

AEI seminar: "Is the Fed on the Right Track?"
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Opening Remarks

I'll start by giving a direct answer to the question in the seminar title, Is the Fed on the Right Track? My answer is a forthright "maybe." Let's face it, economists don't really know enough to make strong judgments on issues that require macro forecasts, and this is one of those issues. But, in the spirit of fostering livelier discussion, I'll stick my neck out a little and say that I've suspected for some time that the Fed has been going overboard in its aggressive actions to address recession risks, in the process contributing to an inflation trend it has been underestimating.

To be sure, the economy has been facing some contractionary impulses that warranted the Fed's attention. A major one relates to the fall-out from the housing and credit bubble. The arguments about Fed culpability for the bubble are interesting, but well known, so I won't take the time now to discuss them. I'll just say that once the downward momentum of house prices was well established and the financial dominoes began to topple last summer, the Fed responded, eventually aggressively. It not only slashed the funds rate well below what a Taylor rule based on current unemployment and inflation data would have dictated, it also introduced a sequence of discount window and securities lending innovations intended to address more directly the persistent liquidity stresses in various markets.

The culmination of this was, of course, Bear Stearns and the opening of the discount window to non-bank primary dealers. Vince Reinhart has declared the March intervention to be one of the greatest errors in Fed history. I hesitate to endorse fully Vince's assessment in part because the facts of the situation remain murky, and in part because I'm confident that the Fed looked at its options with an eye to the very concerns that Vince has highlighted. But I do share his sense that they stretched the previously understood limits of their authority and in the process enhanced the moral hazard problem in financial markets. Going forward, I am not entirely persuaded of Vince's argument that the Fed will be unable to be a broker and not a principal in dealing with any future emergency. I'd even question the notion that it is impossible to turn back the clock on providing an assured liquidity backstop for investment banks—the Fed may have lost its virginity, but that doesn't mean it must become promiscuous, regardless of what some players may hope.

In any event, post Bear Stearns, there has been considerable improvement in some segments of the credit markets. We're not back even to what one might envision as a new normal, but there isn't a pervasive crunch. Meanwhile, the incoming economic news has on balance been a bit better than the Fed apparently expected. The FOMC's April forecast update was very gloomy on near-term growth prospects, with many participants anticipating a net contraction of output in the first half. A lot more data are yet to come,

but a popular interpretation of those we have is that GDP growth in Q2 is running at or above the roughly 1% pace of Q1. Chairman Bernanke in effect recognized this good news when he said last week that “the risk that the economy has entered a substantial downturn appears to have diminished over the past month or so.” But, he also argued that the general outlook for growth and employment hadn’t changed much and he reiterated concerns about downside risks going forward associated with the “ongoing contraction in the housing market and the continuing increases in energy prices.” I would argue that the Fed could well be giving short shrift to possible upside risks. Let me say just a few words on those two factors the Chairman highlighted, to illustrate my point.

On housing, there have been hints in recent monthly indicators that the decline in home sales and starts might have reached bottom. Caution obviously is warranted: The statistics are noisy and we know that huge inventories of unoccupied units remain in many locales. But, it’s conceivable that the direct drag from residential construction will abate sooner than the Fed has recently been thinking. To be sure, that doesn’t mean home prices are about to stabilize, and that’s clearly an important matter for a number of reasons. The Fed is unlikely to cross the housing market off its worry list before there is a prevailing sense that the end of the price decline is in sight; this would have beneficial effects on housing demand, as potential homebuyers would have less incentive to hold off, and on financial asset prices.

I do wonder, though, whether the Fed hasn’t put too much faith in estimates of sizable housing wealth effects when coming up with its forecasts of aggregate demand. The relevant theory is ambiguous, and empirical research hasn’t yielded consistent results. Consumer spending growth has slowed some, but it isn’t clear that falling house prices have played a major role. Perhaps I should add “yet” to that comment, but one might also wonder whether households ever incorporated the full extent of the prior price run-up in their consumption patterns—after all, some of them might have heeded the headlines about a bubble, even if the Fed didn’t.

As something of an aside, I also want to suggest the possibility that the rise in foreclosures, though undeniably painful for many households and involving a good bit of dead-weight loss in the costly process, is of lesser consequence to aggregate demand than the Fed apparently has feared. Two brief observations: (1) it’s unclear how much reduction in consumption one should expect to occur when a family, which might have been struggling with an unmanageable mortgage, moves out and leaves a lender with much of the loss; (2) it’s not clear how much foreclosures reduce aggregate housing demand, rather than reshuffling it. (I recognize that loan losses may lead to tighter credit standards, which definitely is an element in Fed concerns.)

