

# INVESTMENT UPDATE

## Is the US ready for inflation targeting?

There's a long list of countries who've adopted the practice of "inflation targeting," where the country's central bank explicitly lays out both the desired future path of inflation and the means to deal with it. Many of these countries introduced inflation targeting as a way of coming to grips with consumer prices that had been running well above what most of us would describe as "low" inflation. While most of these countries have emerging or developing economies, they have been joined by a number of important developed economies, including Canada, England, Australia, Sweden and Spain (among others); all have adopted inflation targeting as a critical component of their countries' monetary policy.

In most forms of inflation targeting, not only does the central bank quantify the desired level of inflation, they also put in place certain policies that are stipulated to be used in order to achieve the inflation targets. Inflation targeting is also typically associated with full communication to the public regarding the targets, the tools and mechanisms for achieving those targets, and periodic announcements as to the progress the central bank is making towards their goals.

The Federal Reserve, despite many heated discussions over the years (including an important presentation last month by Fed Vice Chairman Donald Kohn), has steadfastly refused to embrace explicit inflation targeting, choosing instead to operate within an announced range of "inflation expectations." It was the long-held opinion of former Fed Chairman Alan Greenspan that moving to specific inflation targets would limit the Fed's flexibility to deal with a wide variety of economic scenarios. Greenspan didn't want to have to follow a set of fixed guidelines that dictated, cookbook-style, what steps the Fed might have to take when inflation edged towards extremes, and he didn't want to communicate to the public all the alternatives the Fed might be considering.

Interestingly, one of Greenspan's most vocal opponents in speaking out in favor of inflation targeting in recent years is none other than new Chairman Ben Bernanke. Bernanke, quite literally, wrote the book on inflation targeting, with 2001's *Inflation Targeting, Lessons from the International*

*Experience* (co-written with Laubach, Mishkin and Posen). While Bernanke has been careful to warn against overly rigid "rule based" inflation targeting policies, he nevertheless favors a far more structured process than is now in place here in the US.

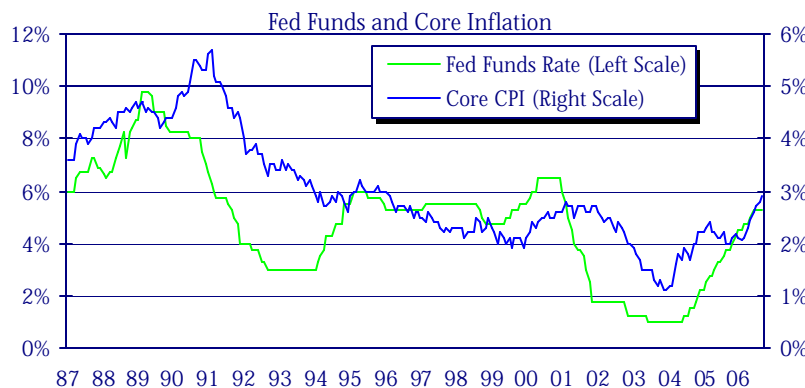
The main argument in favor of inflation targeting is that it lays out, in fairly explicit terms, the ground rules for dealing with inflation. Proponents point out that without these ground rules the fight against inflation, and indeed the health of the US economy, is subject to the whims of the Fed's Open Market Committee. Since the shifting membership of the FOMC largely consists of political appointees, critics argue, the Com-

mittee could be packed with those of a certain economic persuasion (e.g., pro-growth advocates), or with under-qualified cronies of the administration. While these arguments seem far-fetched, it must be pointed out that the previous Chair of this Committee was a man with tremendous persuasive skills and enormous credibility.

Advocates of inflation targeting will be the first to remind us that we haven't always been blessed with charismatic and talented Fed Chairmen.

The other main argument is that inflation targeting helps to anchor inflation expectations. If the central bank operates under the rules of inflation targeting, they have no choice but to follow policies that seek to minimize and stabilize inflation. When inflationary pressures build, consumers and businesses won't have the degree of concern they would otherwise have that inflation might rise unchecked; a system is in place to keep the lid on rising prices. These tools are most effective, according to proponents, when combined with effective communication from the central bank, which explains to the investing public, the capital markets, and their political overseers what actions are being taken and what the future course may be.

"Constrained discretion" is the term Bernanke introduced in a 2003 speech (while serving as a Governor of the Federal Reserve) to describe the type of inflation targeting policy he favors. Under this policy, the Fed would retain some flexibility in dealing with inflation, but would need to take "two princi-

