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Is U.S. Monetary Policy Creating an Inflationary Environment?

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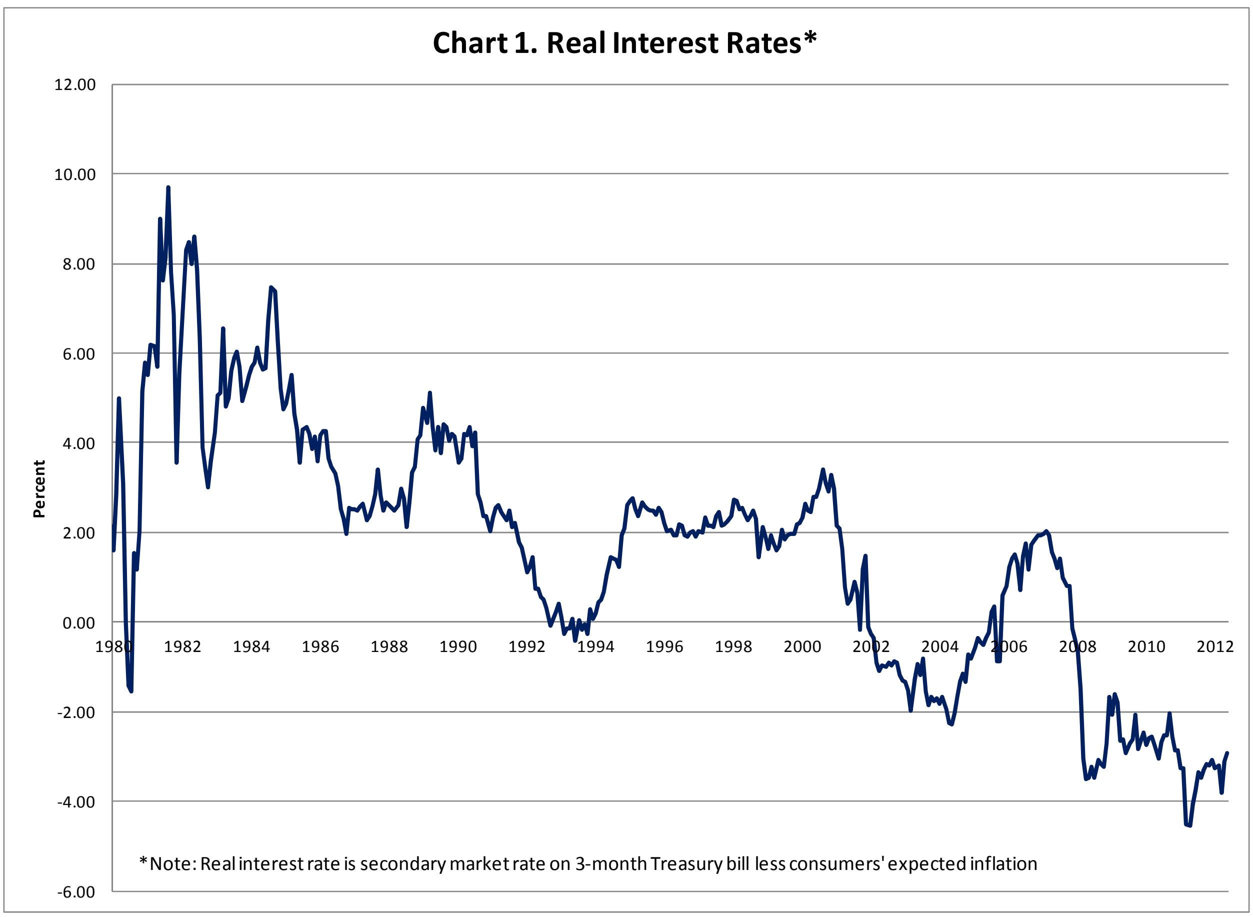
With the U.S. economy still performing poorly, U.S. monetary policy remains quite easy. Because expected inflation is greater than short-term interest rates, real short-term interest rates are negative. In addition, the Federal Open Market Committee (FOMC) announced on Wednesday, June 20 that it will take steps to further reduce long-term interest rates by selling some of the shorter-term government bonds it holds and using the proceeds to buy longer-term government bonds. Is the conduct of monetary policy creating an environment in which we should worry about inflation?

Evidence of Monetary Ease

The most convincing evidence of monetary ease is real short-term interest rates—that is, interest rates on short-term treasury bills minus expected inflation. In late 2007, the FOMC began targeting interest rates below expected inflation, and that action has yielded negative real interest rates for nearly five years (Chart 1).



