Why banks need to watch out for inflation in 2018

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Banking Strategies Magazine

February 8, 2018

No institution has as much influence over price levels as the Federal Reserve Board of Governors—which also acts as the country's paramount financial regulator.

Present and expected future price levels undergird every economic decision: to extend credit, borrow, save, invest and consume. Stable prices make those decisions easier and decidedly less risky. Congress with the **Federal Reserve Reform Act** instructed the central bank to "effectively" promote "maximum employment, stable prices and moderate long-term interest rates." And yet, the Fed has flouted that statutory mandate.

In Federal Open Market Committee meetings up until 1995, there was nary a mention of an employment target. That's because it was generally assumed stable prices begat maximum sustainable employment. In 1999 Fed chairman Ben Bernanke wrote, "In the long run, the central bank can affect only inflation, not real variables such as output."

But just a year later in 1996, the Fed started to socialize targeting modest inflation rather than stable prices. **Decrying the Fed's "monetary mischief" and boosting inflation**, former Fed board member Robert Heller recounted discussion by the Federal Open Market Committee [FOMC] of an appropriate long-term inflation goal. Chairman Alan Greenspan contended price stability was zero inflation. San Francisco Fed President Janet Yellen advocated a 2 percent inflation target.

According to Heller, the FOMC split between those favoring targeting zero percent inflation, 2 percent, or the then current rate of 3 percent and then bringing it down over time. As a compromise Greenspan announced, "We have all now agreed on 2 percent."

In 2012 the Fed on its own prerogative decided **to target a 2 percent inflation rate**, declaring it "most consistent" with its statutory mandate. *However, a 2 percent inflation target is hardly stable prices.* Nobody would consider a mixed martial arts fighter whose weight increased 2 percent every year as having "stable" weight.

At the December 2017 FOMC meeting, it was suggested that the Fed study **targeting price levels or nominal GDP as a means of boosting inflation** (in lieu of targeting an annual inflation rate). Whatever the mechanism employed, aiming for inflation other than zero is not promoting stable prices.

Paul Volcker—the Fed Chairman who broke inflation's back in the early '80s—is not a fan of the central bank pursuing a little inflation commenting "**…aiming for 2 percent inflation every year means that after a decade, prices are more than 25 percent higher and the price level doubles every generation. That is not price stability, yet they call it price stability.**"

Congress has been complicit. It's turned a blind eye to the Fed's flagrantly flouting its instructions. Many congressmen like having an option to blame Fed policy when the economy is weak—and claim credit when growth is robust. The legislature could mandate the central bank boost inflation, but it's politically accountable and congressmen who voted for inflation would be on the hook for having done so.

Thus when the Fed makes rather than implements monetary policy, appointments to its Board of Governors—all of whom sit on the Federal Open Market Committee—wind up consequentially partisan. President Trump put Randal Quarles on the board, nominated economist Marvin Goodfriend and resubmitted Jerome Powell as the replacement for Chairman Janet Yellen. With Yellen's recent departure, he has two more vacancies to fill. With Congress not defending its constitutional prerogative, the new slate of Fed governors could decide 5 percent inflation or deflation represents price stability.

On top of being lawless, promoting modest inflation is bad policy.

Few consumers, businesses or banks lose sleep over inflation as they did in **1980 when it surged to 13.5 percent.** Nevertheless, even modest inflation will prove corrosive. As of **November, annual inflation stood at 2.2 percent**. Sounds low? Not really, when you consider that means *prices will double every 33 years*. Inflation also undermines the dollar's role as a store of value and unit of account and doesn't increase real economic growth or sustainable employment.

Price stability enables individuals and firms to organize their activities to maximize economic value over the long term. Effort managing inflation risk is a dead-weight societal loss.

In the 19th Century—an era of free banking, weak central banks and the gold standard—inflation wasn't a problem. The U.S. **enjoyed gentle deflation for much of the century.**Consumers then and now view lower prices as a good thing, as it improves their standard of living. And for businesses, they enhance competitiveness.

In the 20th and 21st centuries however, powerful central banks have the ability able to create money and inflation has been destructive. From **1792 to 1912, U.S. prices rose 3 percent.** Lo from the creation of the Fed in **1913 to 2013, prices rose a whopping 2380 percent**.

However inexplicably fond one might be of inflation, it's not the Fed's role to choose modest inflation over price stability. Ultimately, Congress is to blame by permitting the Fed to ignore its statutory mandate—and in the process, inflate its continual abdication of responsibility.

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