



## Greenspan's Inflation Is Bernanke's Problem

By John H. Makin

Since 1982, when the Federal Reserve under then-chairman Paul Volcker completed a dramatic victory over the double-digit inflation of the late 1970s and early 1980s, U.S. inflation has remained well under control. From the mid-1980s to the mid-1990s, inflation trended steadily lower with only occasional forays above 5 percent, such as occurred during a brief period of overheated growth in 1990 and 1991. Since 1993, inflation has generally kept below 3 percent and actually fell close to 1 percent during the deflation threat of 2003. Over the past ten years, the average inflation rate as measured by the Consumer Price Index (CPI) has been just 2.6 percent.

Conventional wisdom holds that the core inflation rate (which excludes fluctuations in food and energy prices) is a better guide to monetary policy than the overall rate. Indeed, the Federal Reserve has suggested that its goal is to see core inflation remain in a range between 1 and 2 percent. The implication of focus on the narrower core inflation rate is that most changes in food and energy prices are temporary and reversible, and therefore can be ignored as threats to inflation. However, one caveat applies: if higher energy prices or higher food prices persist, eventually, they are likely to spill through into the core inflation rate because fuel surcharges and higher transportation costs boost prices to suppliers, who then pass through elevated costs to final consumers in an effort to maintain profit margins. If energy inflation seeps into the cost of goods and services, the central bank responds with tighter monetary policy once the core inflation rate

remains persistently above 2 percent on a year-over-year basis. Like overall inflation, U.S. core inflation has been well contained for the last decade—averaging only 2.2 percent. The fact that core inflation has held below overall inflation over the last decades suggests that energy costs have risen modestly, but have not been passed through to non-energy goods or services.

### Recent Jump in Core Inflation

History notwithstanding, inflation concerns have risen sharply—more than actual inflation—during the last two months, primarily since the 0.3 percent month-over-month April increase in the core CPI was reported in May. That announcement was followed a month later with the news of another 0.3 percent month-over-month rise in the May core CPI, which boosted the year-over-year core inflation rate (the target of policy) to 2.44 percent, close to half a percent above the top of the Fed's desired range of 1 to 2 percent. Over the last three months, annualized core CPI inflation has jumped to 3.8 percent. The other measure of core inflation watched by the Fed, the Personal Consumption Expenditures (PCE) deflator, has risen in parallel, somewhat less than the core CPI, but it too has risen above 2 percent.

While the Federal Reserve is said to favor the core PCE deflator over the core CPI deflator as a guide to policy, there is a good case to be made for the core CPI as a better policy indicator. A large part of the difference between the two indexes is attributed to the larger weight of housing costs in the core CPI. The Federal Reserve's measure of the cost of housing services, "owners' equivalent

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rent,” is the indicator for the cost of housing that is factored into the core CPI and the core PCE. That is, the indicator for the cost of housing employed in U.S. inflation indexes is not the price of houses, but rather the price of housing services as measured by rents. Obviously, had the actual price of houses been included in the core CPI, both core and overall inflation would long ago have risen much higher. House prices rose about 13 percent last year and are still rising at a 5 or 6 percent year-over-year rate based on most measures. Had the price of housing been included in the core CPI in 2005, the year-over-year inflation rate would have reached 5.5 percent, more than enough to trigger an aggressive Fed tightening.

Owners’ equivalent rent has risen more rapidly in recent months because rents have risen. The lag in rents is a delayed indicator of higher house prices. As house prices have surged, sharply reducing housing affordability (the Housing Affordability Index has fallen sharply over the past year down to levels not seen since the tight money days of 1990); households have turned more to renting. Substitution of renting (a purchase of a flow of housing services) for the purchase of a house (the source of that flow of services), has boosted rents. Therefore, higher rents are a lagged reflection of the surge in house prices heretofore missing from core inflation measures. The Fed is correct to count higher core inflation measures driven by higher owner-occupied rent as an indication of additional inflation pressures that, in turn, may call for further tightening of monetary policy. Further, the core CPI reflects the lagged impact of higher house prices more fully than does the core PCE deflator and may therefore provide the Federal Reserve with a superior guide to higher living costs.

In fact, one could say that by eliminating house prices from measures of U.S. inflation, the Fed responds only with a lag to a persistent rise in house prices. This has happened over the past business cycle. The lagged response to higher house prices may itself be inflationary. If higher house prices boost wealth and thereby boost aggregate demand and inflation pressure, the Fed’s focus on the rental price of housing may result in delaying a needed tightening of monetary policy. If households feel better off because of substantial wealth gains from higher

house prices, they spend more money and therefore drive the prices of goods and services higher, ultimately requiring a further tightening by the Federal Reserve in order to achieve target levels of core inflation.

## The Fed’s Policy Challenge

The Federal Reserve and its new chairman, Ben Bernanke, are in the midst of a difficult transition period for U.S. monetary policy. Substantial wealth gains over the past five years of more than \$5.5 trillion have enabled U.S. households to maintain high spending levels at or above the level of income growth. Now that both measures of core inflation have moved well above 2 percent, with probable further upward moves in year-over-year inflation persisting at least over the next six months, the Fed, having hoped to end its tightening cycle at about 5 percent on the federal funds rate, will probably have to move to 6 percent by the end of 2006. If month-over-month core CPI increases on average 0.25 percent between now and December, the year-over-year core CPI inflation rate will be 3.1 percent, far above the Fed’s desired 1 to 2 percent range for that variable.