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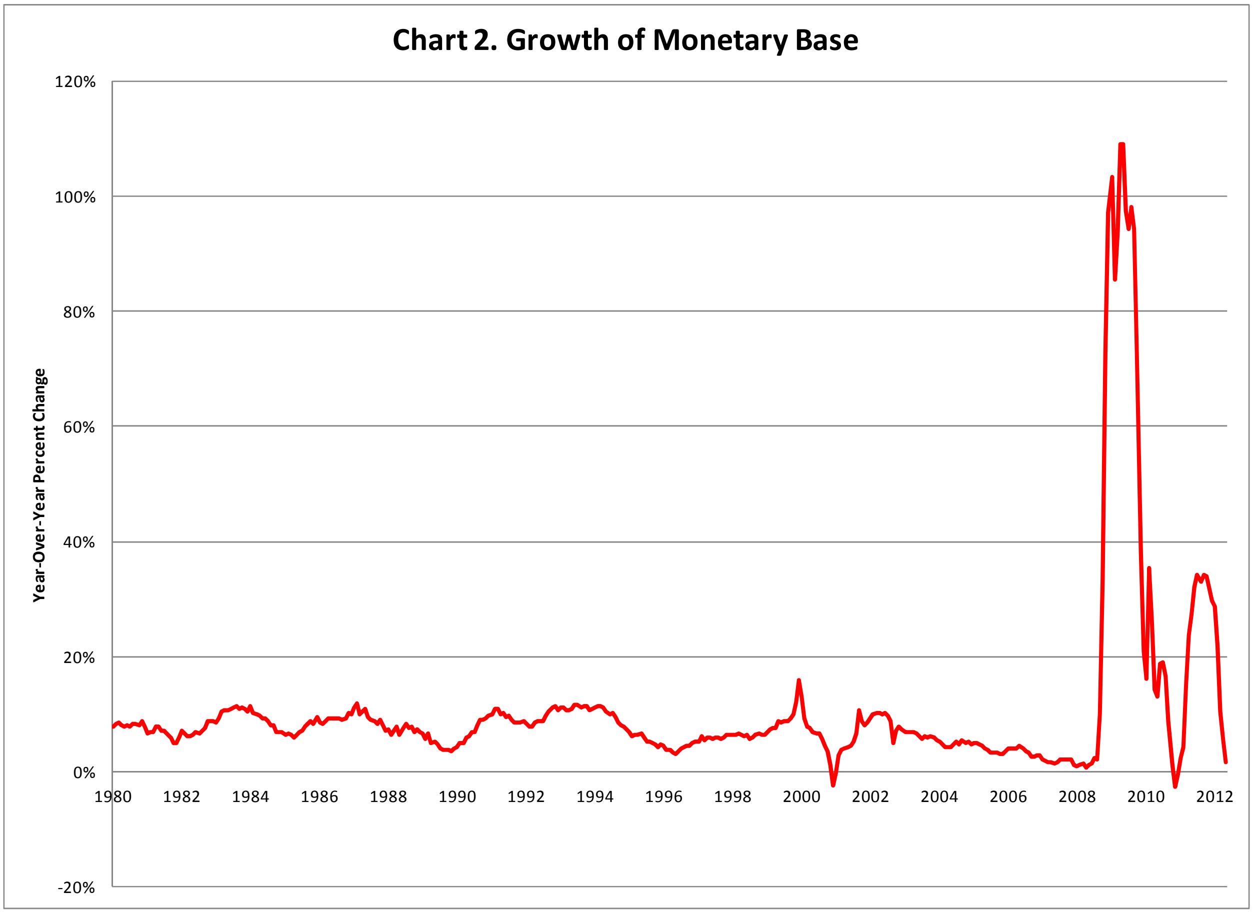
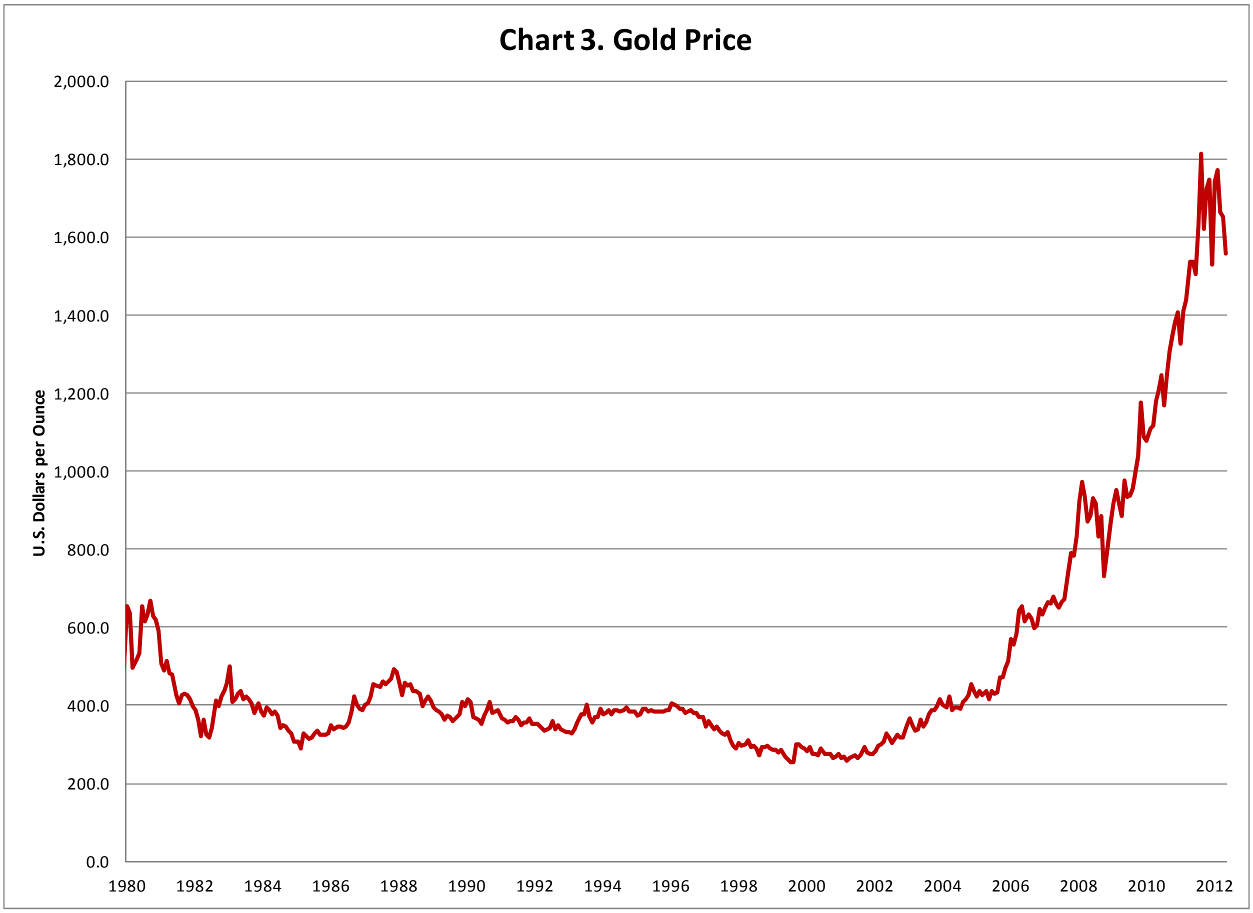
To maintain these exceedingly low real interest rates, the Federal Reserve System (Fed) greatly boosted monetary liquidity. Since late 2007, the U.S. monetary base has grown at a 28.3 percent annual rate (Chart 2).[1] The biggest gains occurred in 2008 and 2009, when some year-over-year growth rates in the monetary base were around 100 percent.



