OUTLOOK

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ECONOMIC DATA AND COMMENTARY

Rethinking the Fed's Inflation Strategy

After years of sluggish economic growth, does a higher inflation target make sense?

Along with supporting maximum employment, keeping inflation at bay is one of the U.S. Federal Reserve's two primary responsibilities. But what happens when the Fed's help isn't needed? During the past several years, the core inflation rate has been stuck significantly and persistently below the Fed's target rate of 2 percent. That reflects, among other things, a lack of upward pressure on wages in an economy that remains somewhat sluggish almost a decade after the Great Recession.

Despite the low rate of inflation, the Fed has already raised interest rates twice this year, implying that Fed Chair Janet Yellen has begun tapping the brakes on the economy. Nevertheless, at a news conference in June, Yellen said she and her board of governors would begin to consider whether their 2 percent target is too low. Could a higher inflation target help the economy pick up the pace, while also giving the Fed more leverage during the next recession?

Economist Josh Bivens, the director of research at the Economic Policy Institute, advocates moving the inflation target as high as 4 percent. Bivens spoke with OUTLOOK about why the Fed has a target rate for inflation, the benefits of allowing inflation to rise even further, and why he disagrees with the Fed's recent interest rate hikes.

OUTLOOK: When did the Federal Reserve establish an explicit target for inflation?

Josh Bivens: Stable inflation has always been one of the Fed's primary goals since it was founded in 1913, and for years it was everybody's assumption that the Fed viewed stable inflation as being around 2 percent. But that was never official until 2012, when the Fed formally designated 2 percent inflation as the official target.

This Month's Expert

As director of research at the Economic Policy Institute (EPI), Josh Bivens covers macroeconomics, fiscal and monetary policy, the economics of globalization, social insurance and public investment. Frequently asked to testify before Congress on fiscal and monetary issues, Dr. Bivens has also provided analyses for the United Nations and the Organization of Economic Cooperation and Development.

Dr. Bivens is the author of several books, including "Failure by Design: The Story Behind America's Broken Economy" and "Everybody Wins Except for Most of Us: What Economics Really Teaches About Globalization." A regular guest on PBS, the BBC and other news outlets, Dr. Bivens previously served as a research economist at EPI and assistant professor of economics at Roosevelt University. He holds a bachelor's degree in economics from the University of Maryland and a doctorate in economics from the New School for Social Research.

OUTLOOK: What prompted them to take that step?

JB: It was funny timing, because putting a lid on inflation was not much of a concern in 2012. In fact, all of the pressure in the economy was pushing prices down rather than up. I think part of it was that the Fed did not want people to think it was going to tolerate zero percent inflation or, even worse, deflation. It knew people had more or less come to expect 2 percent. That was a level people felt comfortable with when making borrowing or lending decisions. Setting an official target was a way to reassure people that the Fed wasn't going to allow the rate to plummet and pull us into Japanese-style deflation.

In addition, after quantitative easing and the other extraordinary measures that the Fed had taken in the wake of the financial crisis, it also may have wanted to assure people that when the economy recovered, it was not going to let inflation run wild. Of course, it never said any of that explicitly, but that's how I read it.

OUTLOOK: What does "inflation target" mean? Is it a hard ceiling or more of a general goal?

JB: Ideally, a target shouldn't be a hard ceiling, nor does it mean that you expect to stay precisely at that number all the time. You're shooting for an average over an entire business cycle. When you're in a recessionary part of the cycle, inflation may drop below 2 percent. That should be matched by periods during recovery when you tolerate inflation above 2 percent.

[Federal Reserve Chair] Janet Yellen has described the target in those terms, as an average rather than a ceiling. It's a crucial point, and something I believe the Fed should make more explicit, perhaps in a formal policy statement. Instead, it has been sending mixed signals. If you look at the Fed's future inflation projections, they never envision inflation going over 2 percent. So, while it says that the target is an average, the Fed's rate policy seems to suggest that it sees it as a ceiling. That creates uncertainty.

