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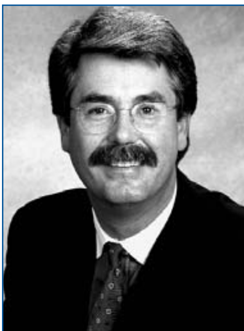
Global Central Bank Focus

by PIMCO's Paul McCulley

A Kind Word for Inflation

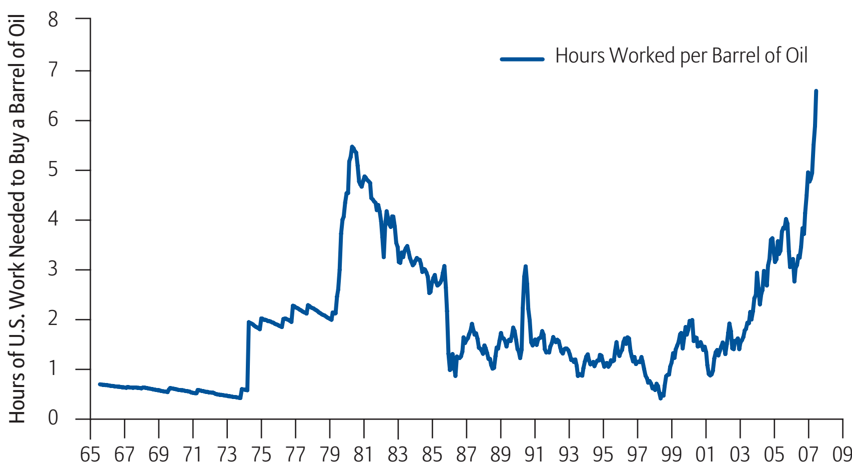


Paul McCulley

No, I have not lost my mind. I'm fully aware that inflation is not kind to bonds, so offering a kind word for inflation is de facto offering an unkind word about my own business. Investment managers don't tend to do that. But facts are facts. And the essential fact right now is that the American economy needs an inflation rate above the Fed's comfort zone. Needs, you ask?

Yes. Soaring commodity prices, particularly for petroleum and food, and especially in recent months, are an unambiguous negative **real** terms of trade shock to America. For those not familiar with the term, a nation's terms of trade is the ratio of what it must give up to get what it imports. The easiest way to understand the concept, at least for me, is to think of the number of hours of work necessary, at the average national hourly pay rate, to buy a barrel of oil—a real variable compared to another real variable. The chart below tells that simple story.

A Negative Terms of Trade Shock:
More Hours Worked for the Same Barrel of Oil



Source: Bureau of Labor Statistics, Wall Street Journal, PIMCO Calculation.
This chart is not indicative of the past or future performance of any Allianz Global Investors product.

Misery is as Misery Does

Americans are working more hours for the same barrel of oil. That is a negative real terms of trade shock. Put differently, we are less rich or more poor than we were before oil prices took off. There is no getting 'round this. In turn, there is no escaping collateral adjustments of temporarily higher inflation and temporarily lower growth and employment. The question of the hour is how this pain should be apportioned. Last week, Fed Vice Chairman Don Kohn provided the right answer, presuming there is a right answer (my emphasis):

> *"… an appropriate monetary policy following a jump in the price of oil will allow, on a temporary basis, both some increase in unemployment and some increase in price inflation. By pursuing actions that balance the deleterious effects of oil prices on both employment and inflation over the near term, policymakers are, in essence, attempting to find their preferred point on the activity/inflation variance-tradeoff curve introduced by John Taylor 30 years ago. Such policy actions promote the efficient adjustment of relative prices:* ***Since real wages need to fall and both prices and wages adjust slowly, the efficient adjustment of relative prices will tend to include a bit of additional price inflation and a bit of additional unemployment for a time, leading to increases in real wages that are temporarily below the trend established by productivity gains."*** [1]

Mr. Kohn was preaching the raw, honest truth: a surge in oil prices raises the Misery Index, temporarily lifting **both** inflation and the unemployment rate. In turn, those outcomes beget lower real wages and, presumably, lower real profits, too. We are less rich or more poor—period.