Turning to energy, there’s no doubt that higher prices are effectively a tax on domestic incomes, as one always hears. The consequences for consumer demand depend in part on how long people resist changing their spending patterns, perhaps in the hope that the rise in prices will prove transitory. It sure seems like we’ve now moved past that point. But, there is some stimulus to expenditure on energy production and conservation. And, to the extent that the rise in commodity prices reflects sustained strong economic growth

abroad—indeed, propels it for some commodity-rich countries--that has positive implications for US exports, which have enjoyed, as well, the tailwind of dollar depreciation.

Time being short, I won't try to flesh out the story further, but I want to suggest that there is a distinct possibility that the Fed not only under-predicted H1 GDP growth, but also could be surprised on the upside with respect to aggregate demand over coming quarters. Which brings me to the inflation risk.

My perspective on the inflation question begins with the observation that overall consumer inflation has been averaging much more than the Fed's implicit target over the past several years. The Fed seems unapologetic about the overshooting, its argument being that an effort to offset fully the impulse from soaring commodity prices would have imposed undue unemployment costs on the economy. In addition, its version of flexible inflation targeting focuses on controlling what inflation will be a couple of years out, with bygones being bygones. I am not persuaded that inflation targeting is preferable to price level targeting, which would call for averaging out misses. Past inflation overshoots, if not reversed, can impose permanent losses on some innocent parties.

But, setting that issue aside, there is the question of how the Fed has modeled the process of inflation and whether the use of core inflation as a sort of intermediate target variable has been leading policy astray. Although the Fed has now assured us that it knows people eat and drive, and that the ultimate objective is overall price stability, policy decisions have been based to a great degree on the notion that core prices are good guide to the underlying trend of general inflation. There is abstract theory that provides a rationale for this approach, and also some evidence of a supportive empirical regularity in the US experience. However, it seems to me arguable that the run-up in commodity prices in this cycle hasn't been an exogenous supply shock producing a transitory relative price movement but rather a reflection of rapid world demand growth, weighted toward emerging economies with rising food consumption and massive appetites for energy and materials-intensive physical investment. For a variety of reasons, capacity in these sectors simply hasn't kept pace, creating an inflationary bottleneck.

The Fed isn't blind to these possibilities. Both Chairman Bernanke and Vice Chairman Kohn zeroed in on the commodity price question in their remarks at the Boston Fed's research conference last week. The Chairman said that "Rapidly rising prices for globally traded commodities have been the major source of the relatively high rates of inflation we have experienced in recent years," a statement that is correct in arithmetic terms but that—as I'm sure he recognized—may be analytically misleading. The economics of the situation might be better captured by the simple characterization that total inflation has been elevated, with a relative rise in the prices of goods and services that are commodity intensive. The corollary of this is that the prices of some core items (SUVs being a prominent example of late) have been under downward pressure, within the average inflation that monetary policy here and abroad has accommodated, intentionally or because of forecast errors.

Vice Chairman Kohn talked at some length about how the optimal monetary policy response in circumstances like those that have confronted us with the run-up in commodity prices is to partially accommodate higher inflation temporarily at the cost of some temporarily higher unemployment. That isn't an innovation in macro/monetary theory, but it strikes me as something of an innovation as a possible public description of current policy; it seems like, up to now, Fed rhetoric hasn't explicitly accepted the optimality of some rise in unemployment. In any event, he also highlighted the risk attending the accommodative strategy that people may extrapolate the inflation overshoot into an expectation of permanently higher inflation.

Chairman Bernanke's recent speeches, including his expression of concern about the consequences of dollar weakness, have stressed the importance of Fed credibility with respect to the containment of inflation over the longer term—the culmination being his promise that the Fed will “strongly resist” any unanchoring of expectations. The market has reacted dramatically, in terms of the fed funds futures curve, perhaps more dramatically than the Chairman expected or intended. I find it difficult to believe that, with his still noting the predominance of downside risks to activity, he was communicating that there is currently a general anticipation of very near-term rate hikes within the FOMC. But, with the Fed leadership having put the markets on notice of its worries, perhaps it has laid some groundwork to move more aggressively if, as I've feared, inflationary tendencies in the economy should prove more stubborn than the FOMC's most recent forecasts suggest.