

## U.S. Price Expectations Not Completely Anchored, Fed Paper Says

By Vivien Lou Chen – April 3, 2007, 16:39:03.600 GMT

U.S. long-run inflation expectations aren't "completely anchored" based on the way bond yields react to economic news, according to an analysis by Federal Reserve officials.

"We've seen inflation expectations better-anchored than they used to be in the 1970s, and there's been a big improvement," Eric Swanson, a research adviser at the San Francisco Fed bank, said in an interview yesterday. "But our paper is finding they're not perfectly well-anchored."

A comparison of changes in yields on nine-year and 10-year Treasury notes showed the rates fluctuated "significantly" to economic data releases, the study showed. By contrast, bond yields in Canada and Chile, which have had formal inflation targets since the 1990s, responded less consistently to news, according to the authors, who included Andrew Levin, chief of the Fed board's monetary studies section.

Economic news ought to have little or no effect on longer-term bond yields if investors' expectations for inflation are stable, Swanson said. Inflation erodes the purchasing power of bonds' fixed payments.

The Fed, unlike central banks including the European Central Bank and Bank of England, doesn't have a specified inflation target. Chairman Ben S. Bernanke has initiated a study into how the Fed communicates its policy objectives, led by Vice Chairman Donald Kohn.

Inflation expectations are "critical" to setting monetary policy even if officials don't fully understand how they're formed, Kohn said at a March 9 conference in Washington. Fed officials expect inflation to ease over the next two years, and are counting on stable expectations to help contain prices.

### Target Has Helped

"It does seem that an inflation target has helped to anchor long-term inflation expectations in countries like Canada and Chile," Swanson said. "Our paper does push in the direction of suggesting that an inflation target would have some benefits. But you could argue that there are also costs we haven't looked into yet."

The study's four authors, who also include assistant professor Refet S. Gurkaynak from Bilkent University in Ankara, Turkey, and Princeton University graduate student Andrew Marder, began their research two years ago while they all worked at the Fed in Washington, Swanson said. The San Francisco Fed posted the report on its Web site on March 27.

The analysis showed that the gap in nine-year and 10-year U.S. note yields responded “significantly to nine of the 12 macroeconomic data releases we consider, often with a very high degree of statistical significance,” the study said.

## **Close to ‘Shore’**

“One might question whether inflation expectations are close enough to the price-stability shore,” Richmond Fed President Jeffrey Lacker said at the March 9 conference. He said in a speech last week that the drop in inflation expectations since the early 1980s was most likely because the Fed was more aggressive in raising interest rates when prices climbed.

Policy makers voted unanimously on March 21 to keep their benchmark interest rate at 5.25 percent, the level it’s been at since June. In their accompanying statement, central bankers dropped their tilt toward higher borrowing costs at the same time as strengthening their language on inflation, calling it their “predominant concern.”

The Fed’s preferred inflation benchmark, the personal consumption expenditures price index minus food and energy, has been at or above the top of the comfort zone articulated by at least six Fed officials for almost three years.

The core PCE index rose 2.4 percent for the year in February and the three-month annualized rate accelerated to 1.9 percent, from 1.5 percent in January. Bernanke and other officials have said they prefer the rate to be 1 percent and 2 percent.