

Dean Croushore Blog about Monetary Policy

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The Fed is Out of Patience

The Federal Reserve faces a difficult choice in setting monetary policy over the next six months. The economy is growing more rapidly than before, people are wealthier, and consumer spending is beginning to rise. In the past, in such a situation, the Fed would begin to tighten monetary policy, raising interest rates to prevent inflation from climbing. Tightening policy is even more important now that banks have over \$2 trillion in excess reserves that they could lend out, leading to a surge in the money supply and a classic inflation caused by too much money chasing too few goods.

But there are reasons to think the Fed does not need to tighten policy anytime soon. Inflation is actually declining sharply, not rising, thanks to the significant decline in energy prices that has occurred over the past few months. There is no sign of inflation in wages, so no wage-price spiral is apparent. The dollar is appreciating sharply, causing U.S. export firms anguish, lost profits, and reduced demand for their products. And if the Fed tightens policy prematurely, it might choke off the economic recovery.

The inflation rate in the PCE price index shows a large disparity between the overall inflation rate and the core inflation rate excluding food and energy prices (Chart 1). While some may worry about deflation (a negative inflation rate), the decline in energy prices may end soon and the overall inflation rate will then tend to revert to the core rate. So, the decline in energy prices is transitory and inflation will ultimately rise.

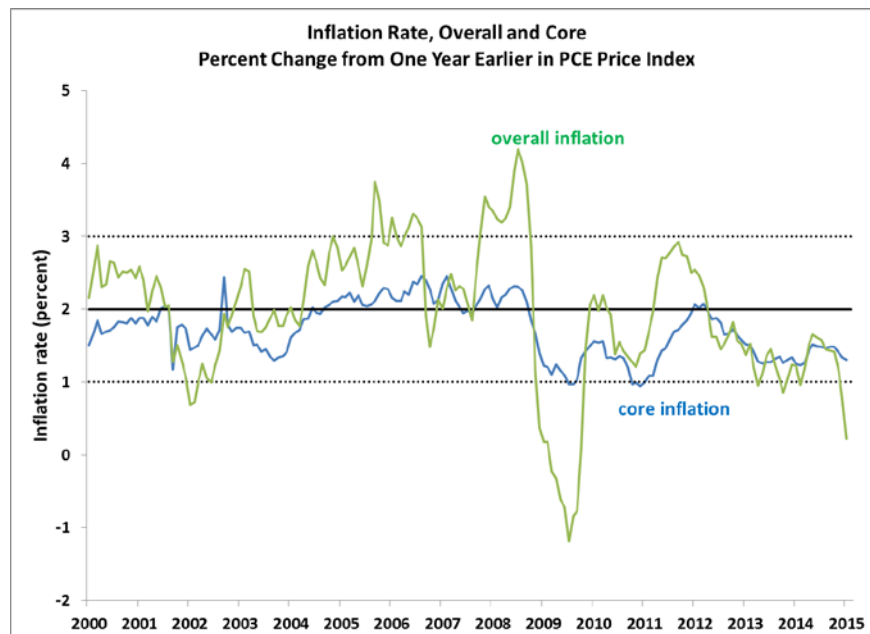


Chart 1. Inflation. The overall inflation rate, measured using the PCE price index, has declined sharply in the past few months. But the core inflation rate (excluding food and energy prices) remains in the desirable range of 1 to 3 percent.

The decline in energy prices is helping to stimulate the economy. Employment growth has increased substantially in the past few months, with the unemployment rate declining. More importantly, the economy's ratio of net worth to income has been restored to pre-financial-crisis levels (Chart 2) and people's debt service obligations as a percent of their incomes has declined and is at an all-time low (Chart 3).

