Macro Views

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A column devoted to understanding monetary policy issues for the long run.

The Fed’s Worries about Inflation

The FOMC’s press release of March 21 caused confusion in financial markets. Some saw the elimination of the phrase “additional firming” as a sign that the Fed was now more likely to ease rates than to lower them. But the statement still noted that the “predominant policy concern remains the risk that inflation will fail to moderate as expected,” as Chairman Bernanke pointed out in testimony before Congress on March 28.

Instead of looking for guidance in the Fed’s word choice in its statements, the markets would be better off looking at the data and considering the Fed’s credibility on inflation. As Chairman Bernanke noted in his testimony before Congress on March 28: “Another significant factor influencing medium-term trends in inflation is the public’s expectations of inflation. These expectations have an important bearing on whether transitory influences on prices, such as changes in energy costs, become embedded in wage and price decisions and so leave a lasting imprint on the rate of inflation. It is encouraging that inflation expectations appear to be contained.”

If inflation continues to rise, as it has been doing in the past year, those inflation expectations will begin to edge up. People will look at the data and wonder if the Fed can really keep the nominal fed funds rate target unchanged as inflation and inflation expectations rise, which means the real interest rate is declining, where the real interest rate is defined as the nominal interest rate minus the expected inflation rate.

Let’s look at the data on inflation and see if they suggest any worries about inflation. The most common variable to use for examining the trend in inflation is the consumer price index excluding food and energy prices. Most FOMC members are looking for this variable to be in the range of 1% to 2%. Data through February show it running at 2.7%, as you can see in the figure. One year ago, the Fed was probably hoping that monetary policy had been tight enough to reduce inflation gradually, as the figure shows. Instead, inflation rose to almost 3%, which is why the hawks on the FOMC were so concerned, and why the Richmond Fed’s Jeff Lacker dissented in favor of tighter policy at the last four FOMC meetings of 2006. Inflation today is a full percentage point higher than the Fed had likely planned. The hawks must be seething.
Last spring and summer, the Fed thought that inflation would begin to moderate. As the figure shows, they were mistaken. Minutes of the May 2006 FOMC meeting suggest that “consumer prices, after increasing at a faster rate in the first half of the year, were expected to decelerate later this year and next year.” At the June meeting, the last one in which monetary policy was tightened, “inflation was seen by most participants as likely to edge down.” At the August meeting, the staff forecast suggested that “core consumer price inflation was projected to drop back somewhat later this year and next, mainly as the effects of higher energy and import prices abated.” With inflation rising over this period from 2.1% to 2.9%, the Fed’s forecasts do not appear to be very accurate.

What must the Fed do to get back on target? Probably nothing in the next few months, as worries about the housing market, sub-prime lending, and autos indeed mean that there will be no “additional firming.” But after the economy settles down this summer, unless the inflation numbers start to decline significantly, look for the Fed to begin tightening again. They have no choice.