Rising Prices, the Cost of Living, and Inflation

Dennis P. Lockhart
President and Chief Executive Officer
Federal Reserve Bank of Atlanta

Calhoun County Chamber of Commerce
Anniston, Ala.
February 8, 2011

I think of Anniston as Main Street America. Main Street is justifiably concerned today about the sustainability of the modest recovery that's been under way now for six quarters, the persistence of high unemployment, and the specter of inflation. These concerns, in combination with appropriate worry over the fiscal track the country is on, make for a heavy weight of apprehension holding back business investment, hiring, consumption, to some extent, and—taken together—the growth rate of the economy.

Today I want to give you my assessment of our current economic circumstances with some recent historical context. I will comment briefly on three principal indicators of economic health: growth, employment, and inflation. And because movements of commodity and other "headline" prices seem to be creating the impression in the popular consciousness of a growing inflation problem, I would like to give particular attention today to inflation.

As is always the case, today I am speaking for myself only. My views may not be shared by my colleagues on the Federal Open Market Committee (FOMC) or in the Federal Reserve.

Economic outlook

First, let me comment on the state of the economy. Economic conditions continue to improve. The economy first began to recover in the summer of 2009 and by the end of last year had reached its prerecession level of activity.

The recovery has been fitful. Economic growth rebounded strongly in the first few quarters after the recession. Growth was propelled by a combination of inventory adjustments, increase in exports, and the satisfaction of deferred demand on the part of businesses and consumers that had been put on hold during the recession. Government stimulus, such as the "cash-for-clunkers" program, also supported growth.

In the spring of last year, the recovery began to lose speed. Disappointing economic numbers and the emergence of problems with European sovereign debt brought out fears that the economy might fall back into recession. Also, inflation continued to drift lower, raising the prospect of tipping into a deflationary dynamic.

In the middle months of last year, weakening growth, ongoing disinflation, and falling inflation expectations prompted the Federal Reserve to begin a second round of large-scale asset purchases. The FOMC announced a policy decision on November 3 to purchase a further $600 billion of Treasury notes by the end of the second quarter of 2011. The possibility of this policy move was signaled at the end of

August in a speech made by Fed Chairman Ben Bernanke. Over the last months of the year, in anticipation of the policy move, the probability of deflation, as measured by Treasury Inflation-Protected Securities (TIPS) began to decline, fears of a double-dip recession started to fade, and equity prices resumed their climb.

The economy steadily gathered momentum through the fall and ended the year on an upbeat note. Unexpectedly robust consumer spending pushed up growth of gross domestic product (GDP) to an annual rate of 3.2 percent in the fourth quarter, and I believe much of that strength has carried over into 2011. I expect that this moderate rate of growth will be sustained as the year progresses.

Improvement in the labor market has lagged broader economic recovery. While the rate of joblessness dipped lower in December and January, unemployment, at 9 percent, is still high, and the pace of job growth has been frustratingly slow. A number of factors are restraining job creation, including improving but still relatively modest growth in overall demand, slower business formation, and productivity enhancements in the workplace that have altered the need for workers. Businesses remain cautious about adding to their payrolls given the still tenuous nature of the recovery and the still high degree of uncertainty they face. I expect the unemployment rate to fall over the coming years, but I think it unlikely that jobs growth this year will be strong enough to generate quick improvement.

Inflation

So what about inflation? I'll start with what the data tell us. The retail price measures jumped at year end as the price of gasoline rose. But looking beyond the rise in gasoline prices, consumer price increases remained exceptionally modest. In fact, about 25 percent of the consumer's market basket as measured by the consumer price index (CPI) showed declines in December.

A similar pattern is evident at the producer level, where industrial commodities prices were elevated during the fourth quarter. But excluding energy, upward price pressures at the producer level were less evident in the data.

In the most recent FOMC statement, following the January meeting, the committee acknowledged the rise of commodity prices, but stated that "measures of underlying inflation have been trending downward."

Yet inflation anxiety is rising. There seems to be a disconnect between what the Fed is saying and what people are experiencing when they fill up their gas tanks or read about rising food prices around the world. Over the last couple of weeks I've taken note of newspaper headlines. Here's a sampling: In *USA Today*, "Prices starting to creep higher"; in the *Wall Street Journal*, "Cost inflation puts a wrench into the works" and "Inflation fears replace other market worries"; in *Fortune* magazine, "How inflation is turning breakfast into a luxury item"; and just last Friday in the *Journal*, "Bernanke denies that Fed is stoking inflation." Are the Fed and the public on different planets?

Certainly not. But I do think in the swirl of official statements and public discourse we may be talking about different things. To my way of thinking, the term "inflation" is misused in describing rising prices in narrow expenditure categories (for example, food inflation). Nonetheless, recent price news has encroached on the public consciousness with the effect that any price rise of an important consumption item is often taken as signaling inflation.

I think it would be helpful, therefore, to remind ourselves of three basic points about inflation and a central bank's obligation to deliver price stability. They are:

First: The rate of inflation encompasses all prices. It is the practical equivalent of the weakening of the domestic purchasing power of our money.

Second: Inflation is to be distinguished from the cost of living. While central banks, and only central banks, can control the domestic purchasing power of our money, central banks are largely powerless to prevent fluctuations in the cost of living.

Third: The primary economic cost of inflation is that it increases the risk associated with long term planning and decision making.

Let me elaborate on these points.

