Is US Inflation Too Low?

The Fed continues to keep interest rates low on a mistaken belief about inflation.

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#inflation #economics #federalreserve

The Federal Reserve on 17 September 2015 decided to not raise interest rates. More precisely, the Fed left unchanged their target or benchmark for the federal funds rate, the interest rate banks use when they borrow from other banks. The current target is a range between zero and .25 percent. The target is set by the Federal Reserve's Open Market Committee, which decides the Fed's monetary policy. The rate when the Committee met was .14 percent.

The "Fed" achieves its target by expanding and contracting the money supply. If the federal funds rate rises above the target, the Fed buys bonds, usually US Treasury bonds, and pays for the bonds by expanding the reserves of the banks, the funds banks keep in their accounts at Federal Reserve Banks. Banks then lower their interest rates to loan out the extra money.

The federal funds rate then pushes and pulls on other interest rates, the rates for bonds, personal and business loans, and mortgages.

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One reason given as to why the federal funds rate target was left unchanged is that price inflation is lower than the inflation goal of the Fed. The majority of the Open Market Committee seeks an inflation rate for consumer goods of two percent. One of the purposes of the Fed, as authorized by maintain price stability, and evidently the members of the Committee think that two percent inflation is more stable than zero percent.

Since the Fed's monetary policy influences but does not directly control price inflation, Fed officials fear that if inflation were zero, market dynamics might push the rate down below zero into deflation, falling prices, which they think is bad for the economy. If people expect lower prices later, they postpone buying furniture, appliances, cars, and houses. In contrast, if folks expect higher prices later, they buy big items now rather than later.

> One problem with this argument is that over the long run, inflation affects incomes as well as goods. If wages rise at the same rate as the prices of goods, there is no gain to buying sooner. Also, a mild deflation will not stop someone from buying a car or furniture, because the buyer will have less time to enjoy it.

One problem with this argument is that over the long run, inflation affects incomes as well as goods. If wages rise at the same rate as the prices of goods, there is no gain to buying sooner. Also, a mild deflation will not stop someone from buying a car or furniture, because the buyer will have less time to enjoy it. Computers have been dropping in price, but people buy them anyway. The US economy experienced a mild deflation during much of the 1800s, when gold was money, without bad effects.

> First, prices can fall because of greater productivity, as has happened with electronic goods. This deflation is good, because a consumer can buy more stuff with the same income. Secondly, prices can fall when the money supply drops, as happened in the Great Depression. That can cause a big reduction of prices, which is indeed bad for business. But since the Fed controls the US money supply, it

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Deflation has two causes. First, prices can fall because of greater productivity, as has happened with electronic goods. This deflation is good, because a consumer can buy more stuff with the same income. Secondly, prices can fall when the money supply drops, as happened in the Great Depression. That can cause a big reduction of prices, which is indeed bad for business. But since the Fed controls the US money supply, it can prevent a big deflation by simply expanding the money supply.

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The problem with even a small inflation such as two percent is that this imposes wasteful costs on the economy. Consider a restaurant with a large menu. When the price of food, labor, and utilities rises, the restaurant must raise all the prices in its menu, which is costly. Economists call this a “menu cost.” This cost applies generally to all sellers: grocery stores have to change thousands of prices, as all businesses feel the cost-push inflation.

Inflation also acts as a tax on money holdings. People with savings accounts lose value, and taxes make the loss worse, as income taxes ignore the loss due to inflation. Price inflation is good for employers, who can leave nominal wages, as measured in money, the same, while inflation reduces real wages, i.e. relative to the price of goods. That makes inflation bad for workers, who have to keep negotiating and begging for cost-of-living increases.

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The best policy would be to leave the money supply and interest rates to market dynamics, based on the supply of savings and the demand to borrow. The Fed kept interest rates low during the past few years in order to stimulate a recovery from the Depression of 2008. With little interest income from bonds, people instead put their money into the stock market and real estate. But rising prices for stocks and land did not help the economy.

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The remedy for a depressed economy is lower costs of production. But after 2008 government imposed higher costs with expanded regulations, lending restrictions, mandated medical insurance costs, and higher taxes on investment gains. Unemployment has gone down as the economy recovers, but possibly the economy would have expanded on its own, as the US economy did after the depression of 1920, when government did nothing about it.

Fiscal policy—taxing, borrowing, spending—has a much greater effect on the economy than monetary policy (unless the money goes crazy in a hyperinflation). The most important policy variable is the marginal tax rate, the tax on extra income, spending, and wealth. The policy that maximizes economic growth and employment is a marginal tax rate of zero. People want higher wages and employment, yet they elect governments that impose high marginal tax rates on both workers and employers.

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> tax rate of zero. If there is no tax on extra income, spending, or building, where can public revenues come from? There is only one logical source of public revenue that does not impose a marginal cost: It is a tax on value not created by the actions of the taxpayer: the surplus value of natural resources, or land. Public revenue from land rent or land value is a fixed cost, independent of decisions to earn, spend, and build.

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The American economist Henry George wrote, in his book *Progress and Poverty*, “We honor liberty in name and in form.... But we have not fully trusted her.... She will have no half service! Liberty! it is a word to conjure with, not to vex the ear in empty boastings.”

American coins are inscribed with “liberty,” but the value of the coins is set by the dictates of central bankers, who also set market-distorting interest rates. Then Congress and legislatures vex the economy with imposed costs on labor even while calling for more jobs, jobs, jobs.

> The thought that a few officials can best decide on the rate of inflation and interest rates for the whole economy is what the Austrian economist Hayek called a “fatal conceit”. That conceit will not only keep many folks poor and unemployed, but will sell the economy down the river to the next financial waterfall plunge.

Americans like to think we are a free country, but most have not fully trusted freedom. And liberty does not require mere trust, as its case is based on logic and evidence. The thought that a few officials can best decide on the rate of inflation and interest rates for the whole economy is what the Austrian economist Hayek called a “fatal conceit”. That conceit will not only keep many folks poor and unemployed, but will sell the economy down the river to the next financial waterfall plunge.

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Edward Dodson ▾

ED

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MC

Mike Curtis

6 years ago

I think this is an excellent article. One thing that might be added is that Inflation robs anyone who is owed money. It cancels obligations like bonds or insurance policies or money in a savings account. On the flip side, a significant portion of a 30 year mortgage is diminished by inflation.

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FRED E. FOLDVARY, Ph.D., (May 11, 1946 — June 5, 2021) was an economist who wrote weekly editorials for Progress.org since 1997. Foldvary's commentaries are well respected for their currency, sound logic, wit, and consistent devotion to human freedom. He received his B.A. in economics from the University of California at Berkeley, and his M.A. and Ph.D. in economics from George Mason University. He taught economics at Virginia Tech, John F. Kennedy University, Santa Clara University, and San Jose State University.

Foldvary is the author of *The Soul of Liberty*, *Public Goods and Private Communities*, and *Dictionary of Free Market Economics*. He edited and contributed to *Beyond Neoclassical Economics* and, with Dan Klein, *The Half-Life of Policy Rationales*. Foldvary's areas of research included public finance, governance, ethical philosophy, and land economics.

Foldvary is notably known for going on record in the *American Journal of Economics and Sociology* in 1997 to predict the exact timing of the 2008 economic depression—eleven years before the event occurred. He was able to do so due to his extensive knowledge of the real-estate cycle.