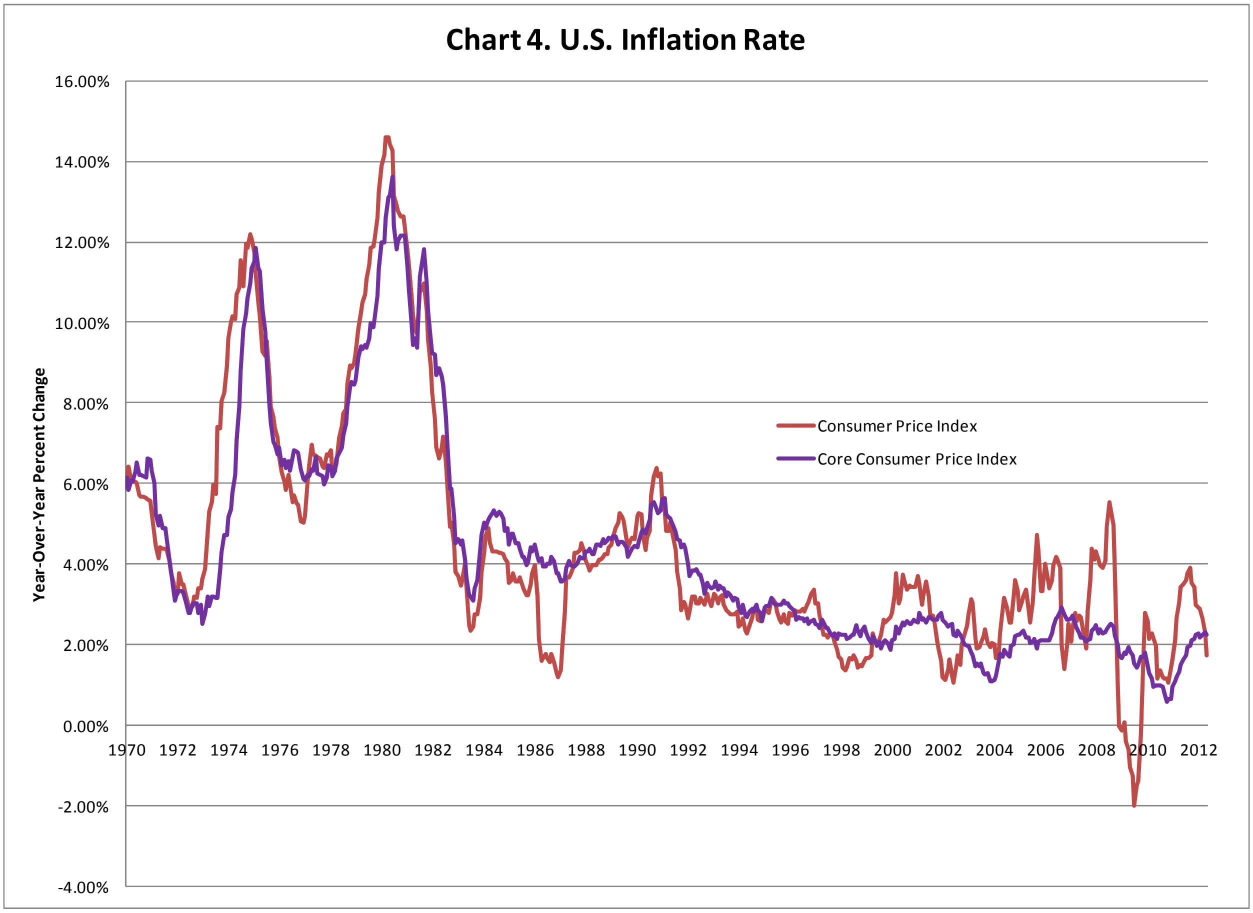
[1] The monetary base is a relatively narrow measure of money. It includes cash and reserve accounts that commercial banks hold at the Fed.

