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Is Inflation Returning?
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CAMBRIDGE – Inflation is now low in every industrial country, and the combination of high unemployment and slow GDP growth removes the usual sources of upward pressure on prices. Nevertheless, financial investors are increasingly worried that inflation will eventually begin to rise, owing to the large expansion of commercial bank reserves engineered by the United States Federal Reserve and the European Central Bank (ECB). Some investors, at least, remember that rising inflation typically follows monetary expansion, and they fear that this time will be no different.

Investors have responded to these fears by buying gold, agricultural land, and other traditional inflation hedges. The price of gold recently reached a four-month high and is approaching $1,700 an ounce. Prices per acre of farmland in Iowa and Illinois rose more than 10% over the past year. And the recent release of the US Federal Reserve Board's minutes, which indicate support for another round of quantitative easing, caused sharp jumps in the prices of gold, silver, platinum, and other metals.

But, unlike private investors, Fed officials insist that this time really will be different. They note that the enormous expansion of commercial banks' reserves has not led to a comparable increase in the supply of money and credit. While reserves increased at an annual rate of 22% over the past three years, the broad monetary aggregate (M2) that most closely tracks nominal GDP and inflation over long periods of time increased at less than 6% over the same three years.

In past decades, large expansions of bank reserves caused lending surges that increased the money supply and fueled inflationary spending growth. But now commercial banks are willing to hold their excess reserves at the Fed, because the Fed now pays interest on those deposits. The ECB also pays interest on deposits, so it, too, can in principle prevent higher reserves from leading to an unwanted lending explosion.

The Fed's ability to pay interest is the key to what it calls its "exit strategy" from previous quantitative easing. When the economic recovery begins to accelerate, commercial banks will want to use the large volume of reserves that the Fed has created to make loans to businesses and consumers. If credit expands too rapidly, the Fed can raise the interest rate that it pays on deposits. Sufficiently high rates will induce commercial banks to prefer the Fed's combination of liquidity, safety, and yield to expanding the quantity of private lending.

That, at any rate, is the theory; no one knows how it would work in practice. How high would the Fed – or the ECB, for that matter – have to raise the interest rate on deposits to prevent excessive growth in bank lending? What if that interest rate had to be 4% or 6% or even 8%? Would the Fed or the ECB push its deposit rate that high, or would it allow a rapid, potentially inflationary lending growth?

The unusual nature of current unemployment increases the risk of future inflation still further. Nearly half of the unemployed in the US, for example, have now been out of work for six months or longer, up from the traditional median unemployment duration of just 10 weeks. The long-term unemployed will be much slower to be hired as the economy recovers than those who have been out of work for a much shorter period of time.

The risk, therefore, is that product markets will tighten while there is still high measured unemployment. Inflation will begin in product markets, rather than in the labor market. Businesses will want to borrow, and banks will want to expand their lending. Under these conditions, the Fed will want to raise the interest rate to prevent an acceleration of inflation.

But, if the unemployment rate is then still relatively high – say, above 7% – some members of the Fed's Open Market Committee may argue that the Fed's dual mandate – low unemployment as well as low inflation – implies that it is too soon to raise interest rates.

There could also be strong pressure from the US Congress not to raise interest rates. Although the Fed's legal "independence" means that the White House cannot tell the Fed what to do, the Fed is fully accountable to Congress. The recent Dodd-Frank financial-reform legislation took away some of the Fed's powers, and the legislative debate surrounding the bill indicated that there could be wide support for further restrictions if Congress becomes unhappy with Fed policy.

Politicians' desire to keep interest rates low in order to reduce unemployment is often in tension with the Fed's concern to act in a timely manner to maintain price stability. The large number of long-term unemployed may make the problem more difficult this time by causing the unemployment rate to remain high even when product markets are beginning to experience rising inflation.

If that happens, Fed officials will face a difficult choice: tighten monetary policy to stem accelerating price growth, thereby antagonizing Congress and possibly facing restrictions that make it difficult to fight inflation in the future; or do nothing. Either choice could mean a higher future rate of inflation, just as financial markets fear.

Although the ECB does not have to deal with direct legislative oversight, it is now clear that there are members of its governing board who would oppose higher interest rates, and that there is political pressure from government leaders and finance ministers to keep rates low.

Rising inflation is certainly not inevitable, but, in both the US and Europe, it has become a risk to be reckoned with.

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