Monetary Policy And Inflation

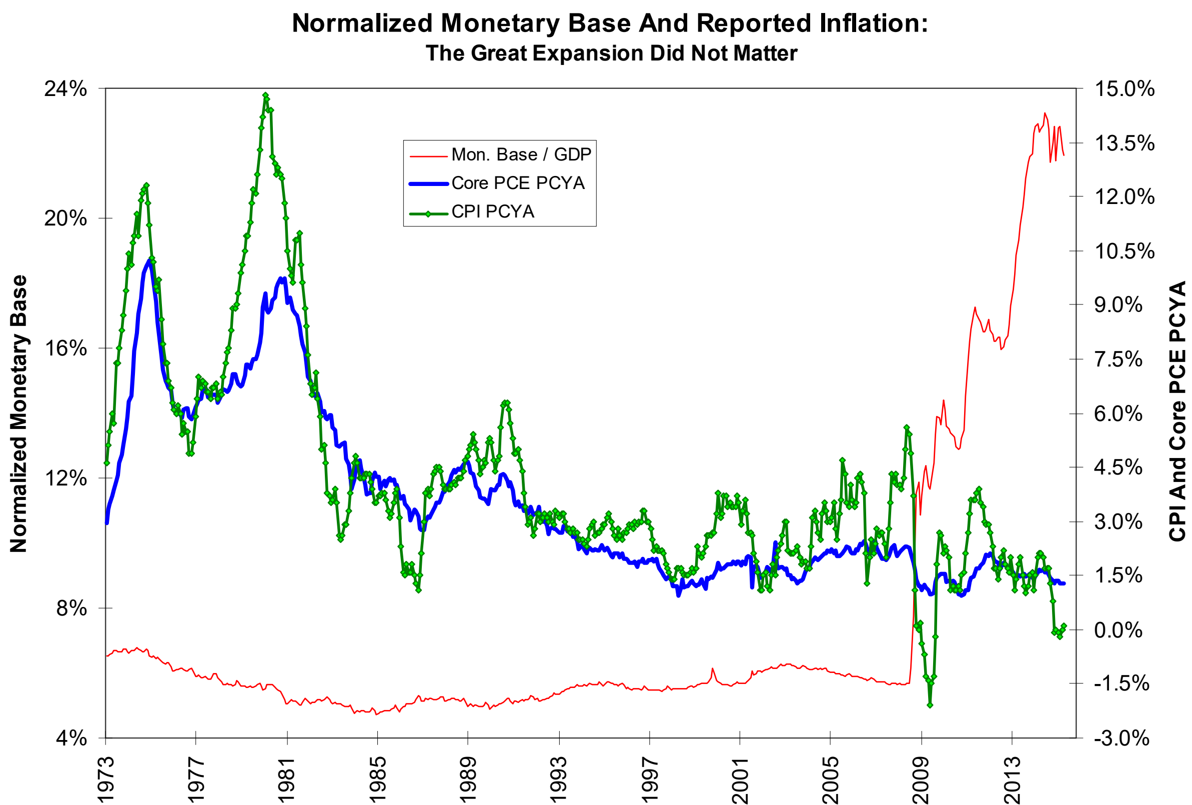
I felt halfway between being angered and amused at a story in Monday's *The Wall Street Journal* on the Phillips Curve, the alleged tradeoff between unemployment and inflation. Anyone who lived through eras such as the inflationary 1970s with its stagnant economic growth or periods such as the late 1990s and the present with declining unemployment and disinflationary pressures has every right and quite possibly every duty to demand evidence for this theory. As it is embedded in many econometric models, it has consequences and leads policymakers to make ill-considered decisions.

