Dec. 16, 2010

On inflation, macroeconomics and predicting the economic future …

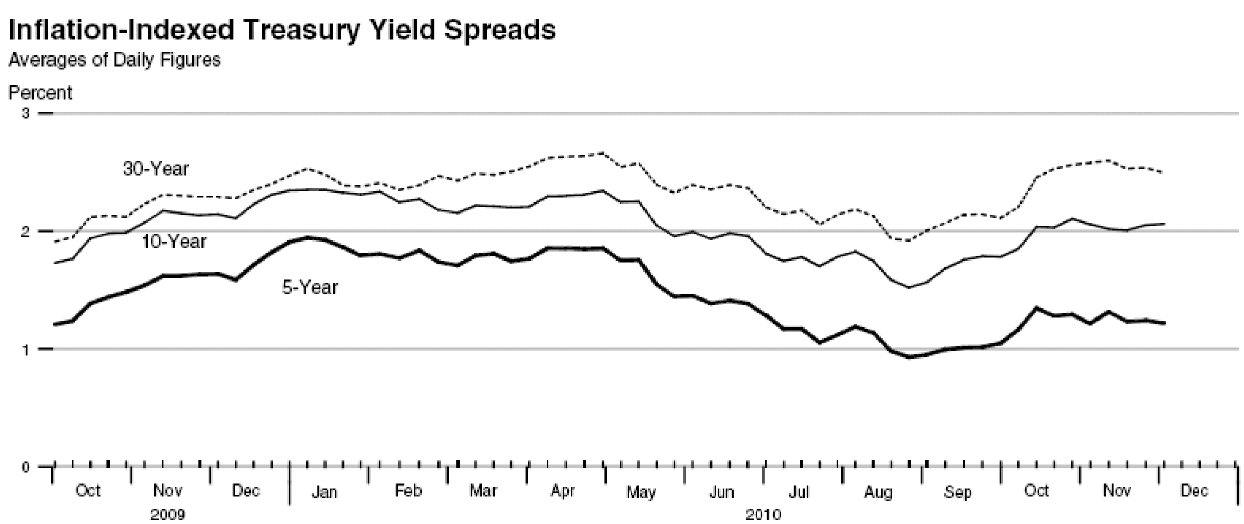
Today's release of the Consumer Price Index reports inflation over the past year (Nov. 2009 – Nov. 2010) to be 1.1 percent (http://www.bls.gov/news.release/pdf/cpi.pdf). The "core" inflation rate (omitting the volatile food and energy sectors) for that period was 0.8 percent. While much could be said about the pluses and minuses of CPI methodology, these are very modest numbers. No one is seriously maintaining that we currently have some kind of hidden inflation problem.

An inflationary future?

Rather, there is debate about what current and possible near-term monetary policy (of the Federal Reserve) and fiscal policy (the domain of Congress and the President) might be doing to future inflation rates. There certainly have been complaints that current stimulatory macro policy (including its effect on the federal budget deficit) inevitably is heading us toward some kind of eventual inflationary explosion. Proponents of that view tend to be believers in free markets. So what are those markets telling us about long-term expectations of inflation?

Fortunately, there is a readily-available means of determining what transactors in financial markets believe. The U.S. Treasury issues conventional securities of various durations. These pay a fixed dividend and repay the principal on maturity. It also issues inflation-adjusted securities — known as TIPs — that adjust the principal according to the CPI. The spread between conventional Treasuries and TIPs is essentially the market expectation of inflation over the maturity period.

The Federal Reserve Bank of St. Louis makes available a weekly chart of the spread:



As can be seen on the chart, financial markets currently predict that over the next 30 years, the CPI will rise an average of about 2.5 percent per annum. Over the next decade, the expected inflation rate is a bit over 2 percent per annum. And over the next five years, the expected rate is under 1.5 percent. These are not exactly Zimbabwe-style inflation expectations.

It is true that the expected inflation rates — as measured by these yield spreads — tend to rise and fall with current economic developments. Expectations rose in the past couple of months, but they are at the same modest levels seen last spring. At the very least, those who counsel against attempts to stimulate the economy should explain why their expectations of looming inflation are correct and why the financial markets have got it wrong. You can't both say that markets know best and that you know better.

The more general economic question

Particularly after the financial meltdown of 2008, there has been a fair amount of soul-searching in economics — especially macroeconomics — about the degree to which the economy can be forecast or about what we really understand about how a complex economy functions. A recent example is an NBER working paper by Harald Uhlig, "Economics and Reality," Sept. 2010 (http://www.nber.papers/w16416). The same issue was raised at the December quarterly economic forecast of the UCLA Anderson School that I attended.

Basically, it was suggested at the forecast conference that those who take strong positions of the op-ed variety typically have a pre-determined model in their head or on their computer. The model contains their view of how the economy functions, and, thus, their predictions and advice are based on predilections. That is certainly true, but what is the implication?

Calls for modesty in economic predictions and advice are warranted. But, ultimately, policymakers do have to make choices. It is always possible to create a scenario in the abstract in which there are inadvertent or perverse consequences of those choices. Nonetheless, choices have to be made.

If I am driving my car and a child darts into the street, my response will surely be to swerve away and hit the brakes. Is there a scenario in which that decision turns out to be a bad choice? Clearly, there is. I might lose control of the car and end up harming more people than if I had done nothing. Whether something worse happens will also depend on how other nearby cars and pedestrians react to the sudden emergency.

It is doubtful, however, that most people — confronted by a situation in which a child darts in front of them — would choose the conservative, do-nothing option. Yet in the economic sphere nowadays, there is no shortage of macro advice these days equivalent to saying that it's best to hit the child because doing anything else *might* — under some scenario — turn out to be worse.

The model in my head suggests that the best time to do nothing is when things are fine and no apparent problems are on the horizon. That isn't the case today.