Commodity Prices, Inflation Targeting, and U.S. Monetary Policy

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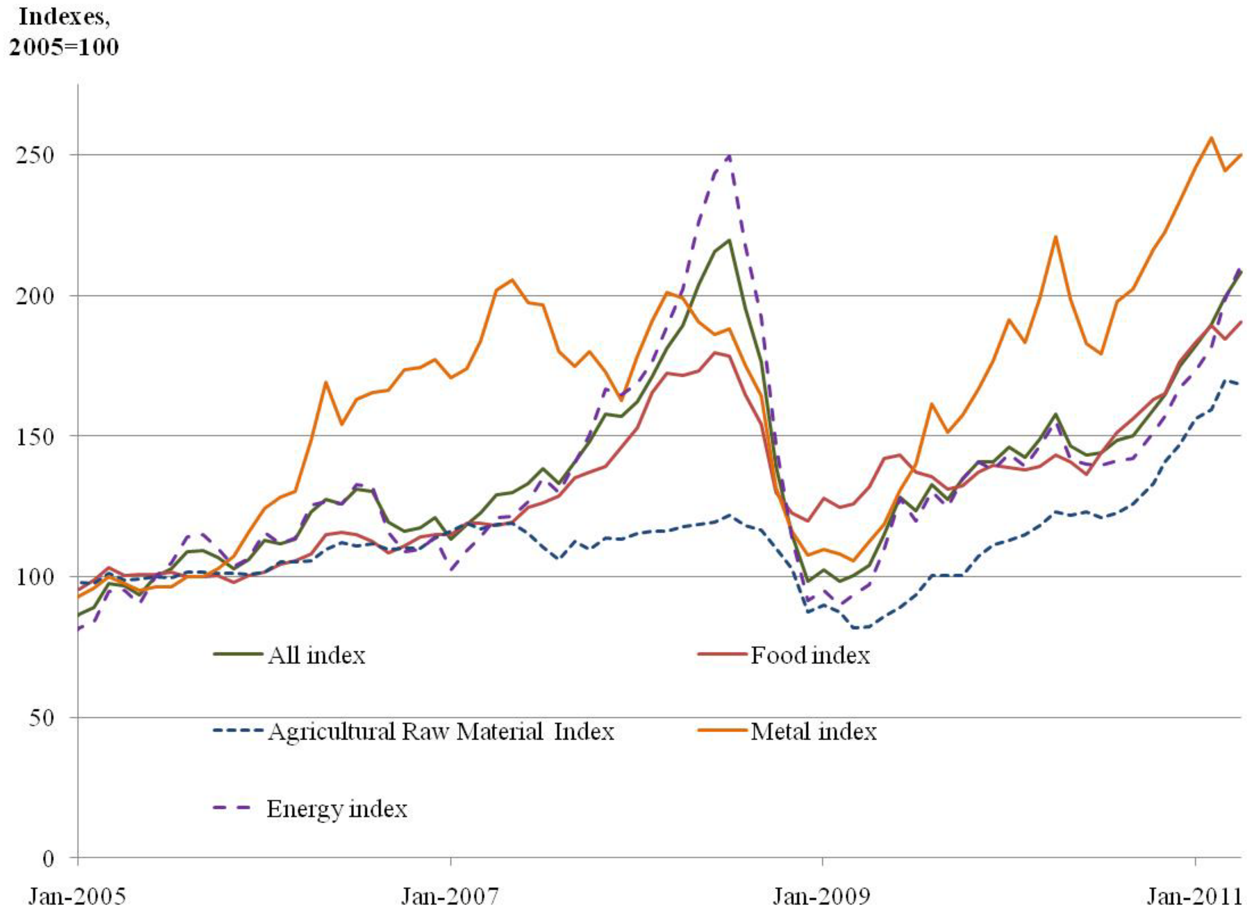
Any opinions expressed here are my own and do not necessarily reflect those of others on the Federal Open Market Committee.

This talk

- Some data on commodity prices.
  - Dramatic increases in recent months.
- Core versus headline inflation: Which one to watch?
  - Controlling headline inflation is the key policy goal.
  - Monetary policy discussions over-emphasize core inflation.
- Monetary policy.
  - A pause allows more time to assess the strength of the economy.
- Inflation targeting = modern commodity standard.