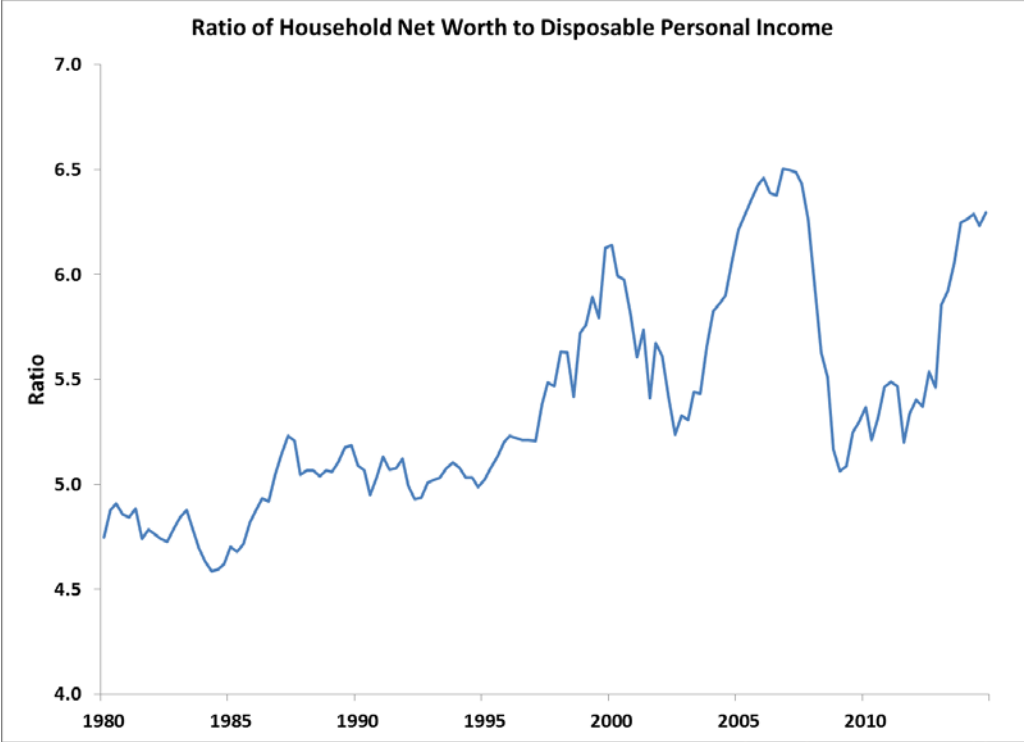


Chart 2. Ratio of Net Worth to Income. The improvement in the economy, increased saving, and increases in housing prices and stock prices have increased the ratio of wealth to income.

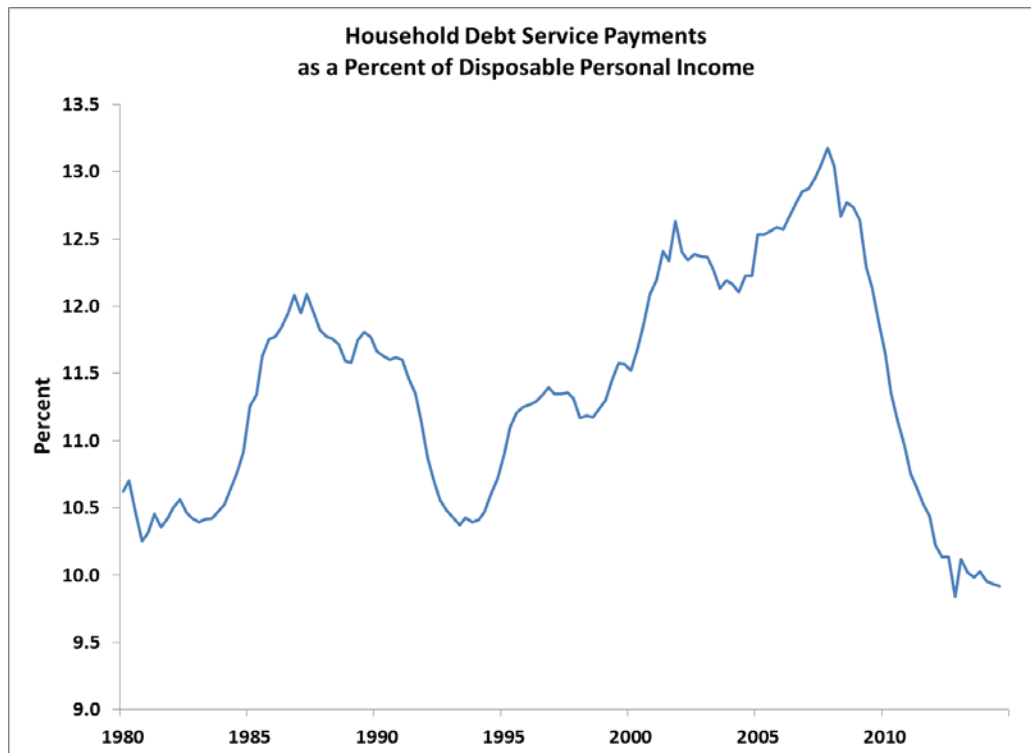


Chart 3. Debt Service Obligations as a Percent of Income. The combination of reduced debt and lower interest rates means that people are spending a lower proportion of their incomes on debt service.

The Fed has to trade off the potential for economic growth to lead to inflation in the future against the very low inflation rate right now. But with consumer spending likely to rise now that consumers feel wealthier, the Fed must consider the impact of economic growth on future inflation. Monetary policy acts on the economy and inflation with a substantial lag, so the Fed must be more concerned with future inflation and not the low inflation rate today. With banks in a very healthy condition and with a lot of excess reserves that they can lend, the money supply could increase very rapidly. The danger is that the Fed will wait too long to tighten policy and that inflation will surge.

For these reasons, the low inflation rate today is unlikely to deter policymakers from acting. The Fed is likely to remove the key word “patient” from its news release this week, with a rise in interest rates very likely in June. The financial markets may react sharply to these changes but in part that is because of substantial uncertainty about how high and how fast interest rates will rise. The rest of 2015 will be interesting!