OUTLOOK: Why is that distinction so important?

JB: If the economy is booming and inflation threatens to stay above the target average for the business cycle, the Fed raises interest rates to slow demand and restrain economic growth. By contrast, when inflation drops below the target for an extended period, the Fed cuts interest rates to try to spur the economy by promoting borrowing and investment by businesses and spending by consumers—all of which is likely to get inflation to climb back up.

If the 2 percent target is an average, you can allow inflation to rise above the target long enough to bring things back into balance. If 2 percent is a ceiling, then you don't have that flexibility. It just makes pulling out of a recession that much more difficult.

> "When we enter the next recession, the Fed needs to have stronger tools available."

OUTLOOK: Do you think it would be smart to raise the inflation target higher than 2 percent?

JB: I do. Even if the Fed moved it to 3 percent, that would be an improvement, but 4 percent seems better. The recovery from the Great Recession has been so slow, and attempts to boost the economy through fiscal policy have been worse than gridlock—they've actually been going in the wrong direction. What this tells us is that when we enter the next recession, the Fed needs to have stronger tools available. Hedging against another event such as the Great Recession is important enough that I think a 4 percent target would be reasonable.

OUTLOOK: How would that help us get out of the next recession?

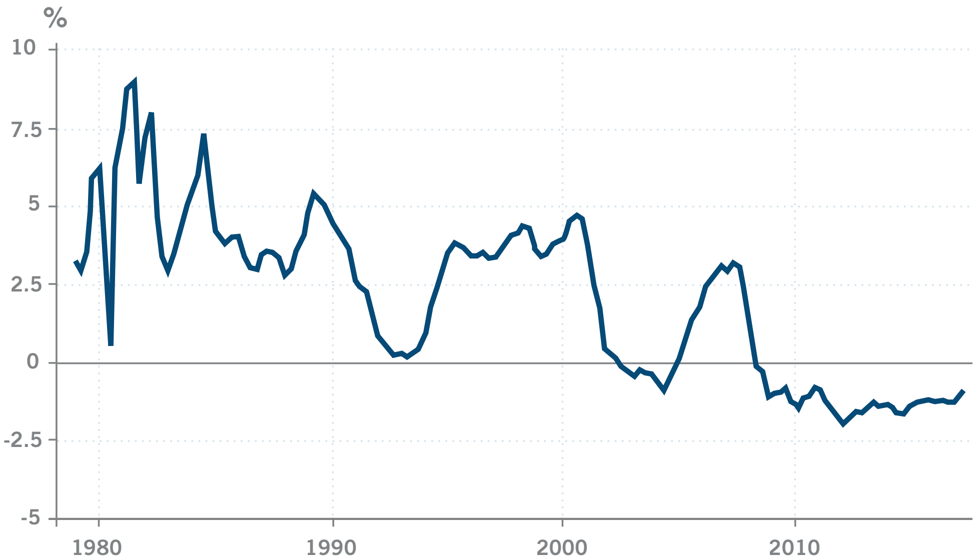
JB: It comes down to the relationship between inflation and interest rates. When the Fed lowers interest rates to encourage businesses to borrow and invest, and consumers to spend, what it's reducing is the nominal interest rate. But what matters more to borrowers is the real, or inflation-adjusted, interest rate, which reflects the actual purchasing power of money. The real interest rate is simply nominal interest minus inflation. For example, when the Fed had nominal rates at 0 percent for a long time over the past seven years, and inflation was 1.5 percent, the real interest rate was minus 1.5 percent.

The higher inflation is, the lower the Fed can push real interest rates into negative territory in response to a crisis. Say, for example, inflation is running at 2 percent when we enter a steep recession. If the Fed pushed the nominal interest rate to 0 percent, you'd have a real interest rate of minus 2 percent. Now, consider instead that inflation was running at 4 percent and the same recession hit. Taking the nominal rate to 0 percent gives you a real interest rate of minus 4 percent. That's a big difference. In essence, you've given the Fed a longer lever to fight recessions and give the economy a boost.

