Fed @ Issue

Always and Everywhere: A Central Bank Phenomenon

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I read about inflation every day, mostly in academic work. But lately, I can't pick up a newspaper or magazine without seeing a story about inflation. Some of it is interesting. Some of it is ill-informed. But the volume of articles being written on the subject today makes one thing clear: people are anxious about inflation. And if you're a central banker with price stability as one of your dual objectives, that anxiety is not a good thing.

Let's look at a few of the more troubling recent developments. Food prices are rising globally, and the United States is no exception. Meat and egg prices are up more than 6 percent since this time last year. In January, gasoline prices were up 3.5 percent and apparel prices were up 1 percent for the month alone. So if you eat food, drive cars, and wear clothes—basically every American household—then your budgets have been getting squeezed.

But at the end of January, the Federal Open Market Committee (FOMC), the folks responsible for keeping inflation in check, had this to say: "[M]easures of underlying inflation have been trending downward … [and] are currently low relative to levels that the Committee judges to be consistent with price stability."

I'm guessing that you'd like to invite someone from the FOMC to walk with you down the aisles of your local grocery or drive with you as you fill up your gas tank and point out that downward-trending inflation they're so concerned about.

Drawing distinctions

I'm not sure I can bridge the gap between what you're *feeling* and what the FOMC is *saying* about inflation, but it might help if I reiterate a few principles Atlanta Fed President Dennis Lockhart discussed in a recent speech to the Calhoun County Chamber of Commerce in Anniston, Ala.:

- Inflation encompasses all prices and is a reflection of a decline in the purchasing power of money. It is a distinct concept from your cost of living, which is the cost of attaining a certain standard of living.
- While central banks—and only central banks—can affect the purchasing power of money, central banks are powerless to prevent fluctuations in your cost of living.

The idea that underlies these principles is that inflation is about money, but your cost of living is about goods and services you buy to maintain a certain standard of living. Since the central bank controls the amount of money that circulates in our economy, it ought to be clear that the central bank can ultimately determine what the rate of inflation will be. But equally clear is the fact that the central bank does not produce oil, or grow food, or make clothes. So if what's happening to prices is a result of droughts or growth or turmoil in emerging nations, central banks will find that their tools cannot prevent these costs from ultimately pinching your wallet.

But in today's vernacular, it seems inflation has become synonymous with any price increase, and the goal of price stability can be mistaken as a commitment from the central bank to prevent *any* price increase. So let me add a third principle to the discussion—price stability isn't assurance that your cost of living won't rise; rather, it's an assurance that as you make long-term financial decisions, you do it with reasonable certainty about what the purchasing power of your money will be in the future.

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How's that third principle looking? Well, economists' forecasts put the average rate of inflation right at 2 percent over the next 10 years, which is where participants of the FOMC see it, too. That forecast should give heart to the central bank, even if the recent behavior of food prices doesn't.

Peering down the road

Does this mean inflation isn't a risk? After all, the Federal Reserve's balance sheet, which has grown from about $900 billion to $2.5 trillion in the past year-and-a-half as a consequence of our asset-purchase programs, is in uncharted territory. Doesn't the size of the balance sheet threaten the purchasing power of our money? It's a legitimate question. But the more than $1 trillion in excess reserves held by the Federal Reserve hasn't made its way into the economy in the form of bank loans and need not be inflationary as long as we have the tools to manage our balance sheet when the time comes.

Let me quote from a speech Federal Reserve Chairman Ben Bernanke gave to the National Press Club on February 3 on this topic:

"[I]t bears emphasizing that we have the necessary tools to smoothly and effectively exit from the asset purchase program at the appropriate time. In particular, our ability to pay interest on reserve balances held at the Federal Reserve Banks will allow us to put upward pressure on short-term market interest rates and thus to tighten monetary policy when required, even if bank reserves remain high. Moreover, we have developed additional tools that will allow us to drain or immobilize bank reserves as required to facilitate the smooth withdrawal of policy accommodation when conditions warrant. If needed, we could also tighten policy by redeeming or selling securities."

In other words, we have a belt and suspenders to do our jobs. ∎

Note: To see the latest inflation indicators and research, please see the Atlanta Fed's Inflation Project web page at http://www.frbatlanta.org/research/inflationproject/.