

The Fed Gambles on Inflation

Over the past couple of decades, the Federal Reserve has coalesced around an idea about inflation that is little more than theoretical, with no real data to back it up. That “idea” is that 2% inflation is the “correct” amount of inflation.

The target is not just a one-year target, it is seemingly a permanent, long-term target. We find this idea very problematic. For example, the Fed’s favorite measure of inflation, the PCE deflator, has averaged 1.5% over the past decade. But the Fed now says it could let inflation in the future run high so that the long-run average rises to 2%. No one knows exactly what this means, but one interpretation is that the Fed is willing to have inflation run at 2.5% for the next ten years so that the 20-year average is 2%.

Really? Why? If we look back over the past ten years, low inflation didn’t hurt the economy, it helped it. Unemployment had fallen to 3.5% in February, the lowest since the 1960s. Yes, we know we’re just emerging from the problems related to COVID-19, but that’s an outside shock to the economic system, not something monetary policy can plan for ahead of time. It had nothing to do with the Fed or the level of inflation.

We have always believed that the underlying reason for the existence of the Fed was to maintain a stable value of the dollar. The most stable environment is one with no inflation. As Steve Forbes has always said, if a carpenter shows up at a job site and his yardstick is a different length than it was the day before, it is awfully hard to build a house, maybe impossible.

The same is true for the value of the dollar. It’s far more complicated to make an investment, build a plant, or sell goods to a foreign country if the value of your currency changes over time making the value of revenues and investment change with it.

This is what worries us about the commitment to 2% long-run inflation. No one knows exactly what it means, or for that matter, why it is appropriate. Again, inflation averaged 1.5% over the past ten years with no serious consequences to the economy. By allowing inflation to average 2.5% over the next ten years, how does that change the past? The answer: it can’t!

What it does do is change the future. In essence, the Fed is saying they really don’t have a 2% inflation target, they have a target above 2% for the foreseeable future. And this is worrisome. The money supply has exploded in recent months as the Fed has monetized federal debt. Inflation is on the way higher. For example, this year the Fed said the PCE Deflator would be 0.8%, but it is already 1.4%, and looks more likely to rise than fall.

And if it rises to 2.5%, the Fed will say that is OK, because the average over some period of time (which it can make up by using any number of years of history) is still 2%. Back in the 1970s, the Fed kept saying inflation was rising, but it was all because of temporary factors (like oil) and it would fall later. But, once inflation is out of the bottle, it doesn’t come down until the Fed tightens, like Paul Volcker did in the late 1970s and early 1980s.

So, letting inflation rise above 2% is potentially very dangerous. The Fed has created an artificial target and given itself an excuse for causing more inflation. If 2% is really the target, the Fed should claim victory when it is less than that and fight to keep it from rising above.

Unfortunately, the Fed is making arguments about inflation that are designed to give it freedom to do whatever it wants and that may actually lead to a devaluation of the US dollar. This is a violation of the real reason for the Fed and it worries us about the future of inflation in the United States.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
10-5 / 9:00 am	ISM Non Mfg Index – Sep	56.2	56.3	57.8	56.9
10-6 / 7:30 am	Int’l Trade Balance – Aug	-\$66.2 Bil	-\$67.2 Bil		-\$63.6 Bil
10-7 / 2:00 pm	Consumer Credit– Aug	\$14.0 Bil	\$14.8 Bil		\$12.2 Bil
10-8 / 7:30 am	Initial Claims – Oct 3	820K	815K		837K