High View Economics

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COMING HOME TO ROOST

When the Fed after last September's FOMC meeting set the stage for QE2 by emphasizing its concern that inflation was running too low, we observed "it's a good bet that when a central bank makes clear that its objective is to see more rather than less inflation, more inflation is likely t o be the result" (see "Fed Sees Deflation, Market Sees Reflation," September 22, 2010). In the minutes of that meeting, it was revealed that policymakers were seeking to raise inflation expectations. As Philadelphia Fed President Charles Plosser explained at the time, the theory is that "there is a tipping point at which the market becomes convinced that money held in reserve earning negligible returns is at risk of being debased through some inflation and, thus, should be spent rather than hoarded."

That's an elegant way of essentially saying that as the public perceives that the Fed is committed to indefinitely maintaining an ultra-accommodative policy posture, it understands that higher inflation will be the inevitable result. Rising inflation expectations reduce the demand for money, eroding the real value of the unit of account. That's how rising inflation expectations produce higher actual inflation.

It appears the chickens are coming home to roost. As we noted earlier this week, the latest Thompson Reuters consumer sentiment survey showed top-line inflation expectations at 4.6% a year out, compared to 2.7% in August (see "Budget Battle," March 28, 2011). The Conference Board's March consumer confidence survey put year-ahead inflation expectations at 6.7%. And that cannot be attributed largely to the recent spike in gasoline prices. In February, before the 45-cent-per gallon price jump, the 12-month expected inflation rate came in at 5.6%. Since late August, when Bernanke gave his Jackson Hole speech paving the way for QE2, the break-even "inflation compensation" spread between nominal Treasuries and inflation-protected TIPS has widened by about 100 basis points to more than 2.5%.

The Fed takes comfort in the fact that it's favored inflation index, the PCE core deflator, is up just 0.9% the past year, and is rising at an annual rate of 1.3% on a three-month annualized basis. But to think that rising food and energy prices can be excluded from consideration and seen as having no connection to the stance of monetary policy is preposterous. It should be noted that crude was already up by about $20 per barrel

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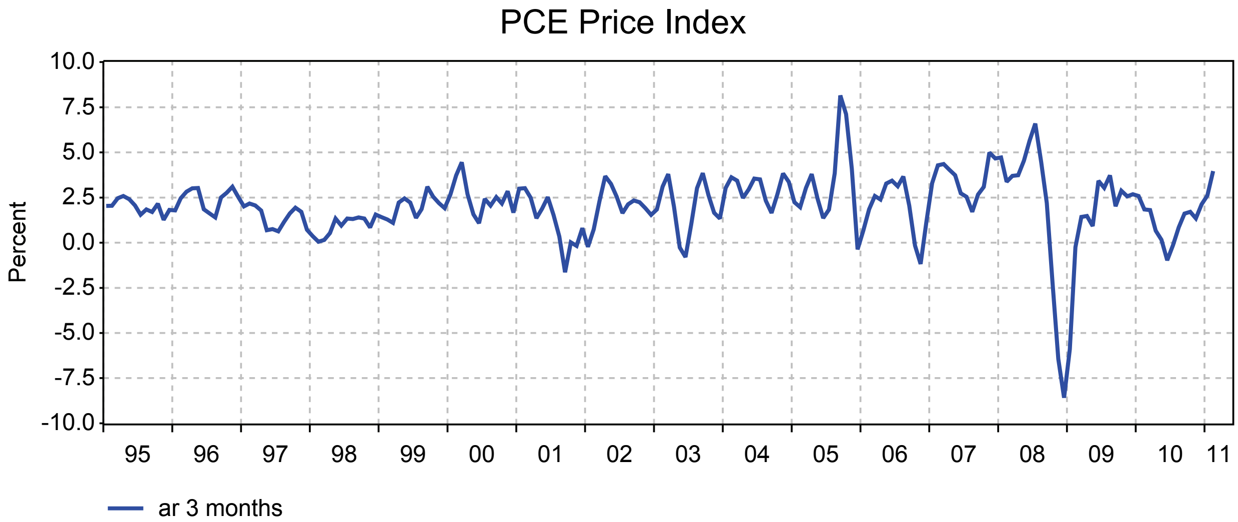

Source: Reuters EcoWin

since last August, prior to the outbreak of unrest in Libya. The headline PCE deflator is rising at a three-month annual rate of 4%, up from 0.85% last August. Headline CPI is up 5.6% on a three-month annualized basis. That rate was 1.4% last August. In a speech last week Plosser said headline inflation – not core – is what "matters." Core, he said, "only matters to the Fed." The presumption that core indices are more forward-looking and accurate predictors of future headline inflation doesn't hold up, he added.

Meanwhile, the Philadelphia Fed reports that it's March "prices received" index rose to 22.6 from 21 in February, 17.1 in January and 10.7 in December. Prior to that the index was negative. Similarly, the Richmond Fed's retail price index was at 1.81 in March, up from 1.46 in February and 1.235 in January. In the ISM March manufacturing report released today, the price index registered 85, up 3 points from February and up from 57 last June. ISM said 72% of respondents reported paying higher prices. And yesterday, Bill Simon, head of U.S. operations for Walmart, said consumers will face "serious" inflation in the months ahead as the rising cost of commodities and other inputs gets passed through.

Although a few hawkish voices have been heard among the reserve bank presidents, including Plosser, the Fed consensus in favor of sustaining the central bank's hyper-accommodative stance remains intact. New York Fed president William Dudley, a close ally of Fed chair Ben Bernanke, told a group today, "We are still very far away from achieving our dual mandate of maximum sustainable employment and price stability." In other words, Dudley – who reflects the thinking of a clear majority of policymakers – still believes the primary inflation risk is on the downside.

The Fed's pledge to maintain a near-zero funds rate for an "extended period" is keeping Treasury yields in check for now. At some point, though, inflation reality will become impossible to deny. Treasuries will get crushed either as a consequence of the market's realization that the Fed is badly behind the curve or if the Fed finally comes to terms with the new reality and transmits that it will need to start aggressively raising rates. In either case, there's no way out for the Treasury market.

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Rising inflation is an economically corrosive phenomenon. The most harmful aspect is the uncertainty it breeds regarding expected real returns to investment. In a rising inflation environment, we're not likely to see robust levels of capital formation. The collapse in productivity growth in the late 1970s was directly attributable to the high and rising inflation of that era.

Ultimately, though, some good may come from this episode. The fiat money system in place since Bretton Woods collapsed in 1971 has relied on the discretion of policymakers to get it right more often than wrong. Following the disastrous tenures of Arthur Burns and G. William Miller, Paul Volcker restored the Fed's credibility and established the foundations for a generation of relative price stability. With this reversal of that accomplishment, the stage could be set for a monetary reform that could either reinstitute the gold standard or put in place a commodity price rule that would establish a fixed value for the dollar. At a supply-side conference last week, former Fed governor Larry Lindsey offered, "We will end the decade with something other than fiat money." It's usually the case that such a major reform can be put in place only as a response to crisis. It looks like we could be heading that way.

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