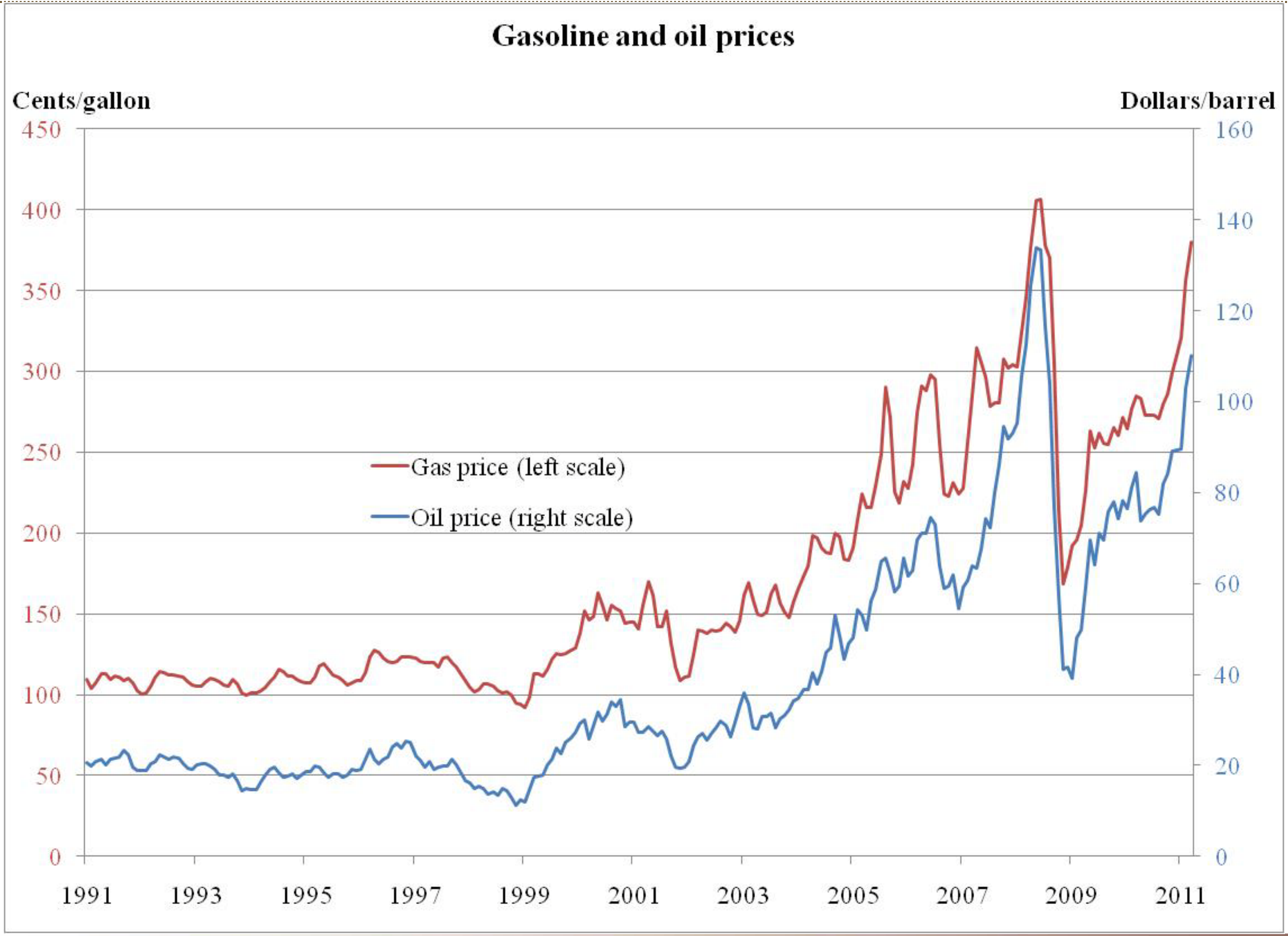
Some Data on Commodity Prices

Indexes of commodity prices



