St. Louis Fed's Bullard Discusses Commodity Prices, Inflation Measures, and Inflation Targeting

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CAPE GIRARDEAU, Mo. – Federal Reserve Bank of St. Louis President James Bullard delivered remarks titled "Commodity Prices, Inflation Targeting, and U.S. Monetary Policy" at a joint meeting of the Cape Girardeau and Jackson Rotary Clubs on Tuesday.

Bullard said ignoring energy prices in measures of inflation may understate the true inflation rate if rising energy prices represent a relative price shift for energy. In addition, he discussed headline and core inflation and stressed that the key policy goal with respect to prices is headline inflation rather than core. He also said that the Federal Open Market Committee (FOMC) "should de-emphasize core inflation in order to reconnect with households and businesses that experience important price changes every day." Bullard briefly discussed the merits of commodity standards and inflation targeting, concluding that "inflation targeting is a better choice in the current environment." With respect to monetary policy, "a pause allows more time to assess the strength of the economy," he said.

Commodity Prices

While there have been substantial increases in commodity prices in recent months, Bullard noted that energy prices cannot continue to increase indefinitely. "Still, some sectoral prices do continuously move in one direction for a long time," he added, citing two examples: prices for medical care, which have increased, and prices for computer technology, which have decreased.

Bullard said that as the giant economies of Asia converge toward Western levels of real income per capita, "it is at least a reasonable hypothesis that global demand for energy will outstrip increased supply over the coming decades." He added, "If that scenario unfolds, then ignoring energy prices in a price index may systematically understate inflation for many years."

Core vs. Headline Inflation

Bullard turned to a discussion of headline and core inflation measures, which refer to overall price index measures and measures without the food and energy components, respectively. He said core inflation is often smoother than headline inflation, but "the 'core' concept has little theoretical or statistical backing" and is very arbitrary.

"Headline inflation is the ultimate objective of monetary policy with respect to prices," Bullard said, noting that these are the prices that households actually pay. "Core is not an objective in itself," he added. He said that while the only reason to look at core is as an intermediate target for headline, "its use as an intermediate target is questionable."

Bullard also said that too much attention to core inflation can mislead policy. For example, from 2003-2006, while core inflation averaged about 2 percent, it was consistently below headline inflation. "Core was not a good indicator of headline during this period," he said. During those years, he added, energy prices were rising and the economy was expanding.

Bullard cited his recent speech, "Measuring Inflation: The Core Is Rotten," and talked about how many of the older arguments in favor of a focus on core inflation have "rotted" over time. Therefore, he said, "U.S. monetary policy should de-emphasize core inflation, and increase the focus on headline inflation." De-emphasizing core would "reconnect the FOMC with American households and businesses who know price changes when they see them."

In addition, Bullard said that the Fed lags behind many other central banks in adopting an explicit, numerical inflation target in terms of headline inflation. "The FOMC should adopt such a target," he said. Having an explicit target for headline inflation "would allow discussion of other measures of inflation in the context of a clearly stated ultimate goal with respect to the price side of the dual mandate."

Commodity Standards and Inflation Targeting

Although commodity standards were last discussed in the 1970s when U.S. inflation was high and variable, Bullard noted that today, inflation is quite low. He said, "Tying the currency to commodities when commodity prices are highly variable is questionable."

While a commodity standard forces some accountability on the central bank, in the past "it did not always work because governments sometimes changed the rate between the commodity and the currency," Bullard said.

"Inflation targeting is another way to force more accountability to the central bank and anchor longer-term inflation expectations," he said. "Make the central bank say what it intends to do, and hold the central bank accountable for achieving the goal."

"In this sense, inflation targeting is the modern successor to a commodity standard," Bullard said.

U.S. Monetary Policy

Bullard also discussed monetary policy after the Fed's current quantitative easing program ends. "Past behavior of the FOMC indicates that the Committee sometimes puts policy on hold," he said. He noted that hold in the current environment would mean:

- the policy rate remains near zero;
- the "extended period" language remains intact; and
- the balance sheet remains at the level as of the time of the decision to go on hold.

A pause "gives the Committee more time to assess economic conditions," Bullard said.