Mitchell's Musings 9-14-15: Fed Up Or Not

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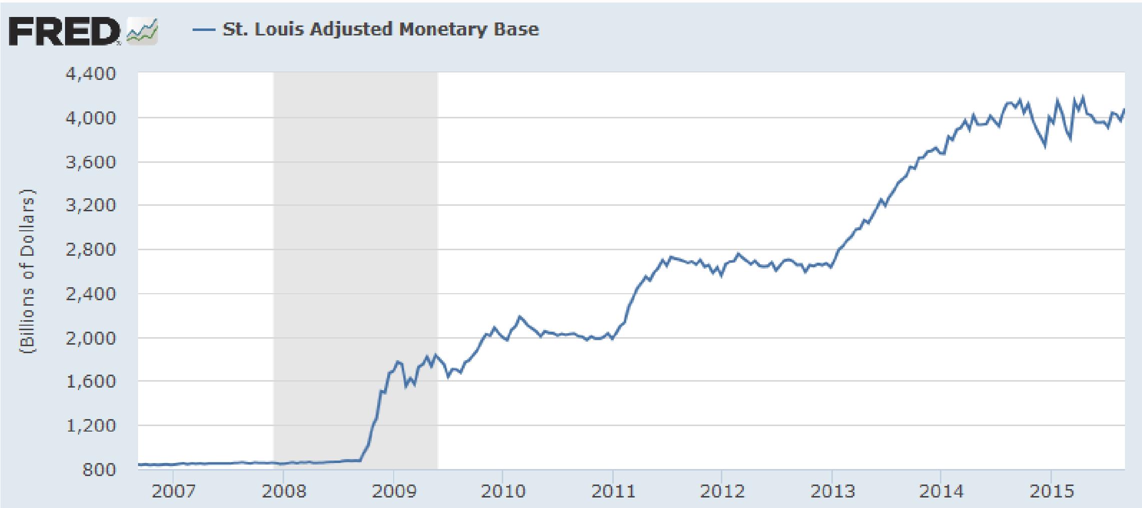
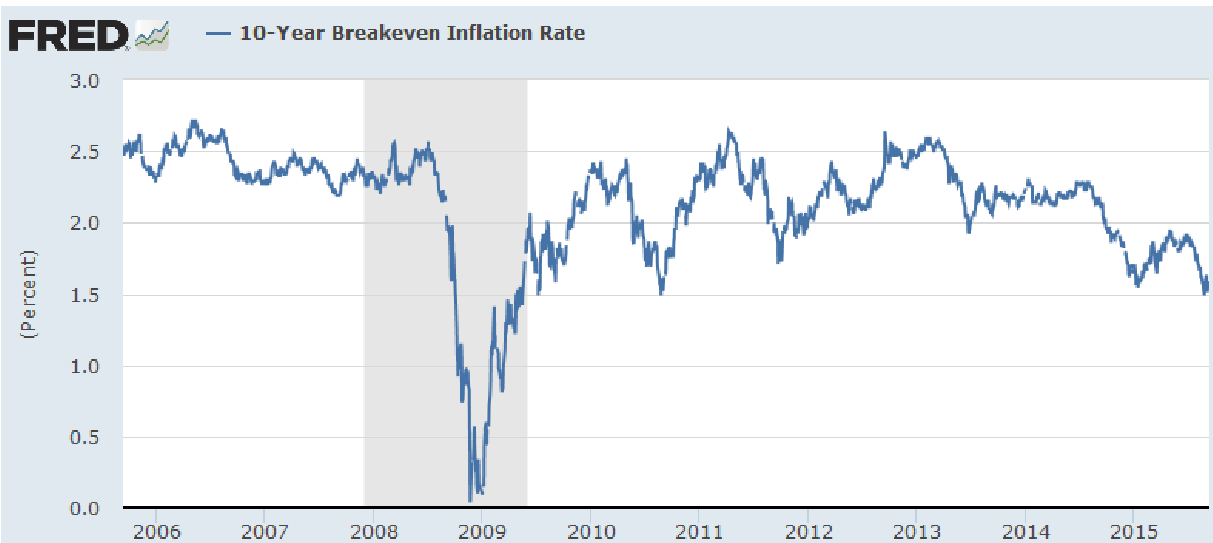
Imagine you are driving a car. If you depress the accelerator, the car tends to go faster as more gasoline flows into the engine. If you ease up on the accelerator, the reverse occurs. Over time, if anyone cared to do so, you could measure the average angle of the accelerator pedal relative to the floorboard for all the years you had been driving. I suppose you could say that this average angle was "normal" in some sense. But would anyone argue that at any point in time it was wrong to deviate from the "normal" angle? If you were driving up a hill, you would push the accelerator down to maintain speed so the angle would be below normal (average). If you were driving down a hill, you might take your foot off the pedal entirely. In neither of these situations would you say you were doing the wrong thing. You were simply adapting to driving conditions.