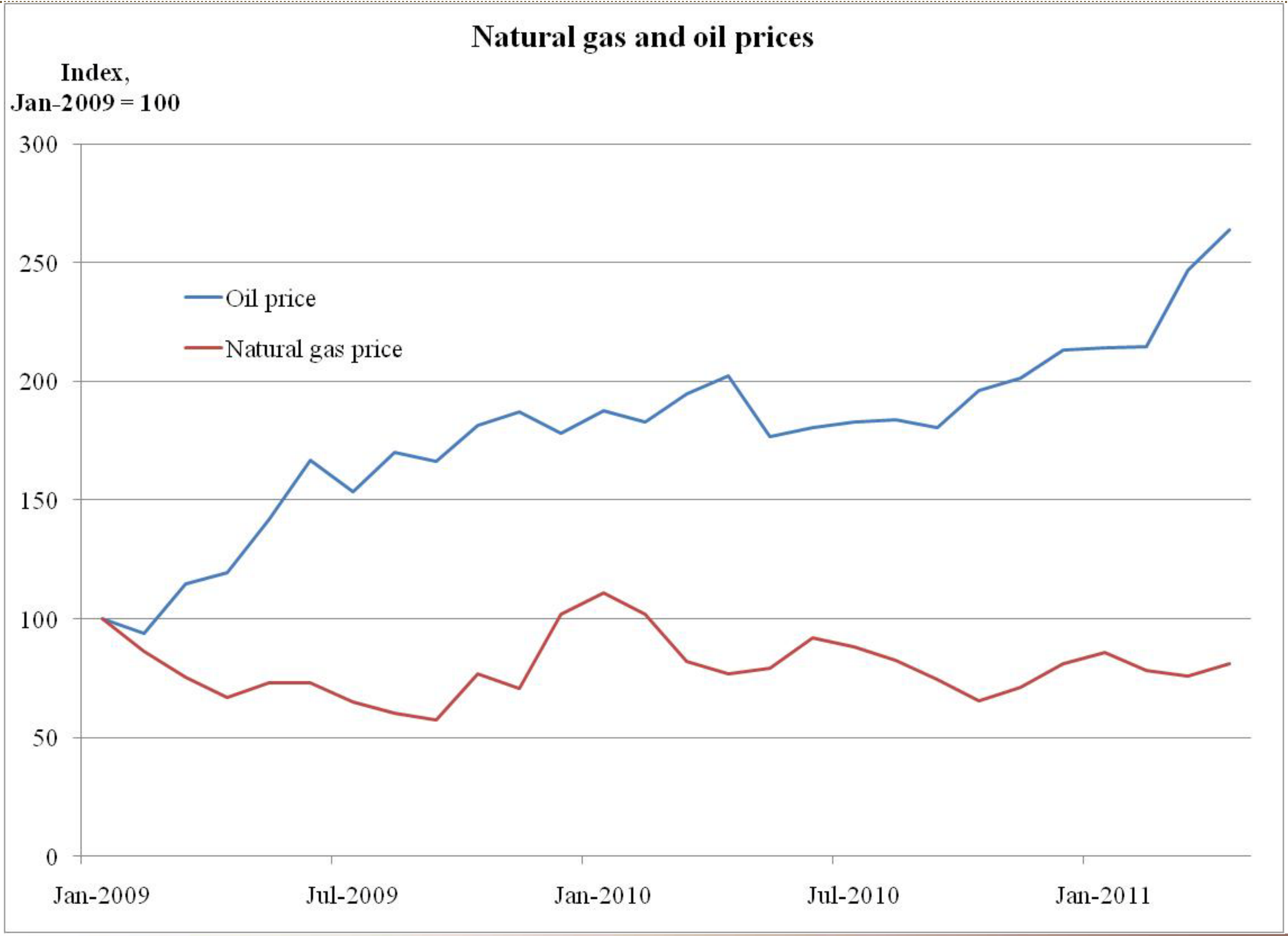
Source: International Monetary Fund. Last observation: April, 2011.