Let's review what inflation is and is not. Inflation affects all prices. Inflation is not the rise of individual prices or the rise of categories of prices.

I want to contrast inflation to the cost of living. In casual language, we often interpret a rise in the cost of living as inflation. They are not the same thing. Cost-of-living increases are a result of increases in individual prices relative to other prices and especially relative to income. These relative price movements reflect supply and demand conditions and idiosyncratic influences in the various markets for goods and services. If some component of a household's cost-of-living basket goes up in price, the higher cost of living is not ipso facto inflation.

In principle, the central bank could respond to the impact of rising costs in particular markets, but only by exerting downward pressure on the dollar price of *all* goods and services. Monetary policy is a blunt instrument without the capacity to systematically influence prices in targeted markets. Because monetary policy affects the value of the dollar across the board, the targeted item would still be expensive relative to income and relative to everything else.

Here's my second point: The Fed, like every other central bank, is powerless to prevent fluctuations in the cost of living and increases of individual prices. We do not produce oil. Nor do we grow food or provide health care. We cannot prevent the next oil shock, or drought, or a strike somewhere —events that cause prices of certain goods to rise and change your cost of living.

So monetary policy is not about preventing relative price adjustments dictated by market forces. It is about controlling the broad direction and pace of change of all prices across the economy.

If monetary policy cannot reliably control the cost of living, what *is* the point? The point is bringing some certainty to planning and long term decision making of individuals and institutions. This is my third basic point. The benefit of price stability—low and stable long-term inflation—is that it reduces the risk associated with longer-term decision-making and avoids the drag on the economy that uncertainty creates.

Uncertainty about the long-term trend of inflation imposes a cost in the form of lower investment, misallocation of resources, redistribution of wealth, and other distortions. These distortions can be quite profound over time.

In the late 1980s I spent a year of frequent trips to South America. I remember a conversation with a Brazilian executive about the impact of hyperinflation on his country. He said that in hyperinflation , the first thought of a business manager each morning is what to do that day to his or her prices. He said that over time the hyperinflationary conditions bred a generation of people in business who were financially adroit, but few operations managers. In other words, the whole country was made up of people who knew how to manipulate their prices to stay alive and ahead of inflation, but few who knew how to run things.

Measurement of inflation

To achieve price stability, policymakers must detect inflation in its early stages before it is firmly established, especially in the psychology of consumers and businesses. This early detection is a challenge because inflation is not easily measured in the short term with any precision. No single price statistic enjoys a sufficient vantage point from which to assess inflation in the short term. With imperfect tools, inflation is more easily monitored than precisely measured.

Almost exactly 100 years ago, the economist Irving Fisher, who laid out many of the foundational ideas about money and inflation, likened measuring inflation or the purchasing power of money to tracking a swarm of bees. The swarm is going in a certain direction, while the bees have their own individual movements within the swarm.

How to measure the direction of the swarm? In the Federal Reserve Bank of Atlanta's monitoring of inflation, we track a large number of indices and evaluate their internal dynamics. We look at both "headline" and "core" measures of several indices to help us see through the specific influences of volatile food and energy prices. We study various "trimmed mean" price compilations to assess underlying price behavior beyond the traditional "core" statistics. We watch so-called sticky prices that businesses tend to change only infrequently as well as a large number of commodity and asset prices to get a sense of price behavior that may be especially forward looking. And we look at indicators that determine costs of both consumer price baskets and producer or business cost input baskets.
We also talk to a lot of people in various walks of life across the Southeast and get grass-roots information on prices and costs. Admittedly, much of this touches on narrow price behavior, but collectively this input provides color and nuance to the data. Using the many methods and tools, we "triangulate" to an estimate of current and projected inflation trends.

What we're searching for is the underlying inflation trend (the direction of the swarm) that the FOMC statement talks about and which we want to control. And since an exact fix on the state of inflation is elusive in the short run, the best policy approach, in my opinion, is to pursue a low, but positive rate of inflation over the longer term. As a policymaker, I think of the desirable level of inflation as high enough to provide a cushion of safety against the risk of tipping into deflation but low enough to be largely irrelevant—not a consideration—in long-term decision making. For me, this number is around 2 percent.

Staying focused on broad inflation

Notwithstanding the energy-driven jump in prices in December, underlying inflation is currently below the level that I would define as price stability. My current projection shows underlying inflation gradually rising over the next few years, putting us back into a range consistent with the 2 percent target by 2013. Key to the realization of this inflation forecast is that inflation expectations of the public remain well anchored. And for this to happen, the public has to have a good appreciation of what the central bank is trying to achieve and have adequate faith that we will achieve it.

In these remarks I have made a distinction between rising prices and a rising cost of living versus inflation. It's a fair question—is this a distinction without a practical difference? Not at all. The distinction is real and important for all of us to grasp. The distinction ought not to be lost on the general public because to understand the intent of current policy, to form reasonable expectations, and to make sound decisions for the long term, the attention should be mostly on the full picture of inflation and the long-term purchasing power of our money. As a policymaker, I watch prices—that is, the behavior of highly evident and prominent prices we all take note of. I am also interested in movements in the cost of living that the great majority of households experience. But I am focused most intently on broad inflation because I believe long-term stable prices to be fundamental to a healthy and growing economy. For the moment, inflation, properly defined, is tame, in my view. And the rise of individual prices does not signal incipient inflation.