Mr. Greenspan's Blind Spot

In early March, former Fed Chairman Alan Greenspan was asked to comment about ECRI's long-held criticism that the Fed is chronically behind the curve on monetary policy because its forecasting models are based on core inflation and the output gap, rather than forward-looking inflation indicators.

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Mr. Greenspan agreed with our critique of both the output gap and core inflation. First, he acknowledged, "I have always been somewhat skeptical about the output gap… The bottlenecks with the system are never captured obviously by that… So it's not an infallible indicator." On the usefulness of core inflation, he then went on to say: "But more importantly the general presumption of core is that oil and food fluctuate, but have no trend. That is incorrect."

Finally, he asserted that the Fed also watches forward-looking inflation expectations and could thus forecast inflation no better – but no worse – than ECRI. He went on to say, "The problem is, none of these indicators will tell you when inflation is about to take hold."

With respect, Mr. Greenspan is wrong.

By using good cyclical indicators, you can – and we do – correctly forecast when inflation is about to take hold.

And it's precisely because the Fed – first under Mr. Greenspan and now under Mr. Bernanke – adamantly believes that inflation turning points can't be predicted, that the current U.S. recovery stands in danger of being snuffed out prematurely.

ECRI's future inflation gauges – which, unlike econometric models, monitor the evolution of self-feeding cycles in inflation – are designed to do just what Mr. Greenspan says can't be done. Specifically, they are more direct measures of underlying inflation pressures that signal the timing of upcoming inflation cycle turning points. In fact, they also anticipate inflation expectations.

Mr. Greenspan says that by watching inflation expectations the Fed can forecast inflation no better – but no worse – than ECRI, yet the real-time records are quite different. This disconnect underscores a fundamental misconception among policymakers, that because inflation expectations can't anticipate inflation cycle turning points, it can't be done. Over the past decade, such misperceptions have led to serious errors in monetary policy timing.

For instance, in June 2003, the Fed cut rates to 1% as "insurance" against deflation, when, based on our ↗*Future Inflation Gauge (FIG)*, we had ruled out any deflation risk. The housing bubble then inflated further, and commodity prices rose.

In June 2008, six months after the recession began, a hawkish Fed was telegraphing rate hikes exceeding 100 basis points by year-end, according to the Fed funds futures markets. At that time, the forward-looking FIG was indicating the absence of any sustained inflation threat.

Just last summer, blindsided by a growth slowdown clearly foreseen by our leading indexes, the Fed abandoned its "exit strategy" rhetoric. Doing an about-face, it launched the second round of quantitative easing to guard against a newfound "tail risk" of deflation. Again, the FIG offered a different conclusion, having ruled out any deflation risk by late 2009.

The Fed's ongoing reliance on inflation expectations, along with core inflation and the output gap – which Mr. Greenspan agrees don't work – strongly implies that they have no workable tools to decide when to pull back on stimulus. Their incoherence about policy timing is rooted in the belief expressed by Mr. Greenspan that forward-looking indicators of inflation can't tell when inflation is about to take hold.

Mr. Greenspan and his successor, Mr. Bernanke, are top-notch economists in an echo chamber where they are surrounded by other economists, who all tend to believe, deep down, that the best forward-looking information must be found in market prices. This is an economist's mistake. Even in the face of compelling evidence that markets aren't the best predictors of what's around the bend, it's really hard for economists to abandon their basic world-view.

This keeps the Fed chronically behind the curve. The "insurance" taken out by the Fed has been far from costless, especially in terms of the collateral damage from unintended consequences. Yet, damaging as it might have been in the past, the sheer size of the Fed's current balance sheet makes it more critical than ever to improve the timing of monetary policy shifts.

As U.S. economic growth begins to revive, the long-term jobless rate, which is still around record highs, remains a festering sore. However, it's obvious from a scrutiny of past cyclical patterns that only a long economic expansion – like those in the 1980s and 1990s – can heal that wound.

Central bankers need to stop clinging to policy orthodoxy and pay attention to proven cyclical leading inflation indicators that can actually tell them when inflation is about to take hold. Otherwise, if a well-meaning Fed stimulates the economy for too long, it will let inflation and/or asset prices get out of control, fostering boom-bust cycles that keep long-term unemployment at elevated readings as each short boom ends with a bust that pushes the jobless rate back up.

So, if the FIG takes off, watch out!