Gasoline and oil prices track closely



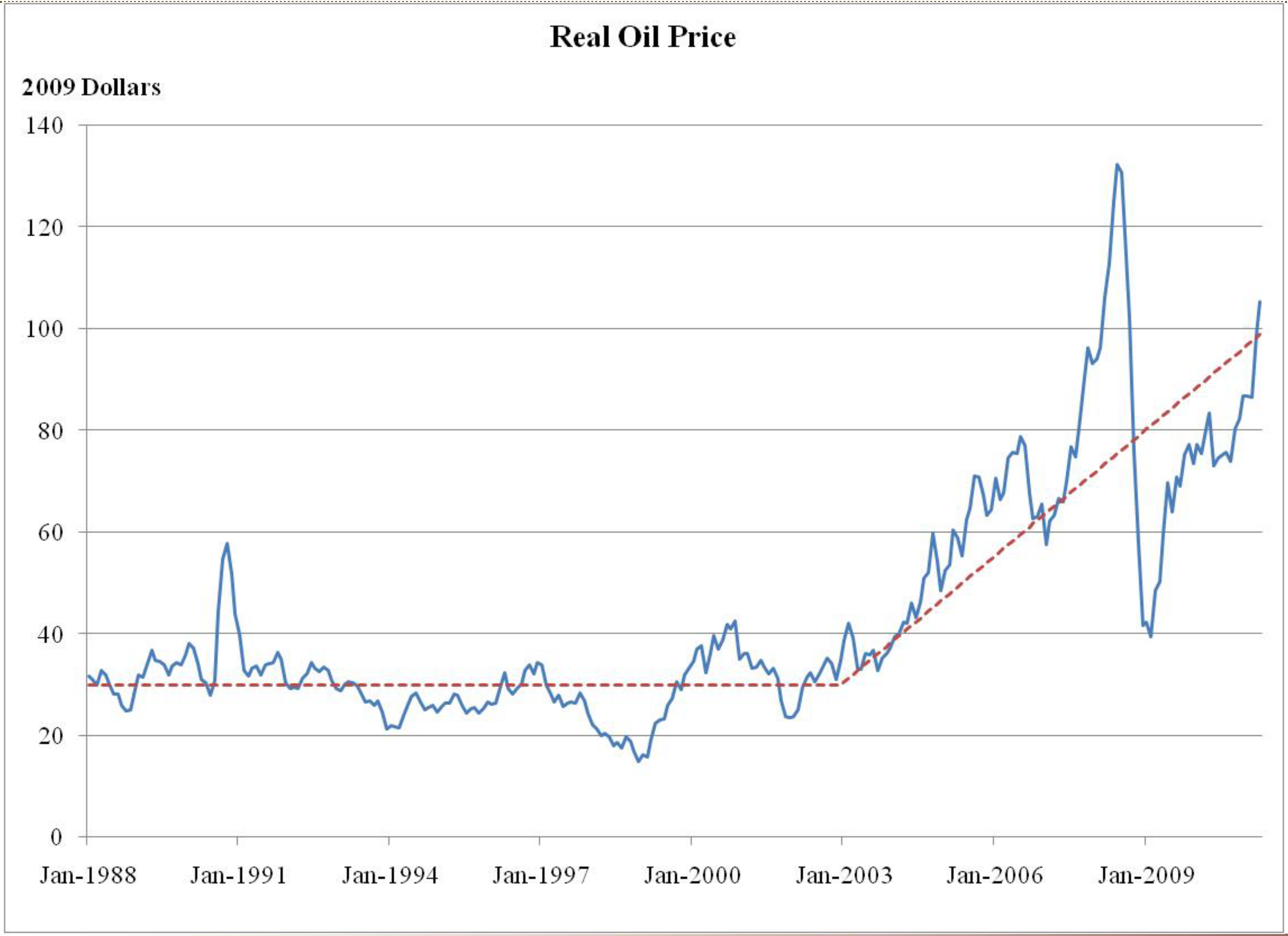
Source: Department of Energy and Wall Street Journal. Last observation: April 2011.

Natural gas and oil prices: different directions



Source: Wall Street Journal and author's calculations. Last observation: April 2011.

Real oil price: a structural change in 2003?



Source: Wall Street Journal, BLS and author's calculations. Last observation: April 2011.

