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

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23 May 2011
Mineral Area College Foundation
Cozean Lecture Series
Farmington, MO

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

Natural gas and oil prices: different directions

Real oil price: a structural change in 2003?

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

Price of computer technology

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

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
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.