OUTLOOK: What's the likelihood the Fed will raise the target?

JB: I think there's a good chance it could happen over the next five years. Whether that's better than 50-50 I can't say, but some very serious academics and policymakers have made strong arguments for it. Before the financial crisis, anyone who argued for 3 percent or 4 percent inflation would have been a complete outlier. But the world has shifted a lot because of the Great Recession. Of course, there are also very influential people, including former Fed Chair Ben Bernanke, who are not huge fans of the idea.

FEDERAL FUNDS RATE ADJUSTED FOR INFLATION, 1979-2017



Source: Josh Bivens

OUTLOOK: What are these opponents' concerns?

JB: They would argue that the 2 percent inflation target was a hard-won anchor, and that it took a long time to convince people that the Fed had real credibility when it said we're not going to allow inflation to get out of hand. The argument is that sticking to your target shows discipline, while raising it sends a signal that when the economy turns around, you won't be able to control inflation. There's some risk of that, but you don't necessarily sacrifice credibility by setting a new target, as long as you enforce it. And the risk of entering another recession without enough tools to get out of it quickly is a greater risk, in my mind.

OUTLOOK: Where does the Fed see the biggest threat of inflation coming from?

JB: The inflation the Fed really worries about and wants to rein in comes from the labor market. It's workers. It's when unemployment goes so low that workers feel empowered to demand really large wage increases that start pushing up prices.

OUTLOOK: Wage growth has been pretty slow since the Great Recession. Are such concerns justified?

JB: Sharp wage increases certainly can happen. During the late 1990s, we had two years of very tight labor markets—around 4 percent unemployment—and wages turned a corner and rose relatively quickly. But they didn't keep accelerating: We got to 2 percent real wage growth and stuck there. If wages do suddenly threaten to push inflation well above the target, I think the Fed would have time to react. Given the agonizingly slow growth we've seen over the past seven or eight years, there seems to be a lot of built-in resistance to sharp wage movements. My guess is that wage growth will be a hard slog. [For more on what to expect from wage growth, see the July Outlook.]

> "Interest rate increases take quite a while to ripple through the economy, so the argument might be that the Fed has to worry about where wage and price inflation will be a year or 18 months from now, rather than where they are right now."

OUTLOOK: Why does the economy still seem to be struggling when the unemployment rate and the stock market have been doing well?

JB: Spending by households, businesses and government has been very slow to recover. Even with improving employment numbers, we're still not back to a labor market healthy enough that workers have the bargaining power to demand and achieve wage increases fast enough to push up prices. That has been a surprise, considering we're down to 4.3 percent unemployment. I would have thought we'd see some upward pressure on wages and prices.

OUTLOOK: The Fed has raised short-term rates twice so far in 2017. Why is it doing that when economic growth remains so tepid?

JB: The Fed would argue that the economy has a lot of momentum. Interest rate increases take quite a while to ripple through the economy, so the argument might be that it has to worry about where wage and price inflation will be a year or 18 months from now, rather than where they are right now, and it wants to stay ahead of the curve.

The Fed would also argue that its rate increases so far have been quite small, so it's not really stomping on the brakes. It's just kind of starting to cover the brake with its foot to make sure it can slow things down if it needs to.

OUTLOOK: Do you disagree?

JB: It would be more persuasive if we saw at least some inflation uptick before deciding the economy has inflationary momentum. I could understand it if we had steadily risen from 1 percent inflation three years ago to 1.2 percent to 1.4 percent to 1.6 percent and so on. Then, you might have reason to worry about where inflation will be a year from now. But we've been completely stuck at about 1.5 percent to 1.8 percent inflation for years (see chart on next page). There's no uptick or momentum that I can see. As interest rates go up and business investment and consumer spending go down, that's going to reduce the demand for labor. As a result, workers will get smaller wage increases, and given that the price of anything is mostly labor, that should put some downward pressure on inflation.

