Economic SYNOPSES

short essays and reports on the economic issues of the day

2006 Number 28



Who's Worrying about Inflation?

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There is a puzzle in U.S. bond yields. The FOMC's statement after its October 25 meeting included some concern over future inflation: "Readings on core inflation have been elevated, and the high level of resource utilization has the potential to sustain inflation pressures." Participants in the long-term bond market do not seem to be worried, though. Should they be? Comparing the U.S. inflation experience with that in the United Kingdom may provide some insight.

The Fed does not have an explicit inflation target, but does have an implicit goal of price stability; and, like the inflation targeting countries, it has had a low and stable inflation rate. The Bank of England has had an inflation target since 1992. The U.K. target was 2.5 percent until 2004, when it was lowered to 2 percent after they changed the price index that was used to define the target; actual and expected U.S. inflation rates have centered on 2.5 percent since about 1996.

The chart shows U.S. consumer price index (CPI) and U.K. retail price index (RPI) inflation rates during the past decade and illustrates the simple idea that the U.S. CPI

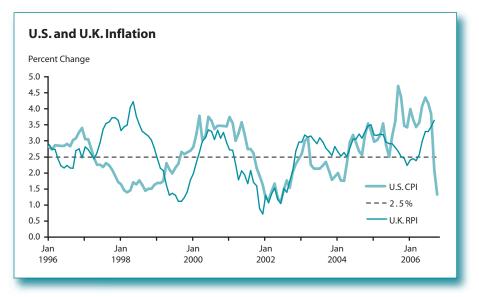
inflation rate has behaved as if the Fed did have an inflation target. The actual deviations of the U.S. CPI from a 2.5 percent trend are not noticeably different from U.K. deviations. At times, there were large differences between U.S. and U.K. inflation, but the *amplitude* and *frequency* of the deviations are approximately the same in both countries.

Some analysts are concerned about what this chart shows: that U.S. CPI inflation has been higher than trend for the past two years. Has something changed? This increase is attributed to the worldwide oil price shock, and yet the same increase does not show up in the U.K. data.

Proponents of explicit inflation targeting have argued that a target would help concen-

trate expectations and encourage pricing behavior that would lessen and shorten deviations from trend. This comparison with the U.K. experience suggests that any improvement in observed deviations from trend probably would be small, but an interesting question arises: Even if it makes no difference in observed inflation dynamics, would the adoption of an explicit target make it easier to achieve any given target with a less aggressive interest rate policy?

The October FOMC statement further cautions that "the Committee judges that some inflation risks remain. The extent and timing of any additional firming that may be needed to address these risks will depend on the evolution of the outlook for both inflation and economic growth, as implied by incoming information." It may be that an inflation target would allow for a gentler policy response, should one be needed; of course, the bottom line is, if the FOMC is truly worried about inflation, then the bond market does not have to be.



Views expressed do not necessarily reflect official positions of the Federal Reserve System.