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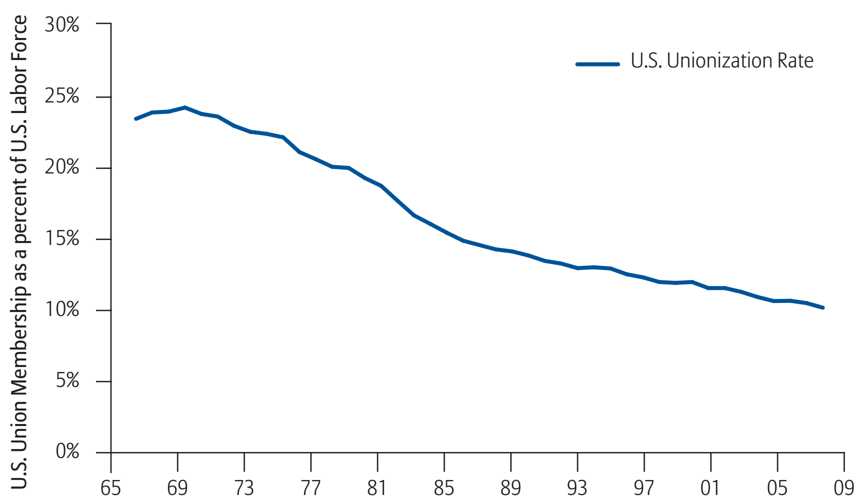
Thus, those who holler and scream at the Fed for letting the inflation genie out of the bottle need to calm down. A negative terms of trade shock is a real shock, so it must be translated into lower real wages and profits. That simple and that painful. Logically, it also must be translated for a time into lower, even negative, real short-term interest rates, the rate of return on money.

Spiral Risk?

But, you retort, if the Fed surrenders to negative real interest rates, it will set off an inflationary spiral, as second and third round effects on prices and wages take hold: capital and labor will extrapolate what should be viewed as a transitorily higher inflation into permanently higher inflation. In a world of perfectly indexed prices and wages, this could well be the case. The 1970s resembled such a world, and nasty oil price shocks that should have been one-off adjustments in the price level via temporarily higher inflation morphed into a price-wage-price inflationary spiral.

In monetary policy terminology, inflation expectations in the 1970s were not firmly anchored at the pre-oil price shock level. This is true, I think, but more elementally, the highly unionized, closed-economy structure of the American economy price and wage setting process was inherently geared to transforming a one-off inflationary shock into an enduring inflationary shock.

Since the First Oil Price Shock, Unionization in America Has Been Cut in Half



Source: Bureau of Labor Statistics, PIMCO Calculation
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We no longer live in such a world. Most importantly, wage inflation is now only loosely connected to price inflation, in the wake of a more globally competitive, less unionized labor force. As Vice Chairman Kohn hinted, the combination of somewhat higher inflation and higher unemployment is a prescription for diminished pricing power by labor, leading to lower real wages (than would be dictated by labor's productivity growth). Thus, unlike the 1970s, there is little wage fuel to generate over-heating aggregate demand and, thus, a sustained price-wage-price inflationary spiral.

This is good news indeed. Fed officials would make this argument through the lens of well-anchored inflationary expectations, and I have no quarrel with that interpretation, though I think it is but a veil over a more global, more competitive, less oligopolistic price and wage setting structure in the United States. Indeed, I believe the more nasty is the negative terms of trade shock, the fatter is the fat tail of asset price deflation rather than the fat tail of accelerating goods and services inflation.

Avoiding a Modern Day Depression

Deflating asset prices in a highly levered economy are a much more nefarious outcome than temporary increases in inflation in goods and services. This is particularly the case from a starting point of low inflation in goods and services (excluding those involved in the negative terms of trade shock). How so? Simple: a negative terms of trade shock **and** asset price deflation are a prescription for not just a recession, but a nasty one. More to the point, from a starting point of low goods and services inflation, the Fed is never far from the zero lower limit on nominal short-term interest rates, commonly known as a liquidity trap.

