Rodney’s Take

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The Fed Adopts Repression in All But Name

I’m not sure what it sounds like when central bankers get together to hammer out internal policies. Do they scream and yell? Do they call each other names, or say things like, “You’re such a monetarist!”, or wear t-shirts that say, “Neoclassical Economics Are Dead”? Somehow, I think the inner workings are just as staid and reserved as I picture in my head, which is a shame. It’s way more fun to think of the Fed governors duking it out over abstract theories.

But even if their conversations are likely tame, the outcome of their year-long review could set off fireworks. When it moved from a 2% inflation target to an average of 2%, the Fed gave itself room to let inflation eat away at the value of money for however long the bankers want, and there’s nothing the rest of us can do about it. The federal government should send the Fed a thank you note. The rest of us should be planning what we’ll do when the inflation storm arrives. It won’t be today, but it will happen.

The Fed announced last week that it had concluded its internal review of how it handles, or rather when it handles, inflation. The central bank is shifting from targeting 2% inflation to focusing on maximum employment, with inflation secondary. Inflation has run below 2% in the last decade, but the Fed now will allow inflation to run higher than 2% as long as employment is expanding. Fed Chair Powell clarified that the bankers won't be bound by any pesky math. The Fed won't say over what period the 2% average inflation will be calculated, how much higher than 2% it will be allowed to run, or even what level of employment will be considered "full" employment.

In other words, they'll treat the limit on inflation like the courts treat pornography… they won't define it, but they'll know it when they see it.

The immediate effect of this is a big, fat "nothing burger." The Fed hasn't been able to generate sustained 2% inflation in its preferred measure for years. Inflation will have to reach that level before it can run higher. That's not a 2020 concern or even a 2021 concern, but it will be at some point.

Buried in the Fed's statement on inflation was a recognition that, due to demographic factors, productivity growth has slowed dramatically since the 1990s. The estimated long-run economic growth rate for the U.S. has fallen from 2.5% to 1.8%. As the Fed and Treasury pump more money into the economy to "save" us, they're pouring fuel into a slow-running machine. Eventually, the outcome will be inflation, once the extra money is used to increase demand beyond what it otherwise would be. We saw it in stocks and bonds, and now we're seeing it in construction. For example, consider the price of lumber, up 100% this year as builders try to catch up with debt-fueled demand.

This might not sound so bad, but remember that the Fed is telling us it will not react to rising prices, which will keep interest rates exceptionally low even as inflation, when it finally arrives, eats away at purchasing power. Allowing the gap between interest rates and inflation to expand gives a tremendous benefit to borrowers at the expense of savers. I've talked about this before; it's financial repression, and it benefits the biggest borrower, Uncle Sam, more than anyone else.

The central bankers know that there's zero chance of any of this happening soon. They're trying to set our expectations for the future. If we believe the Fed will hold interest rates exceptionally low and continue to purchase bonds long after the economy has stabilized, then we might be a bit fearful of rising prices, which would make us willing to spend a bit more today.

Maybe.

But if we don't want more stuff and are trying to sock away assets for our retirement, then inflation for the sake of employment will be an investment burden. If we don't want our assets to be drained away through the loss of purchasing power, then we need to know where we will go when the time comes: perhaps inflation-friendly assets like real estate and commodities or even investing in emerging markets.

Again, this isn't something we have to worry about today, but the Fed just gave us ample notice of how it plans to proceed for years to come. Their previous approach lasted almost 50 years. We'd be wise to take them at their word and map out a plan of action before the need arises.

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Got a question or comment? You can reach us at info@hsdent.com.