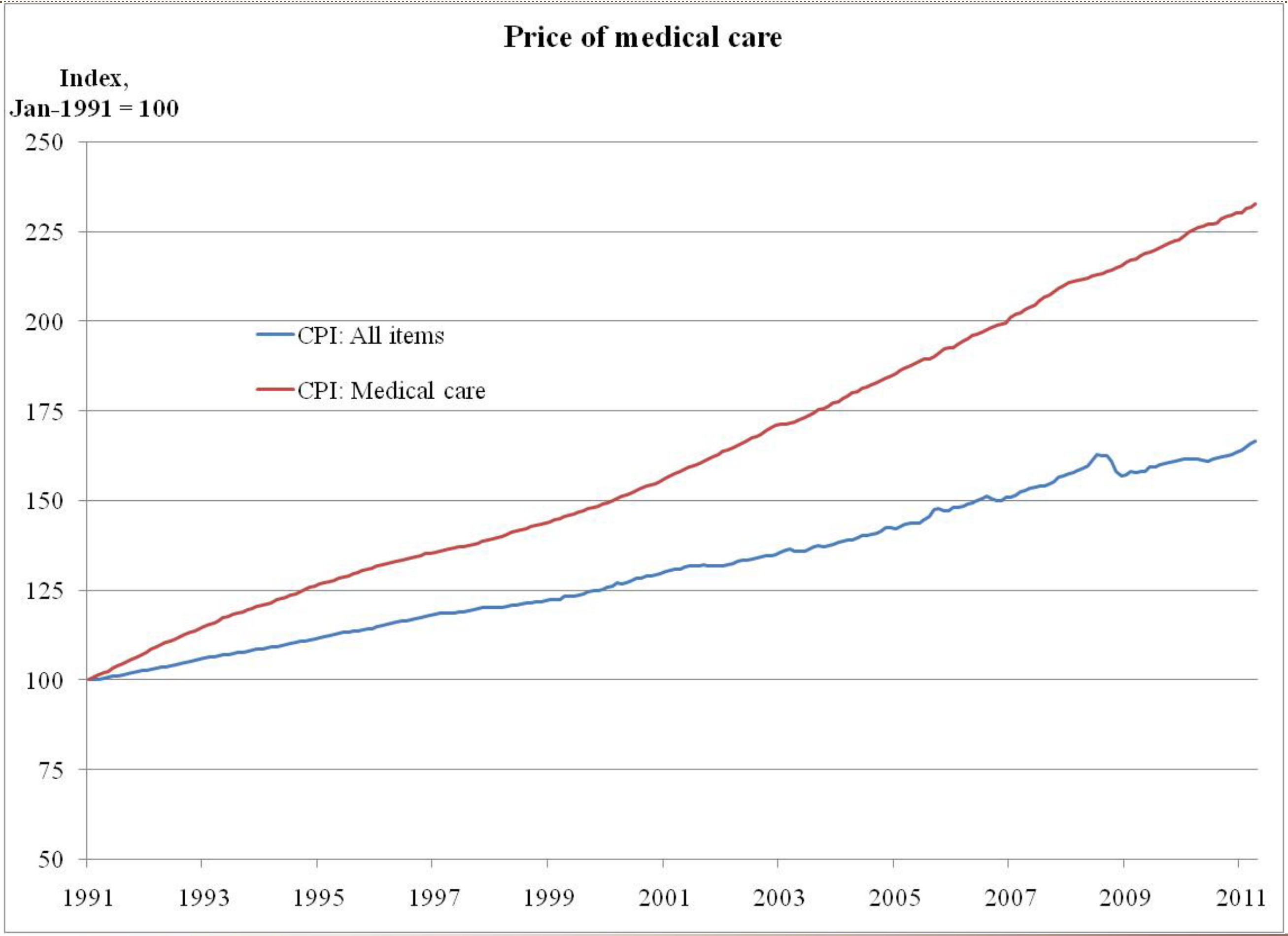
Can energy prices continue to go up indefinitely?

- No, because eventually we would have to spend all our income on energy.
  - Something has to give before that occurs!

- Still, some sectoral prices do continuously move in one direction for a long time.