Gold Prices Suggest Possible Inflation;
Actual Inflation Remains Subdued

Gold prices typically rise in an inflationary environment or from fears that monetary policy is creating an inflationary environment. In the first four years after U.S. monetary policy took real short-term interest rates negative, the price of gold rose by 121 percent, which provides a strong indication of inflationary fears (Chart 3). After reaching a high in November 2011, however, gold prices have slipped by 11 percent, perhaps because the feared inflation had not been realized or the dollar began strengthening.



U.S. inflation has been relatively subdued. As measured by the consumer price index (CPI), inflation has been fairly volatile over the past five years, but it has averaged about 2.0 percent (Chart 4). Much of the volatility in the CPI owes to fluctuations in food and energy prices. Excluding food and energy prices from the index yields a much less volatile series known as "core CPI." Core CPI shows inflation has averaged 1.8 percent over the past five years. By the historical standards set over the past 40 years, these inflation rates are quite low.

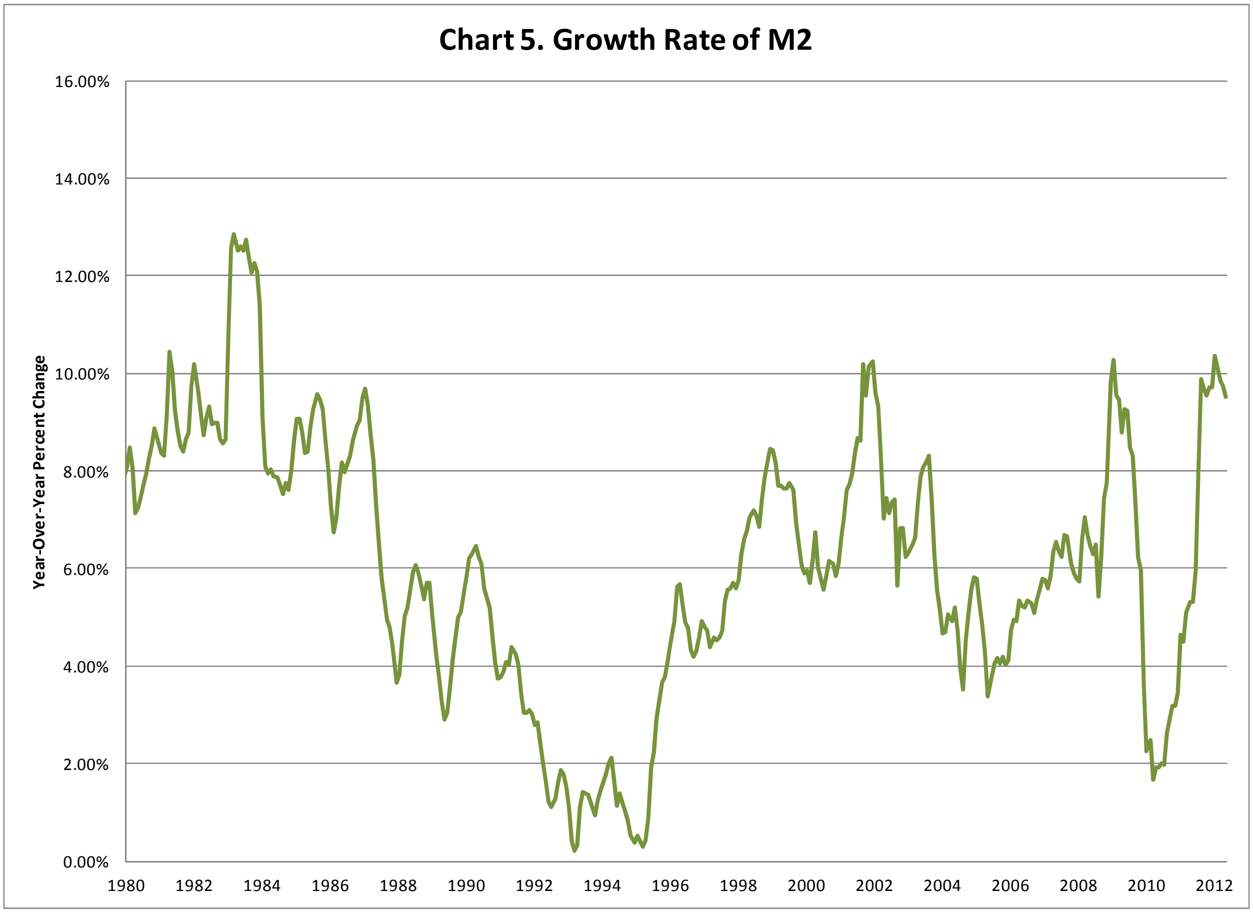


Why Not Much Inflation?

Several different reasons have been offered for monetary ease not generating much inflation. One reason offered for lack of inflation is that the broader monetary aggregates—such as M2—have not grown nearly as rapidly as the monetary base.[2] Another reason offered for the lack of inflation is the considerable excess capacity in the economy. Both of these developments are the result of the financial crisis that created the most recent recession.

[2] M2 includes the monetary base plus checking and savings accounts.

Examining M2, we do find that it has grown much more slowly than the monetary base since late 2007, with the former showing an annualized growth rate of only 6.6 percent over the past 4½ years (Chart 5). As the Fed pushed more liquidity into the economy through the monetary base, it found weaker growth in the broader monetary aggregates. Because commercial banks have not been lending very much, they have not turned all of the additional liquidity provided by the Fed into equally strong growth of M2.



Nonetheless, the growth rate of M2 since late 2007 is consistent with a considerably higher inflation rate than we have actually seen. Given the annualized growth rate of real GDP has been only 0.3 percent since late 2007, we might have expected an annualized inflation rate of more than 6 percent since late 2007. In fact, the velocity of money—which measures the amount of economic activity supported by a given quantity of money—has dropped considerably over the past five years.

The drop in velocity suggests a different explanation for relatively mild inflation—the considerable excess capacity in the economy. At 8.2 percent, the U.S. unemployment rate is much higher than the 5.6 percent rate the Congressional Budget Office (CBO) estimates as the natural rate of unemployment. Similarly, the first quarter 2012 reading of U.S. GDP was 5.5 percent below potential. With such excess capacity in the economy, competition keeps prices from rising, and inflationary pressure remains subdued.

The Inflation Outlook

These findings suggest that current monetary ease is unlikely to generate much inflationary pressure in the near future. Inflation is likely to remain subdued as long as the U.S. economy has considerable excess capacity. As the economy nears full capacity and the relationship between money and the economy tightens, however, the Fed must be prepared to act quickly to remove any excess liquidity. Otherwise, the liquidity will quickly turn into inflationary pressure.

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