



MEMORANDUM

To: PCA Clients

Date: January 6, 2010

From: Pension Consulting Alliance

RE: Some Brief Comments on the Future of Inflation

Ever since the financial crisis of 2008, practitioners from both “Wall Street” and “Main Street” have been debating whether increases in inflation are imminent, or whether, despite record-breaking fiscal stimulus and monetary support, deflationary or disinflationary pressures still exist.¹ At this point of the investment cycle, the varying positions within this debate are the widest they have been in recent memory.

Numerous practitioners highlight that, at least within the United States, under-utilization of industrial capacity, high unemployment, a damaged commercial real estate market, and an unhealthy financial services sector all lead to minimal concern about the near-term inflation trend expanding from its current low levels.² In contrast, one inflationary concern that appears to be gaining more traction is the threat to the independence of the Federal Reserve.³


While the primary purpose of the Federal Reserve is to control and manage inflation and inflation expectations, during the 2008 crisis it (along with the U.S. Treasury and the FDIC) executed a wide range of major stop-gap measures to support the financial services sector of the economy. The basic rationale behind these measures was that if the financial services sector became crippled for a significant period of time, the rest of the domestic economy could tip quickly toward a depression-like trend path.

Fast-forward to today and, regardless of the future outcomes of these stop-gap measures in aggregate, the political accommodation toward the Federal Reserve has shifted. Many legislators and politicians believe the Federal Reserve either (i) exerted too much power, (ii) favored one or more economic sectors (e.g., the financial services sector) during the crisis

¹ See, for example, “Panelists push need for inflation protection,” [Pension & Investments](http://www.pionline.com/apps/pbcs.dll/article?AID=/20091214/PRINTSUB/312149981/1008/PITopicNewsletter11&template=PITopicNewsletter11&issuedate=20091217), December 14, 2009.

² See, for example, McVey, Henry, “Inflation: On the Razor’s Edge,” [Investmentfocus](#), Morgan Stanley Investment Management, November, 2009.

³ See “Will Exiting from the Great Recession Take Us to the Great Inflation?” [Quarterly Institutional Review](#), Dimensional Fund Advisors, 2Q 2009.



versus other sectors, (iii) was “asleep at the wheel” prior to the crisis in terms of regulating the financial services sector, or (iv) a combination of all three. As a result, the threat that the U.S. Congress will limit the independence of the Federal Reserve has become very real.

During December 2009, the U.S. House of Representatives passed Bill H.R. 4173 (this the highly touted “Financial Reform Bill” by a relatively thin margin) that included a bipartisan-supported provision mandating that the Governmental Accounting Office (GAO) audit the Federal Reserve immediately after a final version of the Bill becomes law.⁴ The Bill also allows Congress to direct the GAO to audit the Federal Reserve on an ongoing basis. If these provisions become law, policies enacted by the Federal Reserve may become subject to direct oversight by the U.S. Congress.

It is interesting to point out that Congressional oversight of the Federal Reserve was in place prior to 1978. During that period the Federal Reserve made policy decisions that sought to also address macroeconomic considerations such as maintaining full employment and supporting the value of the U.S. Dollar. Many experts would argue that pursuing multiple objectives (in addition to managing inflation) proved detrimental to the U.S. economy as well as the Federal Reserve itself. In fact, the last time the United States experienced significant and accelerating inflationary trends was during the mid-to-late 1970’s, under the less-than-independent Federal Reserve regime. Only in 1979, after the Federal Reserve was granted increased independence, did it execute the hugely unpopular, politically-risky strategy of raising short-term interest rates to historically high double-digit levels under Federal Reserve chairman Paul Volcker. In hindsight, Volcker’s strategy has proven highly beneficial to the U.S. economy for the subsequent 25 years.

Any loss of Federal Reserve independence is likely to diminish the Federal Reserve’s capacity to take difficult and unpopular action against inflationary threats once they become evident. Therefore, it is important for institutional investors to closely monitor the developments of U.S. Congress’ progress toward increasing its oversight and authority of the Federal Reserve. With passage of the House bill, Congress has taken one significant step toward reducing the Federal Reserve’s independence. If this trend continues within the U.S. Senate, then (at the margin) the prospects for accelerating inflation sometime in the intermediate term become more likely. As a result, institutional investors would be well-served by beginning now to develop explicit policies to factor inflation risk into their investment strategy and manage such risk exposure in an explicit and proactive manner. We look forward to discussing these investment policy issues with you in the near future.

⁴ See “Obama Applauds Financial Bill,” *Wall Street Journal*, December 12, 2009. <http://online.wsj.com/article/SB126061888658388951.html>