The other problem, as I've described, is that even the Fed's own projections basically have it pushing up inflation to 2 percent a couple of years from now, and then it sticks there forever. There's never an overshooting to make up for all that time we spent below the inflation target. I think that's a flawed way to make policy. We should let the economy run a little hotter.

THE FED'S PREFERRED INFLATION INDICATOR:
Personal Consumption Expenditures Price Index, 2007-2017

Source: Bureau of Labor Statistics

OUTLOOK: What impact would raising the target inflation rate have on the economy?

JB: The announcement by itself wouldn't do much for at least six months or so. It's all about future planning. And raising the target would have to be matched by policy actions consistent with that, such as letting the economy continue to push down unemployment, or letting wage growth rise faster without trying to tamp that down. In other words, not hiking interest rates. It would be worthless to say we want a 4 percent inflation target and continue to raise rates.

OUTLOOK: Independent of what the Fed does with regard to target rates, what is the likelihood that we'll see inflation rise on its own?

JB: Four or five months ago, I would have said it will eventually rise. We do seem to be continuing the recovery, with a lower unemployment rate and job growth that's slightly above trend. All of this has been, in my mind, good and healing. The economy isn't accelerating, but it continues to chug along, and there's no housing or stock market bubble so large that it's going to burst and bring down the economy.

The only thing that is a real threat is moving too aggressively on the interest rate front. I think the three interest rate increases over the past nine months that the Fed has done could really start to slow the economy before we get to a long period of slightly above-target inflation that I think we really need. If the Fed continues on this ladder of rate increases, we might never reach 2 percent, and that's a real problem.

Interest Rates and Economic Indicators

The interest rate and economic data on this page were updated as of 7/31/17. They are intended to provide rate or cost indications only and are for notional amounts in excess of $5 million except for forward fixed rates.

KEY ECONOMIC INDICATORS

Gross Domestic Product (GDP) measures the change in total output of the U.S. economy. The Consumer Price Index (CPI) is a measure of consumer inflation. The federal funds rate is the rate charged by banks to one another on overnight funds. The target federal funds rate is set by the Federal Reserve as one of the tools of monetary policy. The interest rate on the 10-year U.S. Treasury Note is considered a reflection of the market's view of longer-term macroeconomic performance; the 2-year projection provides a view of more near-term economic performance.

ECONOMIC AND INTEREST RATE PROJECTIONS

Forecasts courtesy of Bloomberg and Blue Chip Economic Indicators

				US Treasury Securities	
2017	**GDP**	**CPI**	**Funds**	**2-year**	**10-year**
Q3	2.50%	1.80%	1.16%	1.52%	2.44%
Q4	2.30%	2.10%	1.22%	1.70%	2.62%
2018	**GDP**	**CPI**	**Funds**	**2-year**	**10-year**
Q1	2.30%	2.30%	1.29%	1.84%	2.73%
Q2	2.40%	2.20%	1.36%	2.03%	2.83%
Q3	2.30%	2.30%	1.38%	2.17%	2.94%

PROJECTIONS OF FUTURE INTEREST RATES

The table below reflects current market expectations about interest rates at given points in the future. Implied forward rates are the most commonly used measure of the outlook for interest rates. The forward rates listed are derived from the current interest rate curve using a mathematical formula to project future interest rate levels.

