Inflation Dynamics and the Current Monetary Policy Debate

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Inflation: Drivers and Dynamics
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Policy issues

- Should monetary policy continue to be exceptionally accommodative?
- Should the Fed do more to achieve “maximum employment”?
- Should the Fed do more to defend price stability?
- Is inflation too low?
- Is unemployment too high?
Research questions

- Measurement of inflation.
- Costs of inflation.
- Monetary policy transmission mechanism.
- Determinants of inflation (Phillips curve).
- Measurement of “resource” slack—“natural” rates.
- Inflation expectations (anchoring, forecasting, learning).
Inflation and T-bill rate

Current environment more similar to period *before* Great Inflation.
“Maximum employment” a policy objective. Interpretation has evolved over time. Renewed emphasis during crisis may explain continuing excessive policy accommodation.
Fed used to focus on GNP/GDP deflator and CPI measures but more recently has changed focus to PCE deflator.
Which inflation?

“Core” measures reduce noise and are useful for communication.
Which inflation?

Numerous alternative measures of “core” can be constructed.
Recent trend in inflation?

At times, alternative measures can give conflicting signals.
Recent trend in inflation?

Has inflation been trending up or moving sideways?
Appropriate, in light of low inflation?
Current policy?

Appropriate, in light of low inflation *despite* low unemployment?
Current policy?

Behind the curve already?
Behind the curve with overheated labor market. In contrast to Great moderation era, policy not normalized preemptively.
Policy risks

- How risky is it to maintain exceptional accommodation?
- Answer depends on current reading of data and views about the stability of inflation expectations, the Phillips curve and business cycle dynamics.
- Should we rely just on linear models for risk analysis?
- Are inflation expectations linear processes?
- What if recessions are non-linear events?
- What if the Phillips curve is nonlinear?
The Phillips curve

Inflation pressure

Underemployment/Resource gap
A flat Phillips curve

Risks of undershooting unemployment appear low when Phillips curve is perceived to be flat.
At worst, aiming to reduce unemployment further will only result in a slight increase in inflation.
A flat Phillips curve

At best, perhaps it will be learned that the natural rate is even lower than currently believed to be.
A nonlinear Phillips curve

Resource gaps do not materially influence inflation when small. As long as the unemployment rate is close to the natural rate, price stability is preserved.
A nonlinear Phillips curve

Where is the US economy at present? Median CPI readings suggest economy may be at the edge of the “safe” region.
A nonlinear Phillips curve

Continued accommodation with overheated labor market today will necessitate massive tightening to restore price stability in the future.
The policy debate and research on inflation

- Uncertainty regarding inflation dynamics should not be an argument for delaying policy normalization.

- Fed appears to be placing greater emphasis on “maximum employment” relative to price stability than was the case during the Great Moderation era.

- Maintaining excessive policy accommodation will likely set a costly dilemma for the Fed. As the economy overheats:
  - the Fed will need to tighten abruptly to maintain price stability, likely precipitating a recession, or
  - the Fed will tolerate an upward drift in inflation, as it has done before the Great Moderation era.

- More research leading to better answers to the open research questions would be of immense help.