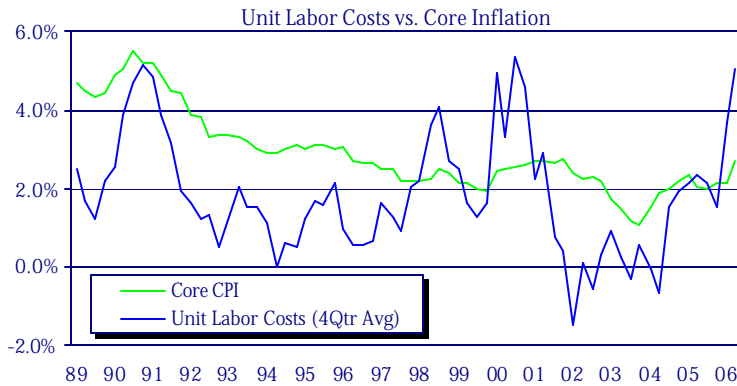


pal steps: first, to quantify (numerically, and in terms of a specific price index) what the FOMC means by ‘price stability’, and second, to publish regular medium-term projections or forecasts of the economic outlook.” Currently, the Fed publishes a semi-annual *Monetary Policy Report to the Congress*, which lays out central tendencies for inflation, GDP growth and unemployment; but this falls short of an explicit quantification of the Fed’s inflation target. It would seem that the second condition is close to being met, as the Fed Chairman testifies twice per year to a joint Congressional Committee in order to personally deliver the *Policy Report* as well as to report on recent Fed decisions and discuss the outlook and likely course of action for US monetary policy. In addition, the Fed has opened up significantly in its communications to the public over the past few years, with more complete press releases on the day of the FOMC meeting, timely release of the FOMC minutes, and periodic speeches by Fed Governors and regional bank Presidents.

With the recent change-over in both houses of Congress, Bernanke might find the job of selling inflation targeting a little tougher: as a general rule, the Democrats on the Banking/Financial Services Committees tend to tilt more towards the “full employment” half of the Fed’s dual mandate, rather than the “price stability” side of the equation. They are likely to view any attempt at formal inflation targeting as raising its relative importance at the expense of ensuring job growth. Of course, Bernanke would be eager to point out that the two aren’t mutually exclusive, as the low inflation/low unemployment experience of the last decade has clearly demonstrated.

Flexibility is exactly what the Fed is likely to need in the coming months. Currently, the bond market is torn between a slowing economy and a core inflation rate that has remained stubbornly above the 2% upper band of the Fed’s “comfort zone.” The formal rules of inflation targeting dictate that the Fed not lower rates with inflation well above the target and still rising. But with consumer spending on a downtrend due to the twin punches of higher rates and a weakening housing market, lower short rates may soon be the Fed’s desired prescription.

Yet, the inflation picture is troubling. As the top chart on this page shows, unit labor costs have been rising over the past few quarters, and, at a four-quarter moving average of 5%, are near the peaks of the past two cycles. Unit labor costs have proven to be one of the most highly correlated data series with core inflation, and given the relatively tight labor market in the US, are a source of deep concern for inflation hawks.



Meanwhile, the services component of CPI is currently inflating at a 4% rate year-over-year, as is the influential “owners equivalent rent” component. The medical component has been running above 4% for years now, and the education component has dipped recently—all the way down to a 5% rate over the past 12 months.

Perhaps the Fed will concentrate on the good news on the inflation front—and there is some good news, especially in the energy sector—crude oil prices are now below \$60 per barrel, their lowest levels since Hurricane Katrina, while other commodity prices have barely budged over the past year. Import prices (excluding energy) which spent most of 2006 on a disturbing uptrend, were up only 0.5% in October compared to last year. Gold prices (a traditional gauge of inflationary fear) are 8% lower than their recent peak this past Spring, and, as the bottom

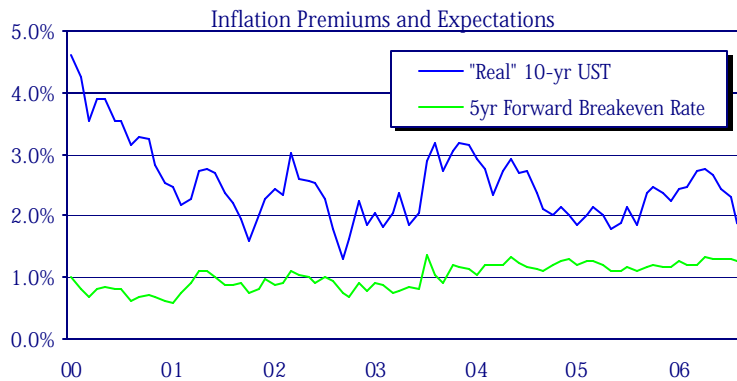


chart shows, inflation premiums (“real” or inflation-adjusted interest rates) have fallen since mid-year to their lowest levels in four years. And looking at the breakeven between how investors are pricing nominal and inflation-protected Treasuries in “forward” rates reveals no fear that inflation will move higher over the next few years.

Perhaps the absence of inflationary concerns simply reflects investors’ confidence in the Fed’s ability to suppress any real surge in US consumer prices. If their confidence is well-founded, there’ll be no groundswell in favor of inflation targeting, much to Mr. Bernanke’s chagrin.

Yet it’s still likely that the US will continue to move towards inflation targeting, at least in deed if not in name. That’s fine with us, as this may be a rare case where more regulation might actually benefit the economy.