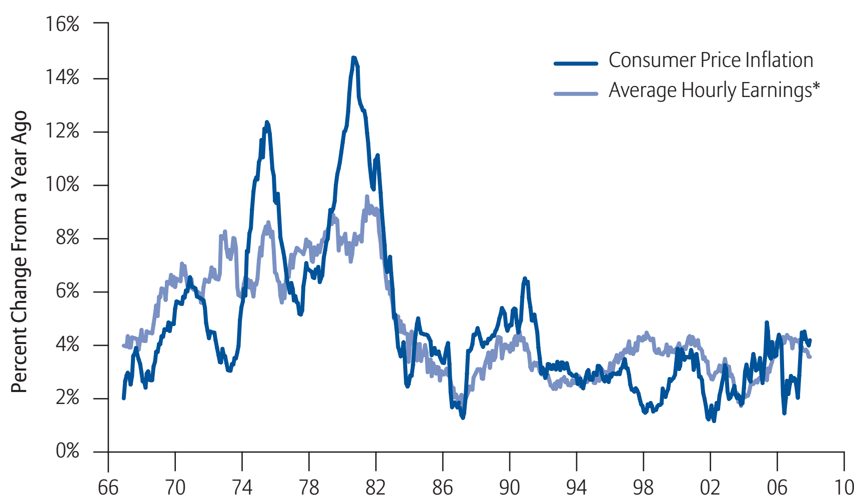
Therefore, the more flexible are wages in the face of a negative terms of trade shock, particularly if it coincides with asset price deflation, the greater is the risk of policy makers losing control of the economy on the downside. In turn, this reality argues for the Fed to tolerate higher headline inflation in the wake of a negative terms of trade shock.

To be sure, the Fed must be aware of the dreaded second and third round effects, constantly checking to make sure that real wages and real profits are being eroded by the aberrantly high headline inflation. But, assuming the evidence supports that thesis, as the following graph displays, it would be an absolute folly

for the Fed—or any central bank in similar circumstances—to hike interest rates in an attempt to make the negative terms of trade shock go away. By definition, it can't. And if it tries, it will create an even bigger mess. In this case, the motto of a central bank should be the same as that of a physician: first, do no harm.

I think the Fed thoroughly understands these exigencies in the wake of a negative terms of trade shock. It doesn't mean that the Fed won't or shouldn't rhetorically sound tough at times, in the name of preventing inflationary expectations from becoming unmoored. But the bottom line is that as long as there is a huge gulf between the negative terms of trade cup and the wage inflation lip, the Fed should talk about the cup and focus on the lip.

Wages Are Not Chasing Headline Inflation Higher



Source: Bureau of Labor Statistics.
*Average wage per hour worked for production of non-supervisory workers in private sector.
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Bottom Line

Which means, my friends, that low, even negative real short-term interest rates are here to stay for a considerable period. Yes, I know that many believe that it is somehow sinful or immoral for the Fed to hold nominal short rates so low as to render the real return on cash to be negative. I don't buy this proposition. Why should it be that those who only have labor to offer to the market should **not** be made whole for a negative terms of trade shock, while those with cash should be made whole?

In the wake of a negative terms of trade shock, **all** factors of production should absorb a negative hit to their real returns. If indexing to headline inflation is inappropriate for labor wages and capital's profits, why should cash yields be indexed by the Fed?

And what if holders of cash don't like it? Then they can step out on the risk spectrum. After all, a basic of capitalism is no risk, no reward. And temporarily higher inflation in the wake of a negative terms of trade shock is an efficient lubricant for the economy to make the necessary **real** adjustments.

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[1] http://www.federalreserve.gov/newsevents/speech/Kohn20080611a.htm

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