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1/08

| | | | | | |
|---|---|---------------------------------|----|---------------------------------------|----|
| Research and Policy _____ | 2 | CFS Working Papers _____ | 9 | CFS Conferences _____ | 22 |
| CFS Financial Center Index _____ | 2 | Events _____ | 10 | CFS Executive Education _____ | 26 |
| Fiscal Action versus Monetary Stimulus? | | CFS Colloquium _____ | 10 | CFS-DAI Seminar _____ | 29 |
| A Faulty Comparison _____ | 3 | Joint Lunchtime Seminars _____ | 14 | Miscellaneous _____ | 30 |
| Otmar Issing – Book Presentation _____ | 7 | CFS Presidential Lectures _____ | 16 | Timetable of Forthcoming Events _____ | 31 |

Editorial

Yes, inflation is back on the agenda.

After 11 months of first aid, heavy medication, personalized therapy and localized surgery, the fears of financial system breakdown and widespread recession are subsiding. These fears were most pronounced in the United States, where the strongest medicine in terms of monetary and fiscal stimulus was administered earlier this year (see our analysis on pages 3-7). But even former U.S. Treasury Secretary Lawrence Summers has changed his tune: “for the first time since last August, I believe it is not unreasonable to hope that in the U.S., at least, the financial crisis will remain in remission,” (FT, Mar. 31). And former Under-Secretary John B. Taylor has pointed to the danger ahead: “if you come out of this and inflation is still high or rising, that is going to be a challenge for the Fed for the next few years,” (SFC, Mar. 23).

On our side of the Atlantic, policy makers have been warning for months that higher inflation rates may become entrenched in the economy. Bundesbank President Axel Weber said: “I am concerned that, with regard to the conduct of wage and fiscal policy, the recent temporary heightened inflation rate could be consolidated for longer than is necessary above the tolerance

level of the Eurosystem. Should indications of this increase, we must react with interest rate policy” (Welt, Apr. 26).

Inflation, however, is measured differently by the ECB and the Fed. The ECB has defined its price stability objective in terms of overall consumer price inflation, i.e., the harmonized index of consumer prices (HICP). The Fed has not committed to a particular measure, but its preferences are indicated by the inflation projections of the Federal Open Market Committee (FOMC) published twice a year in a report to

| Inflation 2008Q1 | U.S. | Euro area |
|------------------|------|-----------|
| CPI /HICP | 4.2 | 3.4 |
| Core CPI/HICP | 2.4 | 2.5 |
| PCE | 3.4 | |
| Core PCE | 2.0 | |

the U.S. Congress. In 2000 FOMC inflation projections changed from the overall consumer price index (CPI) to the deflator for personal consumption expenditures from the national accounts, the PCE index. In July 2004 the FOMC switched again, this time to the core PCE index excluding food and energy prices. Last November they began publishing quarterly projections for core and overall PCE inflation.

Minor details, you might think, but take a look at the annual rate of inflation in the first quarter of 2008: Euro area inflation measured by the HICP stands at 3.4 percent

compared to 2.5 percent if food and energy prices are excluded. U.S. headline inflation is 4.2 percent measured by the CPI, but only 3.4 percent according to the PCE. Excluding food and energy reduces U.S. inflation to 2.4 percent in terms of core CPI and 2.0 percent in terms of core PCE. And conveniently, the FOMC just predicted that overall PCE inflation will decline towards core inflation by next year.

Should the ECB also switch to a core PCE measure? The FOMC’s track record with PCE projections suggests otherwise. In 2003 and 2004, FOMC projections substantially underpredicted inflation. In February 2004, for example, the FOMC projected PCE inflation of 1 to 1.5 percent for that year. Retrospectively, it is measured at 3.1 percent. This forecast provided crucial support for the federal funds rate target of 1 percent maintained till summer 2004 and for the slow pace of subsequent policy tightening. With the benefit of hindsight, Fed policy has been criticized for fueling U.S. housing prices and contributing to the environment that eventually caused the 2008 credit crisis. Had the Fed focused on forecasts of CPI inflation similar to those of private sector experts at the time, it would have raised interest rates more quickly as shown in CFS Working Paper 2008/16 by Orphanides and Wieland.

Thus, with inflation back on the agenda, measurement ought to be a key concern today.

Volker Wieland, CFS Director