When it comes to Federal Reserve policy on interest rates, however, the notion that deviations from the norm are wrong and should be corrected ASAP, regardless of economic conditions, seem to be in the air. Interest rates are being kept low presently, which is seen as "abnormal" because on average they have been higher. Because the current level is abnormal, the Fed – it is argued - should raise rates. If the Fed doesn't raise rates, Bad Things will happen because, well, it's not normal for rates to be so low. The economy is sure to overheat and break out in inflation.

When you dig into it, there are folks who believe terrible things will happen if we don't revert to "normal" because there was much previous monetary creation by the Fed to combat the Great Recession and then to stimulate the recovery, as the chart below shows.



The problem is that there still is no sign of this inflation. Moreover, there is no sign that financial markets are currently expecting inflation. The 10-year "breakeven" inflation rate – the difference between 10-year inflation adjusted Treasury security yields and conventional 10-year Treasury yields shown below - has bounced around since the Great Recession (when something like the Great Depression was feared and zero inflation or less was projected). But the breakeven rate is currently in the 1.5-2.0%/annum range. So in what sense is the economy overheating or are financial markets expecting such overheating? The problem seems to be that for some folks, facts don't get in the way of theory.



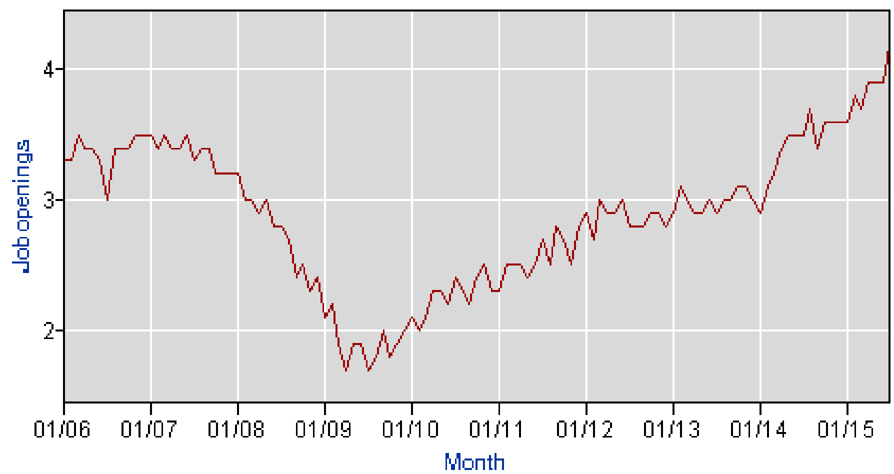
There is another strand of the argument that the Fed should be raising interest rates now, even though inflation isn't high. In this view, there is a "natural" rate of unemployment. Below that level, labor shortages will arise, employers will start bidding up wages (faster and faster the theory goes). The rising labor costs will show up in prices through markups and therefore will pass into price inflation.

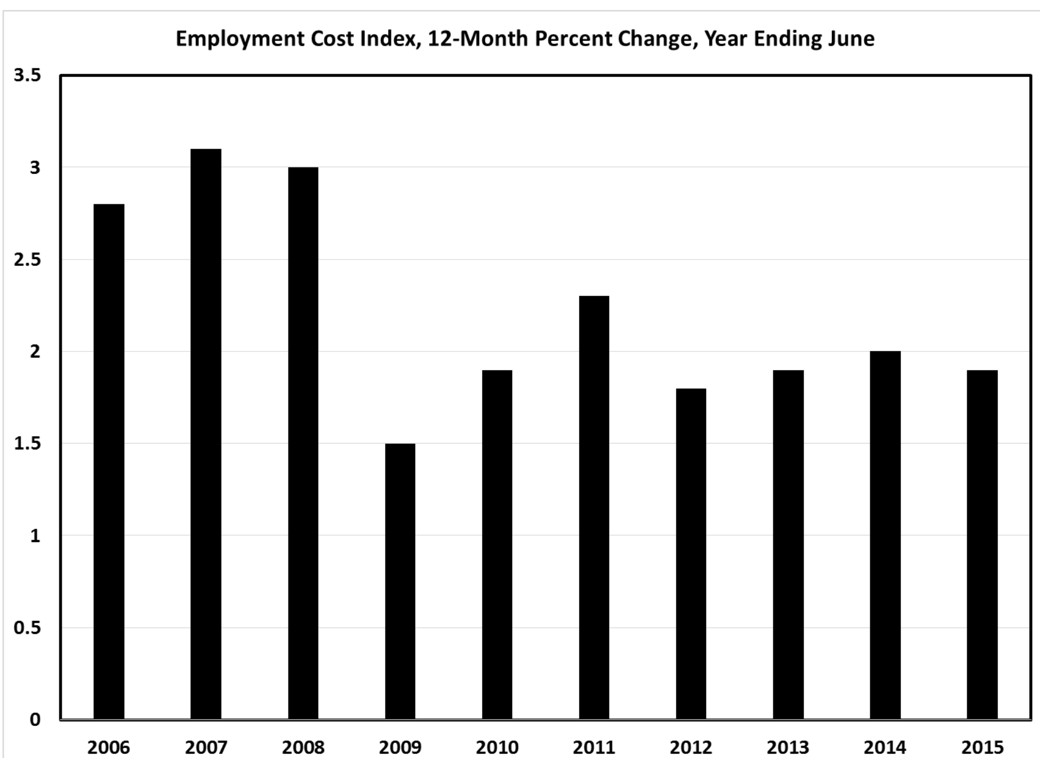
It is true that as the unemployment rate has declined in recent years, the U.S Bureau of Labor Statistics' (BLS) job openings (vacancy) rate has increased. In fact, the job openings rate (shown below) has exceeded its pre-Great Recession peak. But before panicking, there is a question as to whether we have the right story. Where is the ever-accelerating wage inflation? As measured by the latest release of the BLS Private-Sector Employment Cost Index, for example, accelerating wage inflation has yet to emerge, suggesting that past relationships are not holding.[1]

