October 9, 2012

Supporting Price Stability

All of the five questions that Chairman Ben Bernanke addressed in his October 1 speech to the Economic Club of Indiana rank high on the list of most frequently asked questions I encounter in my own travels about the Southeast. But if I had to choose a number one question, on the scale of intensity if not frequency, it would probably be this one: "What is the risk that the Fed's accommodative monetary policy will lead to inflation?"

The Chairman gave a fine answer, of course, and I hope it is especially noted that Mr. Bernanke was not dismissive that risks do exist:

> "I'm confident that we have the necessary tools to withdraw policy accommodation when needed, and that we can do so in a way that allows us to shrink our balance sheet in a deliberate and orderly way. ...
>
> "Of course, having effective tools is one thing; using them in a timely way, neither too early nor too late, is another. Determining precisely the right time to 'take away the punch bowl' is always a challenge for central bankers, but that is true whether they are using traditional or nontraditional policy tools. I can assure you that my colleagues and I will carefully consider how best to foster both of our mandated objectives, maximum employment and price stability, when the time comes to make these decisions."

While the world waits for "take away the punch bowl" time to arrive, here is another question that I think worthy of consideration: "Looking back over the past several years, what is the risk that the Fed's price stability mandate would have been compromised *absent* accommodative monetary policy?"

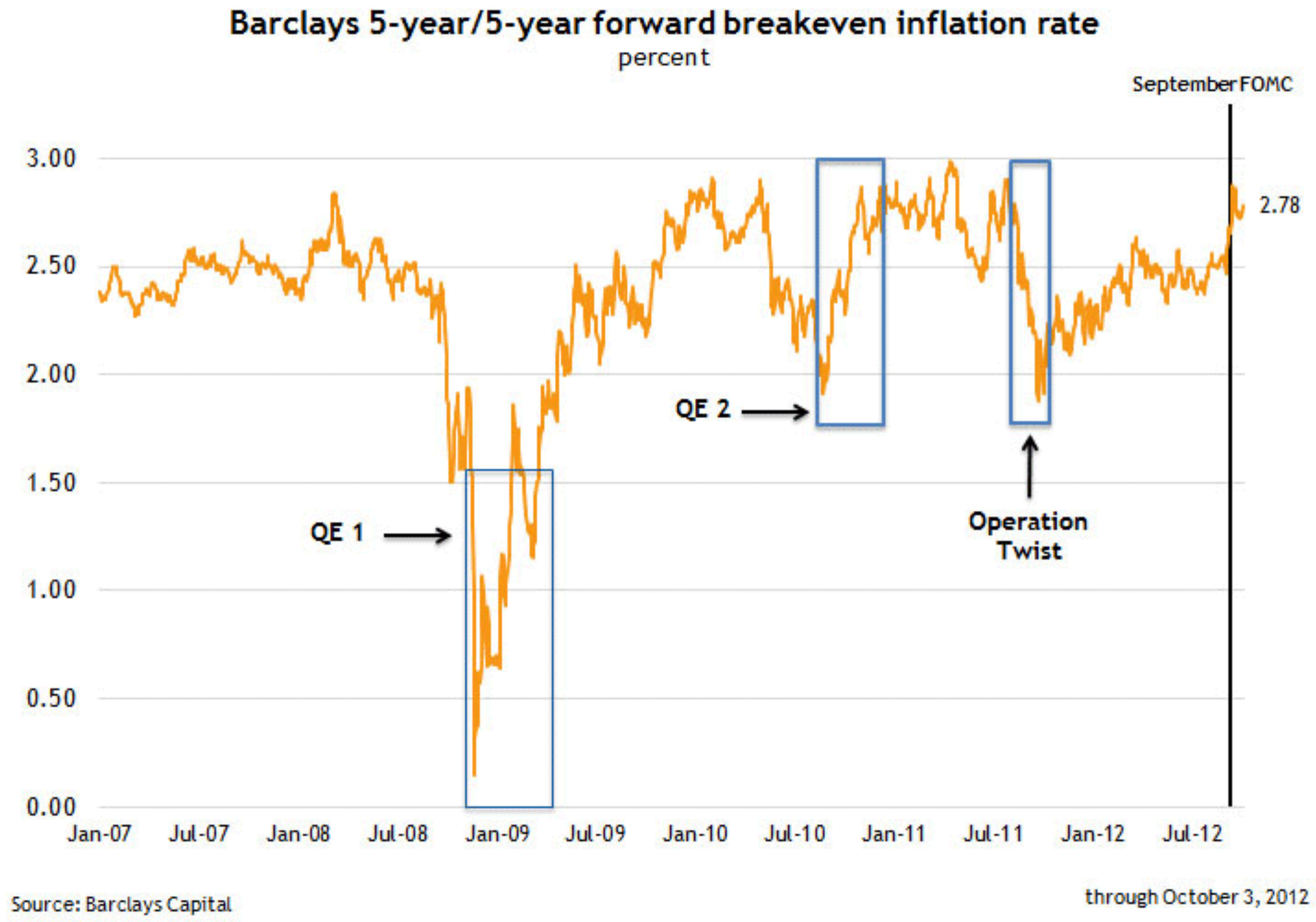
As the Chairman noted in his speech, it isn't easy to take the evidence at hand and argue any inconsistency between the Federal Open Market Committee's (FOMC) policy actions and its price stability mandate:

> "I will start by pointing out that the Federal Reserve's price stability record is excellent, and we are fully committed to maintaining it. Inflation has averaged close to 2 percent per year for several decades, and that's about where it is today. In particular, the low interest rate policies the Fed has been following for about five years now have not led to increased inflation. Moreover, according to a variety of measures, the public's expectations of inflation over the long run remain quite stable within the range that they have been for many years."

To the question I posed earlier, I am tempted to take those observations one step further. Without the policy steps taken by the FOMC over the past several years, the "excellent" price stability record would indeed have been compromised.

Consider the so-called five-year/five-year-forward breakeven inflation rate, a closely monitored market-based measure of longer-term inflation expectations. If you are not completely familiar with this statistic—and you can skip this paragraph if you are—think about buying a Treasury security five years from now that will mature five years after you buy it. When you make such a purchase, you are going to care about the rate of inflation that prevails between a period that spans from five years from today (when you buy the security) through 10 years from today (when the asset matures and pays off). By comparing the difference between the yield on a Treasury security that provides some insurance against inflation and one that does not, we can estimate what the people buying these securities believe about future inflation. The reason is that, if the two securities are otherwise similar, you would only buy the security that does not provide inflation insurance if the interest rate you get is high enough relative to inflation-protected security to compensate you for the inflation that you expect over the five years that you hold the asset. In other words, the difference in the interest rates across an inflation-protected Treasury and a plain-vanilla Treasury that does not provide protection should mainly reflect the market's expected rate of inflation.

When you look at a chart of these market-based inflation expectations along with the general timing of the FOMC's policy actions, from the first large-scale asset purchase in 2008–2009 (QE1) to the second asset purchase program (QE2) in 2010 to the maturity extension program (Operation Twist) in 2011, the relationship between monetary policy and inflation expectations is pretty clear:



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In each case, policy actions were generally taken in periods when the momentum of inflation expectations was discernibly downward. A simple-minded conclusion is that FOMC actions have been consistent with holding the bottom on inflation expectations. A bolder conclusion would be that as inflation expectations go, so eventually goes inflation and, had these monetary policy actions not been taken, the Fed's price stability objectives would have been jeopardized.

Statements like this do not come without caveats. A perfectly clean measure of inflation expectations requires that Treasuries that do and do not carry inflation protection really are otherwise identical. If that is not the case, differences in rates on the two types of assets can be driven by changes in things like market liquidity, and not changes in inflation expectations. Calculations of five-year/five-year-forward breakeven rates attempt to control for some of these non-inflation differences, but certainly only do so imperfectly.

Perhaps more pertinent to the current policy discussion, inflation expectations have, in fact, moved up following the latest policy action—which I guess people are destined to call QE3. But unlike the periods around QE1, QE2, and Twist, QE3 was not preceded by a period of generally falling longer-term breakeven inflation rates. So this time around there will be another, and perhaps more challenging, chance to test the proposition that monetary accommodation is consistent with price stability. As for previous actions, however, I'm pretty comfortable arguing the case that the price stability mandate was not only consistent with accommodation, it actually required it.

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