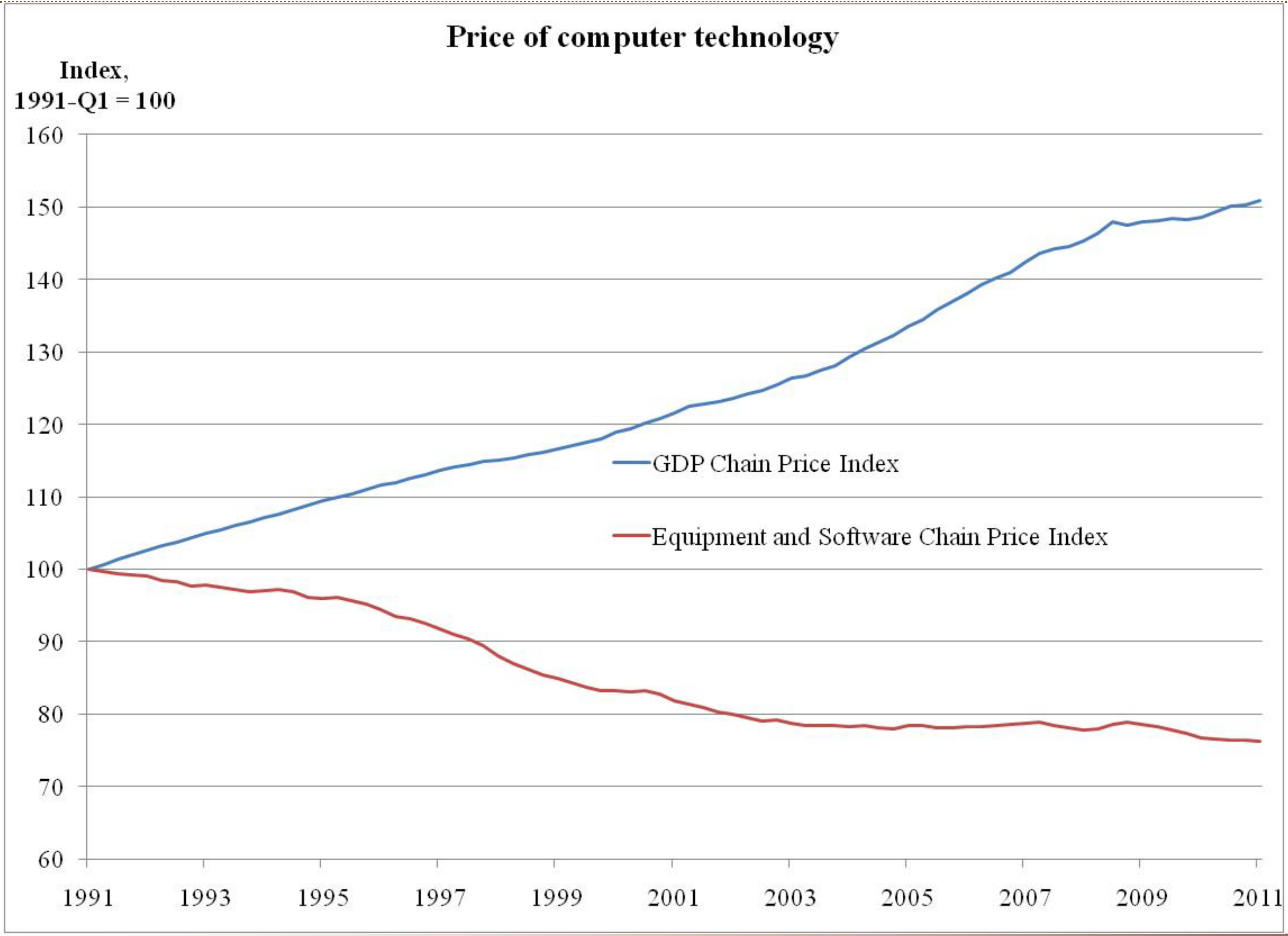
- Examples: medical care prices have increased, and prices for computer technology have decreased.

Price of medical care



Source: Bureau of Labor Statistics and author's calculations. Last observation: April 2011.

Price of computer technology



Source: Bureau of Economic Analysis and author's calculations. Last observation: Q1-2011.

A relative price shift for energy?

