St. Louis Fed Analysis: Inflation May Be the Next Dragon to Slay

As the 2007-09 recession recedes, there is growing disagreement whether the legacy of the Fed’s unprecedented monetary stimulus policies to stabilize the economy will spark a surge in inflation. Indeed, this rising level of disagreement may itself provide a clue to what lies ahead, according to new research from the Federal Reserve Bank of St. Louis.

St. Louis, MO (Vocus) January 7, 2010 -- As the 2007-09 recession recedes, there is growing disagreement whether the legacy of the Fed’s unprecedented monetary stimulus policies to stabilize the economy will spark a surge in inflation. Indeed, this rising level of disagreement may itself provide a clue to what lies ahead, according to new research from the Federal Reserve Bank of St. Louis.

“A considerable amount of disagreement seems to exist among economists about the inflation outlook over the next few years,” said St. Louis Fed economist Kevin Kliesen in the January issue of The Regional Economist, the St. Louis Fed’s quarterly review of business and economic conditions.

In his article, “Inflation May Be the Next Dragon To Slay,” Kliesen examines the inflation debate from both sides and the need for an effective policy to prevent the monetary stimulus from destabilizing prices. Accurately predicting inflation over the next few years is also a key factor, he said.

“Some analysts believe that inflation will remain low as long as the unemployment rate stays well above its natural rate of unemployment (a measure of slack),” Kliesen said. “Others believe that the risk of higher inflation has risen sharply because of the Fed’s large-scale asset purchase program and the advent of large, and possibly protracted, budget deficits.”

Looking at past five-year forecasts of the average Consumer Price Index (CPI) inflation rate from Blue Chip Economic Indicators, Kliesen noted that when inflation was relatively high and variable, such as the late 1980s and early 1990s, there was sizable disagreement among forecasters. In contrast, during periods when inflation was relatively low and stable, such as the mid-1990s to mid-2000s, forecasters tended to disagree less about the inflation outlook.

Since early 2007, the level of inflation disagreement among forecasters has increased rather sharply, Kliesen said.

“Ultimately, one’s view of the inflation outlook over the next few years depends on one’s view of how to best forecast inflation over that horizon,” Kliesen said, noting that economists use several different forecasting methods. These methods include tracking the growth rate of the money supply relative to the growth rate of real GDP; viewing the inflation process as a random walk; or using some variant of the Phillips Curve (or what is now often called the New Keynesian model.) According to an August 2009 survey by the Federal Reserve Bank of Philadelphia, nearly two-thirds of professional forecasters use a variant of the Phillips Curve to forecast inflation.

“In this view, today’s inflation rate depends on the inflation rate expected over some horizon and the amount of slack in the economy,” Kliesen explained. “The amount of slack is also often measured as the difference between actual real GDP and an estimate of potential real GDP; this is termed the output gap.”
However, the output gap is often subject to considerable measurement error, and it is often revised because of revisions to real GDP and to estimates of the economy’s underlying rate of productivity growth. The latter then affects estimates of potential real GDP and, in turn, the output gap.

“As a result, policymakers are often confronted with considerable uncertainty about the size of the gap as they deliberate the stance of monetary policy,” Kliesen said. “Many New Keynesian economists assume that the output gap matters more than the expected inflation rate for determining today’s inflation. That assumption has been questioned by some economists, who instead believe that the public’s expectation of future inflation, in part determined by actions of the Federal Reserve, matters more than the degree of economic slack currently in the economy.”

In addition, the 2007-2009 recession has likely induced considerable structural change in the economy, he said. One indication of this change, the rising percentage of the labor force characterized as the long-term unemployed, must be adequately captured when viewing inflation through the lens of a Phillips Curve framework.

“Indeed, this development already appears to be in train since many economic resources—labor and capital—that were employed in the automotive, housing and financial industries will need to migrate to industries that offer higher rates of return,” Kliesen said. Once such structural changes are included, the size of the output gap might be smaller than conventional wisdom might believe, he said.

“Those who foresee little risk to the near-term inflation outlook because of a large, persistent output gap may be too optimistic,” he said.

In addition, uncertainty remains over how the Fed will rein in the potential acceleration in money growth as the economy improves.

“Fed Chairman Ben Bernanke and other senior Fed officials are quite confident that they have the tools and the determination necessary to prevent an unwelcome acceleration in inflation or inflation expectations,” Kliesen said. “Unlike previous episodes, though, the magnitude of the policy responses to the financial crisis and the Great Recession suggests that the FOMC’s margin of error seems much smaller than at any time in the Fed’s history.”

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