Meanwhile, Fed tightening that has moved the fed funds rate to 5 percent from 1 percent at its June 2004 low, with increases to 5.5 percent deemed highly likely by most observers, has produced some signs of economic slowing. Smaller increases in housing prices, higher borrowing costs, and the drag from higher energy prices will probably slow U.S. growth from the 5.3 percent rate seen during the first quarter of 2006 to about 3 percent in the second quarter.

The real question mark about U.S. growth arises in the second half of 2006. Nervousness about the prospect of further Fed rate increases has produced a sell-off in stock markets that erased about \$1.4 trillion of U.S. wealth between mid-May and mid-June. That figure represents about half of the increase in U.S. household net worth over the last year. In short, as persistent increases in year-over-year core inflation have forced the Fed to tighten further and further, the economic slowdown, or the prospect thereof, becomes more intense. Lower asset prices contribute to a self-reinforcing slowdown.

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Wealthier households, whose spending has held up very well thanks to past wealth gains, begin to slow spending and thereby to slow growth, thus further curbing wealth gains from higher prices of assets like stocks and housing. A \$1.4 trillion wealth loss is likely to cut growth over the following year by about one-half of one percent.

Meanwhile, higher energy prices have already reduced real incomes of poorer households that do not enjoy the cushion of wealth gains to help sustain their spending, as disposable incomes are reduced by higher energy costs. The 30 percent rise in energy costs over the past year is the equivalent of a tax increase on U.S. households and business that could reduce growth by about a percentage point. Taken together, higher energy costs and wealth losses that have already occurred may gradually lower U.S. growth from the current 3.5 percent rate to about 2 percent.

The Federal Reserve's tightening problem is complicated by some well-known characteristics of macroeconomic data. Macro trends usually persist for longer than many observers expect. Both growth and inflation are slow to come down as the Federal Reserve tightens. Once the inflation measure rises above the Fed's desired target range, as it has done this year, the Fed faces the problem of steadily rising inflation while growth persists. Since the Fed's only way to drive inflation back down is to force growth below trend levels, tension arises as inflation and growth persist, and markets therefore project further tightening by the Fed.

The combination during the second quarter of this year of targeted inflation measures above 2.5 percent, coinciding with growth at or close to the trend level of 3.5 percent, suggests the need for more tightening. The likely persistence of inflation, even as future growth slows, may well signal a need for more Fed tightening while weakening asset markets raise caution flags about the risks of overtightening. The awkward combination of inflation persisting as growth and asset prices fall—stagflation—makes the macroeconomic situation in 2006 the most challenging for a central bank to face. Certainly it is a scenario that Bernanke would not have chosen for himself. That said, the current challenging policy environment presents Chairman Bernanke and the Fed with a chance to prove to markets, households, and businesses their ability to manage monetary policy in the most difficult of circumstances. Chairman Bernanke's considerable abilities and sophistication as an astute student of U.S. business cycles provide him with an opportunity to build the public's confidence in the Fed.

## Past Fed Policy Errors?

With the benefit of hindsight, it is possible to say that the Fed has tightened too slowly at 25 basis points per meeting since the tightening began in June 2004. That judgment follows simply from the fact that, in the process of moving the fed funds rate from 1 percent to 5 percent at a rate of 25 basis points per meeting, the Fed has failed to contain inflation within its target ranges. The gradual and gentle tightening has been undertaken consciously with the desire to avoid overly upsetting asset markets while simultaneously moving to reduce inflation pressure that results from higher demand growth, which in turn is driven, in part, by substantial wealth gains associated with higher asset markets. It may be fair to suggest that an understandable fear of hurting asset markets on the part of Alan Greenspan, Chairman Bernanke's predecessor, allowed inflation pressure to build to a point where the Bernanke Fed faces some painful choices. The likely persistence of inflation and growth may force a higher terminal fed funds rate, more slowing of growth, and additional wealth losses than would have occurred had more tightening by the Greenspan Fed preempted building inflation pressures.

## The Goal Is to Maximize Growth

Through it all, markets should understand that the Fed will be unwavering in its determination to bring inflation back into the 1 to 2 percent target range. That is because the primary lesson of macroeconomic experience over the past half century has been that lower and more stable inflation go hand in hand and are associated with higher growth—and probably with gains in productivity and wealth. In effect, lower and more stable inflation reduces the economic energy that has to be devoted to managing the risks associated with higher and more volatile inflation and thereby enables higher and more stable growth as productivity improves.

Even if the Fed decides that it needs to slow the economy to growth rates well below potential in the 3 to 3.5 percent range in order to contain inflation, such measures should be viewed as an investment in maximizing the average growth rate over the next several years. Once the Fed achieves its inflation target and as markets understand, once again, the Fed's commitment to low and stable inflation, the growth of output and employment will be considerably higher than they would have been had the Fed simply allowed inflation to rise unchecked.