- It is at least a reasonable hypothesis that global demand for energy will outstrip increased supply over the coming decades.
- The increased demand comes as the giant economies of Asia, particularly India and China, converge toward Western levels of real income per capita.
- If that scenario unfolds, then ignoring energy prices in a price index may systematically understate inflation for many years.

Core Versus Headline Inflation

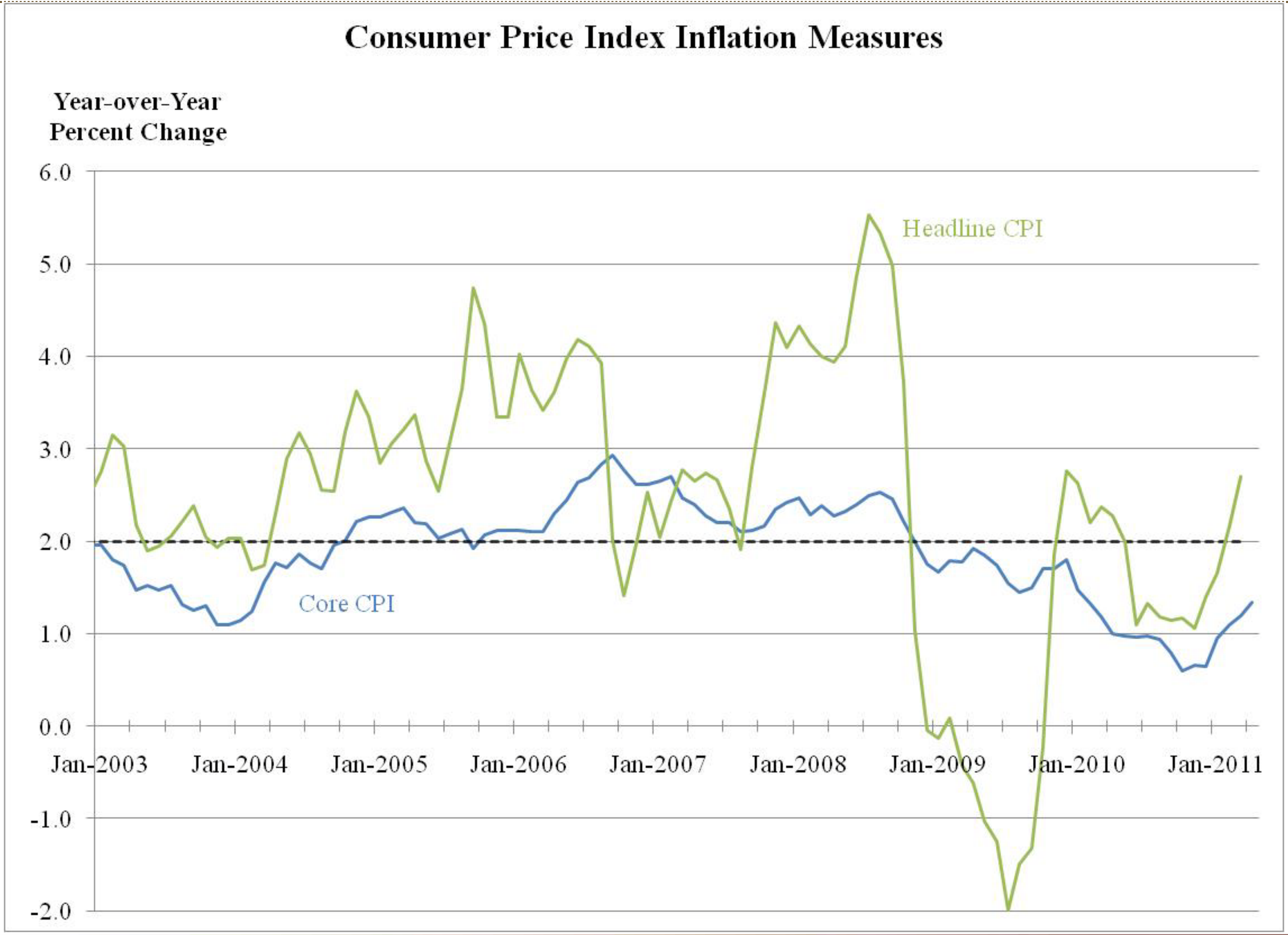
Building a price index: not easy

- There are a lot of prices out there.
- Inflation is a general rise in the price level.
  - Individual prices can go up and down …
  - … but households will shift their consumption in response.
  - This makes building a price index difficult.
- Quality adjustments are also difficult.
- The Fed does not compute the price level.
  - It is the job of the Bureau of Labor Statistics (BLS)—for the Consumer Price Index (CPI) —and of the Bureau of Economic Analysis (BEA)—for the Personal Consumption Expenditures (PCE) chain-type price index.

Core versus headline inflation

- Headline inflation refers to overall price indexes.
- Core inflation refers to the same indexes, but without the food and energy components.
- Core inflation is often smoother than headline inflation.
  - Core eliminates 20% or so of the prices in the index.
- The "core" concept has little theoretical or statistical backing. It is very arbitrary.

CPI inflation: headline versus core



Source: Bureau of Economic Analysis. Last observation: April 2011.

Headline inflation is the ultimate objective

- Headline inflation is the ultimate objective of monetary policy with respect to prices.
- These are the prices households actually pay.
- The only reason to look at core is as an intermediate target for headline.
  - Core is not an objective in itself.
  - Its use as an intermediate target is questionable.

Too much attention to core can mislead

- From 2003-2006, core inflation was consistently below headline inflation.
- Core inflation averaged about 2.0 percent during this period.
- But headline inflation averaged about 2.9 percent for the CPI, and about 2.6 percent for the PCE.
  - Core was not a good indicator of headline during this period.
  - Energy prices were rising and the economy was expanding.

Many of the older arguments for core have "rotted"

- See my recent speech, "The Core is Rotten."
- "Core inflation is less volatile than headline inflation."
  - It is less volatile by an arbitrary definition (throwing out food and energy).
  - That does not make it the right variable for monetary policy.
- "Core predicts future headline inflation."
  - This is not true for standard core PCE inflation according to recent research.
