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OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

BEN S. BERNANKE
CHAIRMAN

May 24, 2006

The Honorable Jim Saxton
Chairman
Joint Economic Committee
Washington, D.C. 20510

Dear Mr. Chairman:

I am pleased to enclose my responses to the questions you submitted for the record following the hearing of April 27, 2006, concerning the economic outlook.

Please let me know if I can be of further assistance.

Sincerely,

Enclosure

Chairman Bernanke subsequently submitted the following in response to written questions received from Chairman Saxton in connection with the Joint Economic Committee hearing on April 27, 2006:

Q.1. Your testimony regarding the stance of monetary policy indicated that the Fed is not locked into a rigid, predetermined schedule of increases in the federal funds rate. Rather, future decisions will be data dependent, i.e., made on the basis of the most recent economic and financial information available. Your statement did not rule out any future increases in the federal funds rate. Is this a fair summary of the point you were making?

A.1. Yes. As conveyed in my testimony, monetary policy must be forward looking and depend on the Federal Reserve's best assessment of the economic outlook as inferred from economic and financial information. Indeed, the Federal Open Market Committee was quite explicit on this point in the statement issued after its meeting on May 10. The statement explained that "the Committee judges that some further policy firming may yet be needed to address inflation risks but emphasizes that the extent and timing of any such firming will depend importantly on the evolution of the economic outlook as implied by incoming information."

Q.2. As you know, there are a number of reasons why inflation targeting allows for a good deal of operational flexibility. Yet critics of inflation targeting often contend that adopting this procedure removes much of monetary policymaker's discretionary powers and flexibility.

- This criticism appears questionable given the host of adjustments and exceptions used in inflation targeting. For example, numerical bands rather than point estimates are usually used as policy targets by those countries successfully implementing inflation targeting. Similarly, multi-year targets are often employed. The inflation indices normally used are adjusted for volatile components as well as for other factors. In practice, countries adopting inflation targeting have all used a flexible approach in implementing monetary policy. Doesn't this suggest that inflation targeting is quite flexible?

A.2. By definition, an inflation targeting framework focuses on keeping inflation low and stable, and on clearly communicating to the public both the objectives of monetary policy and the strategy for achieving those objectives. The key advantage of such a framework is that it can help anchor inflation expectations more firmly and therefore promote greater stability in both inflation outcomes and resource utilization. As you point out, however, inflation targeting frameworks can be quite flexible. For example, in practice, all inflation-targeting central banks pay important attention in their policy decisionmaking not only to inflation but also to output and employment. Objectives generally are set for some date in the future, in recognition of the fact that monetary policy affects the economy only with a considerable lag. Some inflation-targeting central banks set multi-year targets, while others set policy so as to keep their inflation projection at a certain horizon close to its target; yet others aim to keep inflation close to its target on average over the business cycle. Specifying the inflation objective as a band may help convey the reality that inflation cannot be controlled perfectly at every instant, though a band may also increase the challenges around the communication of objectives and strategies to the public. These are a few of the key design features that can be used to build flexibility into the overall policy framework.

Q.3. What is the role of asset prices in a monetary policy focused on price stability? Should the central bank respond to asset price "bubbles" or disturbances such as a bubble in the stock market or a bubble in the real estate market? Or should it ignore such movements in asset prices?

- o Are there "moral hazard" problems associated with highly predictable central bank attempts to respond to asset price bubbles?

A.3. In setting monetary policy to achieve price stability, a central bank should take account of all factors influencing the economic outlook. Accordingly, a central bank cannot ignore movements in stock prices, home values, and other asset prices, but should respond to them only to the extent that they have implications for future output and inflation. Some observers have argued that a central bank should respond more aggressively to asset-price booms thought to have an important speculative component. In so doing, so the argument goes, a central bank can limit the future expansion of the bubble, thereby mitigating the fallout from its eventual bursting. However, the validity of this argument rests on several conditions for which there is little or no empirical evidence, including the presumptions that the central bank is better able than the market to identify speculative bubbles and that it can successfully "deflate" such bubbles without harming the broader economy. Given our limited knowledge of the forces driving speculative bubbles, the more prudent approach is to respond only as the overall outlook for output and inflation merits. Such a limited approach should also mitigate potential moral hazard problems that might arise were a central bank to, in effect, take responsibility for the appropriateness of asset prices.

Q.4. Federal Reserve officials often refer to the PCE (personal consumption expenditures) deflator in addressing measures of price changes. What are the advantages of the PCE deflator over the CPI? Does the CPI overstate inflation to some extent?

- What does the core PCE deflator currently tell us about the degree to which inflationary forces are being contained at present?

A.4. While the PCE price index generally moves roughly in line with the CPI--and indeed is derived largely from CPI source data--it does have some advantages relative to the CPI as a measure of inflation. The PCE chain-type index is constructed from a formula that reflects the changing composition of spending and thereby avoids some of the upward bias associated with the fixed-weight nature of the CPI. In addition, there is some evidence that the PCE weights are measured more accurately than the CPI weights. The PCE price measure also has some disadvantages relative to the CPI; most important, its broader scope necessitates the inclusion of some prices that are not derived from market transactions and so may add some noise to the overall index as a proxy for the cost of living.

Most analysts believe that changes in the CPI overstate changes in the cost of living to some extent. In 1996, the Senate Advisory Commission to Study the CPI (The Boskin Commission) assessed the bias in CPI inflation as centering on 1.1 percentage points per year, with a range of 0.8 to 1.6 percentage points per year. This result was similar to the findings of other analysts. Since the time of these studies, the BLS has made several improvements to the CPI that have, on balance, served to reduce that bias. In part for this reason, more recent estimates of bias in CPI inflation have generally been a little smaller than estimated by the Boskin Commission. For example, a recent study by Federal Reserve economists judged the bias in CPI inflation currently to center around 0.9 percentage point per year. The PCE price index likely is also biased upward, though probably by less than the CPI in light of the PCE measure's advantages cited above.

Although increases in energy prices have pushed up overall consumer price inflation over the past couple of years, core inflation has been more stable. The core PCE price index increased 2 percent over the twelve months to March of this year, about the same as the increase over the preceding twelve months. Similarly, the core CPI has increased 2¼ percent over each of the past two years. The stability of core inflation, even as many firms have faced substantial cost increases for energy products, has been enhanced by the fact that long-term inflation expectations appear to remain well contained. Of course, inflation expectations will remain low only so long as the Federal Reserve demonstrates its commitment to price stability.