery, at this point, is why so many people find low inflation mysterious. The Fed isn't hitting its target because it doesn't take its target seriously.