Off-Base

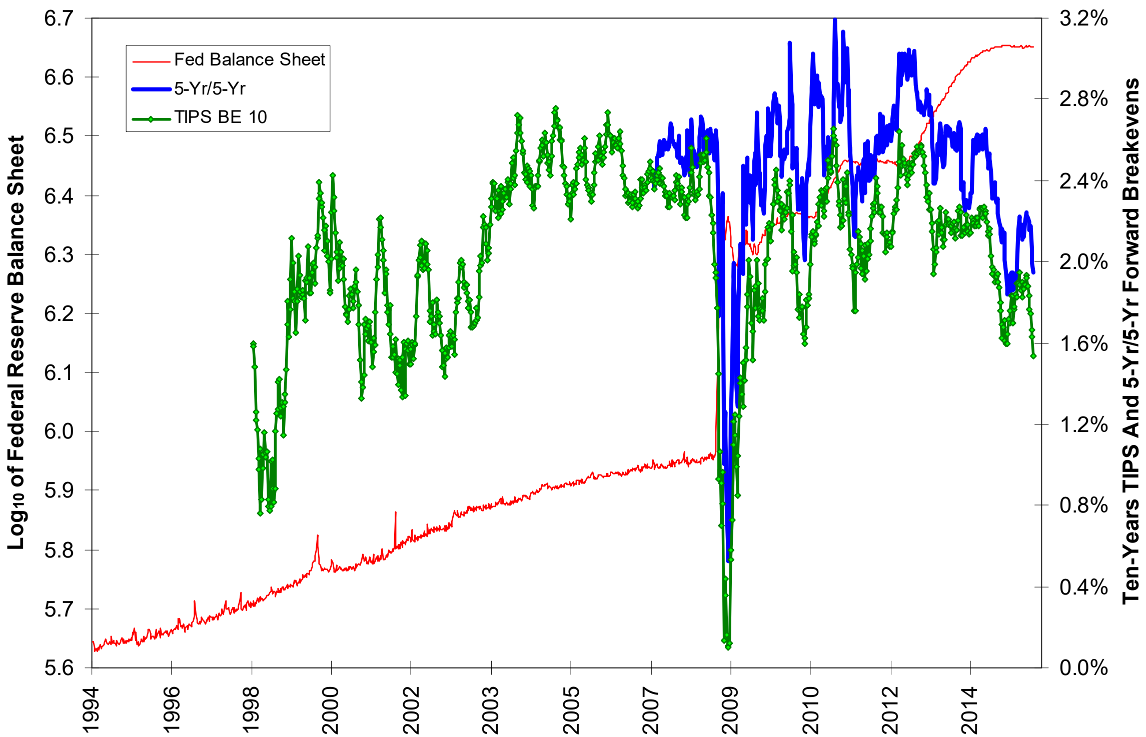
The central hubris of monetary policy is that it has deterministic outcomes, a fancy way of saying when you turn the steering wheel clockwise you expect the car to turn right. One of the Federal Reserve's stated goals is to destroy the purchasing power of the dollar at a 2% annual rate, and they believe low interest rates and their own bloated balance sheet will lead to this outcome. The data say otherwise.

The monetary base normalized to GDP peaked at 23.2% in August 2014 and pulled back to 21.9% in June, the last available datum for GDP. While the monetary base has contracted 2.80% since August 2014, it is unlikely the Federal Reserve will allow it to contract significantly even if short-term interest rates are raised in September.

The relationship between the normalized monetary base and reported measures of inflation during the ZIRP and recently concluded QE eras has been nonexistent at best and arguably inverse. While the collapse is energy prices over the past year affected headline CPI, core PCE has been in a secular downtrend for almost 35 years.



The Federal Reserve's balance sheet has stopped expanding with the end of QE and actually stands 0.19% below end-2014 levels. However, both ten-year TIPS breakevens of five-year/five-year forward breakevens moved independently of the Federal Reserve's balance sheet after QE1 began and have continued to move independently during both the tapering era and its aftermath. Both measures of expected inflation have declined significantly of late and the ten-year TIPS breakeven broke through its January low on Monday.



Milton Friedman's famous dictum inflation is always and everywhere a monetary phenomenon remains true. However, there can be and are differences between the monetary outcomes and monetary policies. Central banks continuously find themselves trumped by the yield curve, by currency exchange rates and by the ability of the commercial banking system to convert the monetary base into credit in their efforts either to stem inflation, as in the 1970s, or to increase it today.

Unless someone can demonstrate theories work in reality, why should they be allowed to keep repeating experiments in the vain hope they will work someday, out of sheer luck if nothing else?