- "Oil prices are affected by supply and demand factors."
  - Every price is affected by supply and demand factors.

What should we do?

- U.S. monetary policy should de-emphasize core inflation, and increase the focus on headline inflation.
- One immediate benefit would be to reconnect the FOMC with American households and businesses who know price changes when they see them.
- The headline measures are designed to be the best measures of inflation we have.
- The FOMC should respect the construction of the price indexes and the policy problem it poses.

Explicit, numerical inflation targets

- The Fed lags the world's central banks in adopting an explicit, numerical inflation target in terms of headline inflation.
- The FOMC should adopt such a target.
- This would allow discussion of other measures of inflation in the context of a clearly stated ultimate goal with respect to the price side of the dual mandate.

Monetary Policy

Policy on hold

- Past behavior of the FOMC indicates that the Committee sometimes puts policy on hold.
- This gives the Committee more time to assess economic conditions.
- Hold in the current environment would mean:
  - The policy rate remains near zero.
  - The "extended period" language remains intact.
  - The balance sheet remains at the level as of the time of the decision to go on hold.

Commodity standards

Commodity standards

- Commodity standards were last discussed in the 1970s, when U.S. inflation was high and variable.
- Ironically inflation is quite low today.
- Tying the currency to commodities when commodity prices are highly variable is questionable.

A commodity standard forces accountability

- A commodity standard forces some accountability on the central bank.
  - The paper currency can be traded for the commodity at any time at a given rate.
- It did not always work, because governments sometimes changed the rate between the commodity and the currency.

Inflation targeting substitutes for a commodity standard

- Inflation targeting is another way to force more accountability to the central bank and anchor longer-term inflation expectations.
- Make the central bank say what it intends to do, and hold the central bank accountable for achieving the goal.
- In this sense, inflation targeting is the modern successor to a commodity standard.
- Inflation targeting is a better choice in the current environment.

Conclusions

Conclusion

- Headline inflation, not core, is the key policy goal with respect to prices.
- The FOMC should de-emphasize core inflation in order to reconnect with households and businesses that experience important price changes every day.
- Inflation targeting is the modern equivalent of the older commodity money standards.

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