IMPLIED FORWARD SWAP RATES

Years Forward	3-month LIBOR	1-year Swap	3-year Swap	5-year Swap	7-year Swap	10-year Swap
Today	1.34%	1.46%	1.70%	1.88%	2.04%	2.22%
0.25	1.42%	1.52%	1.76%	1.92%	2.07%	2.24%
0.50	1.48%	1.59%	1.82%	1.97%	2.11%	2.27%
0.75	1.59%	1.67%	1.86%	2.03%	2.17%	2.32%
1.00	1.65%	1.73%	1.89%	2.05%	2.19%	2.34%
1.50	1.72%	1.82%	2.00%	2.16%	2.28%	2.42%
2.00	1.82%	1.90%	2.06%	2.21%	2.33%	2.45%
2.50	1.91%	1.99%	2.14%	2.28%	2.39%	2.49%
3.00	2.00%	2.08%	2.22%	2.35%	2.44%	2.54%
4.00	2.15%	2.23%	2.37%	2.47%	2.54%	2.61%
5.00	2.31%	2.38%	2.49%	2.60%	2.63%	2.67%

HEDGING THE COST OF FUTURE LOANS

A forward fixed rate is a fixed loan rate on a specified balance that can be drawn on or before a predetermined future date. The table below lists the additional cost incurred today to fix a loan at a future date.

FORWARD FIXED RATES

Cost of Forward Funds

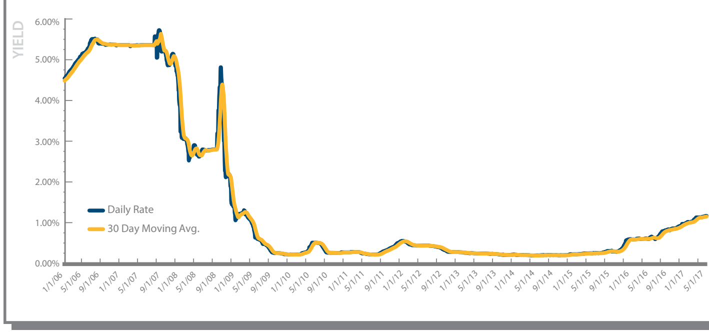
Forward Period (Days)	Average Life of Loan			
	2-yr	3-yr	5-yr	10-yr
30	5	5	5	5
90	8	8	10	8
180	13	14	18	14
365	30	29	35	27

Costs are stated in basis points per year.

SHORT-TERM INTEREST RATES

This graph depicts the recent history of the cost to fund floating rate loans. Three-month LIBOR is the most commonly used index for short-term financing.

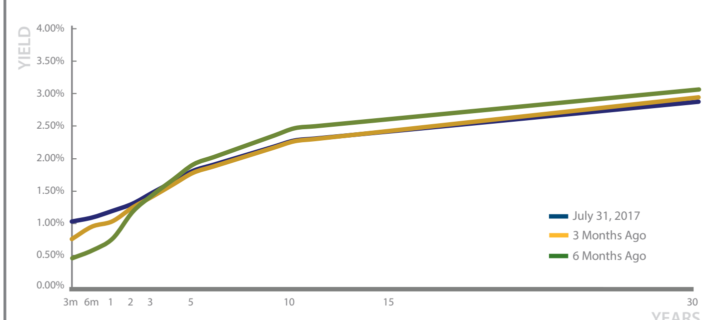
3-MONTH LIBOR



RELATION OF INTEREST RATE TO MATURITY

The yield curve is the relation between the cost of borrowing and the time to maturity of debt for a given borrower in a given currency. Typically, interest rates on long-term securities are higher than rates on short-term securities. Long-term securities generally require a risk premium for inflation uncertainty, for liquidity, and for potential default risk.

TREASURY YIELD CURVE



COBANK UPDATE

CoBank Reports Second Quarter Financial Results

Tom Halverson

CoBank has announced financial results for the second quarter and first six months of 2017. The bank experienced loan volume growth in all three of its operating segments, and credit quality and earnings remained strong.

Net income for the second quarter increased 7 percent to $259.8 million, compared to $243.3 million in the second quarter of 2016. For the first six months of 2017, net income was $522.6 million, a 7 percent increase from $486.6 million in the same period of 2016. The bank benefited during the quarter and year-to-date periods from a lower provision for loan losses. No provision was taken during the second quarter of 2017, compared to a $20 million provision in the same period last year. Provisions for loan losses in the first six months of 2017 totaled $15 million, compared to $28 million in the prior-year period.

