Inflation trends and the role of central bankers
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On Friday in Washington the inaugural meeting of the US Monetary Policy Forum brings together academic economists, financial market participants and senior officials of the Federal Reserve system. It features discussion of a report, Understanding the Evolving Inflation Process, and a panel discussion of liquidity and monetary policy.*

The report is the product of an unusual collaborative effort between university and senior market economists. We expect it will trigger a combination of academic and applied research.

It contains findings that are important for monetary policymakers. The first is that, over decades, the level and volatility of trend inflation in the Group of Seven industrial countries rose and fell almost in unison.

This synchronisation narrows the economic factors that could have triggered the great inflation of the 1970s and what the report labels the “inflation stabilisation” that began in the mid-1980s. The usual suspects – commodity prices, globalisation, misestimates of productive capacity and the like – cannot explain the inflation experience.

The culprit was systematic shifts in central banks’ interest rate decisions. In the late 1960s central bankers lost control by consistently under-responding to rising inflation and in the mid-1980s they collectively became more assertive and regained control.

Looking at the relationship of actual inflation to inflation expectations, the report finds that, while changes in expectations did help to forecast movements in the inflation trend, they no longer do. Instead, things are the other way round. That is, changes in actual inflation trigger movements in expectations. This is sobering, since it means that controlling expectations may not provide policymakers with the leverage they hoped to use in keeping future inflation low and stable.

The panel discussion should prove interesting as well. A Google search for “liquidity and monetary policy” turns up 1.22m hits. Yet there is no accepted definition of what liquidity is and whether accounting for it is necessary to understand phenomena in capital markets. Likewise, there is no agreement about whether any of this matters for monetary policy.

With respect to process, the meeting also breaks new ground. It is rare to find two Fed officials speaking at an event. On Friday four members of the Federal open market committee will deliver prepared remarks. The audience will include another FOMC member and a number of the economists, associate economists and research directors of various Federal Reserve district banks who provide key staff support for the FOMC.

Aside from the annual Jackson Hole meeting, which is an official Federal Reserve event, Friday’s meeting is likely to represent the largest public gathering of Fed officials this year.

More important, the US Monetary Policy Forum is the next natural step in the Fed’s improved transparency. It is easy to forget that as recently as January 1994, the FOMC did not even announce its interest rate target. On Friday, in front of the press, many of the Fed’s leaders will be taking questions from an audience of money managers, market economists and US representatives of foreign central banks.

Twenty-five years ago, at the height of the great inflation, prices were rising at an annual rate of more than 10 per cent in more than half the world’s industrialised countries. Today, inflation is below 4 per cent in all of them. The conference report suggests that this change was the result of a
shift in the behaviour of central banks, not of changes in the structure of the economy or anything to do with the stability or instability of the relationship between inflation and unemployment.

Likewise, the evidence suggests that the current low inflation has helped stabilise expectations of future inflation, not the other way around.

This means that expectations are not likely to become unhinged until after trend inflation changes, so the Fed should not take too much comfort from the current confidence exhibited by markets. Instead, as the report suggests, continued vigilance to keep actual inflation contained is what is important.

* Available at: http://research.chicago gsb.edu/gfm/events/conferences/2007-us monetaryforum.aspx

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