Yellen fears banks' inflation forecast models broken
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By Rich Miller, Bloomberg

Federal Reserve chair Janet Yellen is concerned that the standard models central banks use to forecast inflation may be broken.

Behind her disquiet: the failure of the models to foresee the path of prices in the US during the last recession and its aftermath and in Japan during its deflationary period from 1998 to 2012. US inflation has been higher than the simulations suggested, while Japanese price declines proved more persistent.

Yellen alluded to her concerns in a speech last week, saying the Fed has to "watch carefully" to see if inflation rises as the central bank projects — and hopes — during the next few years.

If it doesn't look as if this is happening, Yellen suggested the Fed would keep short-term interest rates near zero as it seeks to avoid Japan's experience of a prolonged period of falling prices and wages and a stagnant economy.

"The slower the projected progress" toward the Fed's 2% inflation goal, "the longer the current target range for the federal funds rate is likely to be maintained," she told the Economic Club of New York on April 16, 2014.

Investors are looking for the central bank to begin raising rates by September of next year, according to trading in the federal funds futures market in Chicago. Inflation, as measured by the personal-consumption-expenditure price index, has been below the Fed's target for 22 months; it was 0.9% in February 2014.

Inflation Expectations

Standard computer models rest on two main pillars in trying to forecast longer-run price pressures: the amount of slack in the economy, usually measured by unemployment, and inflation expectations.

The higher the joblessness rate is above its so-called natural rate, the harder it is for employees to win pay increases and for inflation to accelerate. Yellen pegs that

natural rate — at which price increases neither speed up nor slow down — at 5.2% to 5.6%. Unemployment in March 2014 was 6.7%.

The more anchored expectations are in the models, the less likely price rises will stray from the central bank's target.

The trouble is the recent experience of the US and Japan calls both hypotheses into question.

The behavior of US inflation during the financial crisis has been "deeply puzzling," Christina and David Romer, co-directors of the National Bureau of Economic Research's Monetary Economics Program, wrote in a report earlier this year. With unemployment more than doubling to 10% in October 2009, the traditional models suggested the US should have suffered from deflation, the Romers said. It did not, though price acceleration did slow.

Full Understanding

"We remain far from having a full understanding of the recent behavior of inflation," wrote the Romers, who are professors of economics at the University of California at Berkeley. Christina Romer is also a former chair of president Barack Obama's Council of Economic Advisers.

Yellen referred to the conundrum in her speech last week. "During the recovery, very high levels of slack have seemingly not generated strong downward pressure on inflation," she said. "We must therefore watch carefully to see whether diminishing slack is helping return inflation to our objective."

One potential explanation, according to research by economists Mary Daly and Bart Hobijn of the Federal Reserve Bank of San Francisco, lies with the unwillingness of many employers to reduce wages outright when their sales collapsed during the recession. That helped prevent the country from sinking into deflation. It also sheds light on why some businesses have been so stingy since then with raises.

Japan Puzzle

Japan poses another puzzle for inflation modelers. As noted this month by the International Monetary Fund in its World Economic Outlook, Japanese "inflation expectations remained positive for many years, even as the economy slid into deflation."

Japanese consumer prices fell by an average annual 0.2% from 1998 through 2012, while inflation expectations as measured in the Japanese government bond market averaged a positive 0.2%, according to data compiled by Bloomberg.

The Fed's forecast of higher inflation in the years ahead "rests on the view that inflation expectations will remain well anchored near 2% and provide a natural pull back to that level," Yellen said last week. "But the strength of that pull in the unprecedented conditions we continue to face is something we must continue to assess."

The Japanese example "is a worrisome one," John Williams, president of the San Francisco Fed, said in an April 21, 2014 interview.

Pricing Power

Department-store chains and clothing sellers are among the companies feeling a pinch from a lack of pricing power.

Michael Nicholson, chief financial officer of Ann Inc, with womenswear brands such as Ann Taylor and Loft, said on a March 14, 2014 conference call that he sees "a very promotional environment in terms of the consumer" so far this year.

At Macy's Inc, consumers are "putting importance on value and pricing," chief financial officer Karen Hoguet told analysts at a consumer conference on March 25, 2014. While that isn't new for the Cincinnati-based retailer, "it's something we will continue to deal with going into the future."

Most Fed policy makers see inflation climbing to 1.5% to 2% by the end of next year and 1.7% to 2% at the end of 2016, according to projections released on March 19, 2014. Williams said it will increase as some of the temporary forces that have held it down — including lower import prices and restrained health-care costs — dissipate.

Volatile Costs

After stripping out volatile food and energy costs, inflation was 1.1% in February 2014. This so-called core rate probably rose to 1.2% last month and will increase to 1.3% to 1.4% in April 2014, Michael Feroli, chief US economist at JPMorgan Chase & Co in New York, wrote in an April 15, 2014 note to clients.

Further rises are likely, according to Drew Matus, deputy chief US economist at UBS Securities LLC. He sees the core rate increasing to 1.9% by the end of this year and 2.5% by the end of 2015.

Such a rise would call into question the wisdom of buying 10-year Treasury notes at around current yields, he added. The yield was 2.68% at 5pm yesterday in New York, according to Bloomberg Bond Trader data.

Yellen, 67, is overestimating the amount of slack in the labor market and underestimating the risk that inflation will rise, Matus said. He reckons the natural rate of unemployment is about 7% because many of the jobless have been out of work for a while and thus lack skills companies are looking for.

“We’re definitely in an area where you have to be worried about inflation,” Matus said.

Concerned Colleagues

Some of Yellen’s colleagues on the central bank’s policy-making Federal Open Market Committee also are concerned.

“Given the large amount of monetary accommodation that we have added and continue to add to the economy, I think there is some upside risk to inflation in the longer term,” Charles Plosser, president of the Federal Reserve Bank of Philadelphia, said in a March 6, 2014 speech in London.

He has repeatedly stressed how hard it is to determine the amount of slack in the economy and warned against relying on particular economic models to conduct monetary policy.

Yellen, for her part, is more worried inflation will continue to undershoot the Fed’s target than overshoot it.

“The FOMC is well aware inflation could also threaten to rise substantially above 2%,” she said in New York last week. “At present, I rate the chances of this happening as significantly below the chances of inflation persisting below 2%.”

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