Net interest income for the second quarter was $347.2 million, an increase of 0.4 percent from $345.9 million in the same period last year. For the first six months of the year, net interest income increased 3 percent to $703.3 million, compared to $682.8 million for the first six months of 2016. Higher average loan volume was a key driver of the increase for both the quarter and year-to-date periods, partially offset by decreases in fair value accretion income related to CoBank's merger with U.S. AgBank in 2012.

Average loan volume rose 3 percent in the second quarter to $95.4 billion, from $92.4 billion in the same period last year. For the first six months of 2017, average loan volume rose 6 percent to $96.7 billion, from $91.1 billion in the same period last year. The increases resulted primarily from higher levels of wholesale lending to the bank's affiliated Farm Credit associations, driven by greater demand for credit from farmers, ranchers and other rural borrowers. The bank also saw increased demand for loans from farmer-owned cooperatives, agricultural export finance customers, rural electric cooperatives and project finance borrowers.

"Through mid-year, CoBank has delivered solid financial performance on behalf of its customer-owners," said Tom Halverson, president and chief executive officer. "In particular, we have benefited from increased demand for credit in agriculture and agribusiness, as well as continuing good credit quality in our loan portfolio."

About CoBank

CoBank is a $125 billion cooperative bank serving vital industries across rural America. The bank provides loans, leases, export financing and other financial services to agribusinesses and rural power, water and communications providers in all 50 states. The bank also provides wholesale loans and other financial services to affiliated Farm Credit associations serving farmers, ranchers and other rural borrowers in 23 states around the country.

CoBank is a member of the Farm Credit System, a nationwide network of banks and retail lending associations chartered to support the borrowing needs of U.S. agriculture, rural infrastructure and rural communities. Headquartered outside Denver, Colorado, CoBank serves customers from regional banking centers across the U.S. and also maintains an international representative office in Singapore.

For more information about CoBank, visit the bank's web site at www.cobank.com.

CoBank Reports Second Quarter Financial Results *(continued)*

Net interest margin for the quarter declined to 1.11 percent from 1.16 percent in the second quarter of 2016. For the first six months of the year, net interest margin was 1.12 percent compared to 1.17 percent in the prior-year period. The reduction in net interest margin reflected the impact of slightly lower overall loan spreads as well as lower fair value accretion income, somewhat offset by increased earnings on balance sheet positioning.

At quarter-end, 1.01 percent of CoBank's loans were classified as adverse assets, compared to 0.81 percent at December 31, 2016. Nonaccrual loans increased to $229.2 million as of June 30, 2017, from $207.2 million at December 31, 2016, primarily due to a small number of agribusiness loans and a communications loan. The bank's allowance for credit losses totaled $676.9 million at quarter-end, or 1.41 percent of non-guaranteed loans when loans to Farm Credit associations are excluded.

As of June 30, 2017, shareholders' equity totaled $8.8 billion, and the bank's total capital ratio was 15.6 percent, compared with the 8.0 percent (10.5 percent inclusive of the fully phased-in capital conservation buffer) minimum established by the Farm Credit Administration (FCA), the bank's independent regulator. At quarter-end, the bank held approximately $30.1 billion in cash, investments and overnight funds and had 179 days of liquidity, which exceeded FCA liquidity requirements.

Halverson noted that the bank continues to face a number of marketplace challenges, including intense competition in the banking industry, declining margins and a prolonged low interest rate environment that has lowered returns on invested capital. In addition, the bank is making significant investments in people, processes and systems that will enable it to operate more efficiently and meet the evolving needs and expectations of customers and partners.

"Despite strong net income so far this year, we continue to see ongoing pressure in our other profitability measures," Halverson said. "Our board and executive team are squarely focused on that issue and on improving the efficiency and scalability of our operating platform. We are committed to serving as a dependable financial partner for our customers and on building the capacity of the bank to fulfill its mission in rural America over the long term."