[1]Readers of these musings will know that in a prior post, I expressed the view that it looked like there was some acceleration in wage inflation. See http://employmentpolicy.org/page-1775968/3328512#sthash.1ymQLhfw.dpbs. But we have to let the latest data talk and right now that is not the tale they are telling.

Maybe the (new) natural rate of unemployment has yet to be reached. Maybe it has changed from whatever level it stood at prior to the Great Recession. Maybe the past is not prologue. There seem to be a lot of maybes here – too many – to make a major monetary policy decision based on old assumptions.

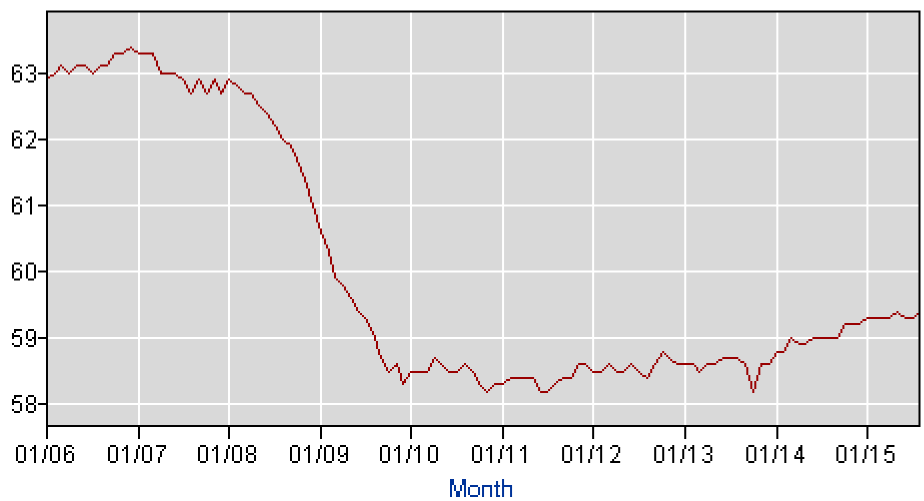
Private Sector Job Openings (Vacancy) Rate, Seasonally Adjusted





We know there have been other changes in the labor market apart from the old wage inflation/vacancy/unemployment link. For example, the employment-to-population ratio is well below its pre-Great Recession peak. So there may be more slack present in the labor market than is suggested by measured unemployment or vacancies. No one knows for sure.

Employment-to-Population Ratio, Seasonally Adjusted (Percent)



Apart from whether the wage/vacancy/unemployment rate relation is the same as it was, say, ten years ago before the Great Recession, there is still another question to be posed. The theory or story of the natural rate of unemployment is basically a labor market tale. It involves demand for labor pulling up wages and the resulting wage inflation being passed along into price inflation. The problem is that broad macro measures such as the unemployment rate are correlated with other broad measures such as estimates of the gap between actual GDP and "capacity." It's hard to say empirically which index we should be looking at or what the true story is.

At one time when unions were strong, stories of worker bargaining and labor costs passed into prices may have made sense. But today, the determinants of price inflation (which in the end is what the Fed cares about) may be largely a product market story, not a labor market story. We may be looking in the wrong place when it comes to predicting the point when price inflation will become a problem. All of which brings us back to our car analogy. The current position of the accelerator seems consistent with our current driving conditions. Current interest rate policy is not causing inflation. Why make a change?