

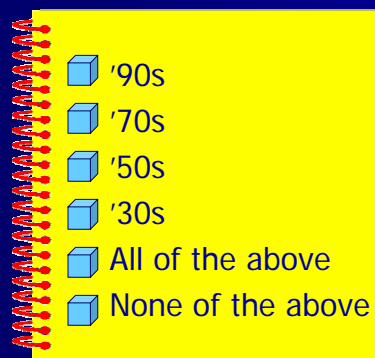
Inflation: It's Not Only Monetary Policy That Matters

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The Economy at a Tipping Point: Back to the ...



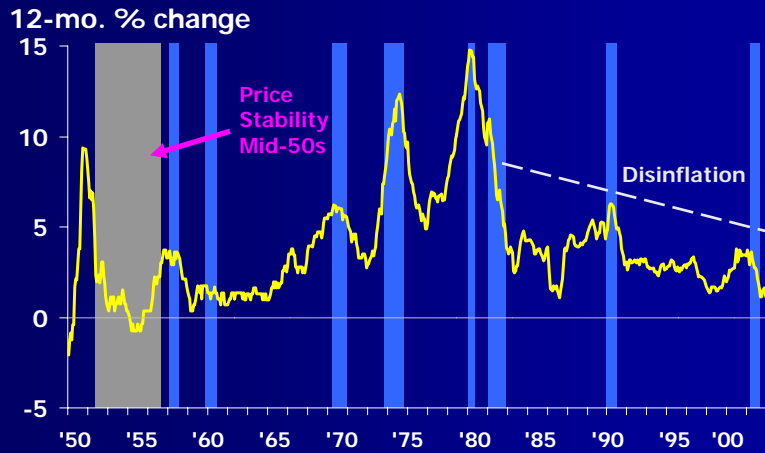
Whither Inflation?

Or Withering Inflation?

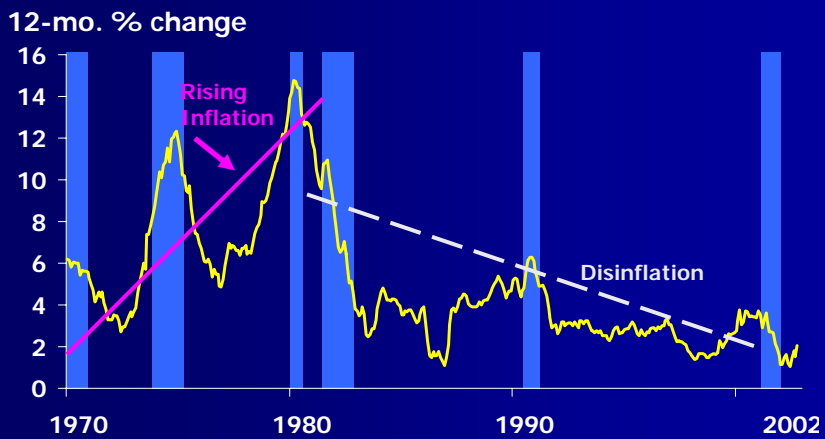
Implications of Price Stability: Back to the 1950s?



Consumer price inflation: 1950 - 2002



Inflation: more recent experience



Q: Why do the '80s & '90s look different from the '70s?

A: Monetary policy

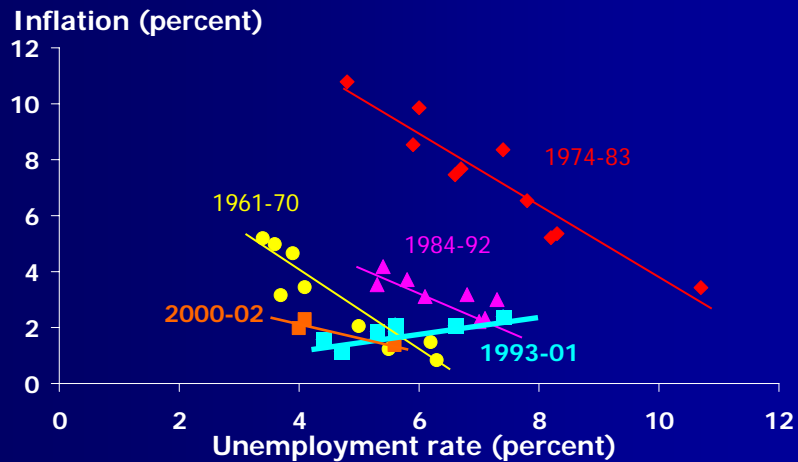
Microeconomic forces

- Globalization
 - NAFTA
 - Deregulation
 - Immigration
 - Technology
 - Competition
 - Productivity
- } **Interrelated**

The Phillips Curve

- Declining unemployment implies rising inflationary pressures, other things equal

The Phillips Curve slopes **up** in the 1990s!



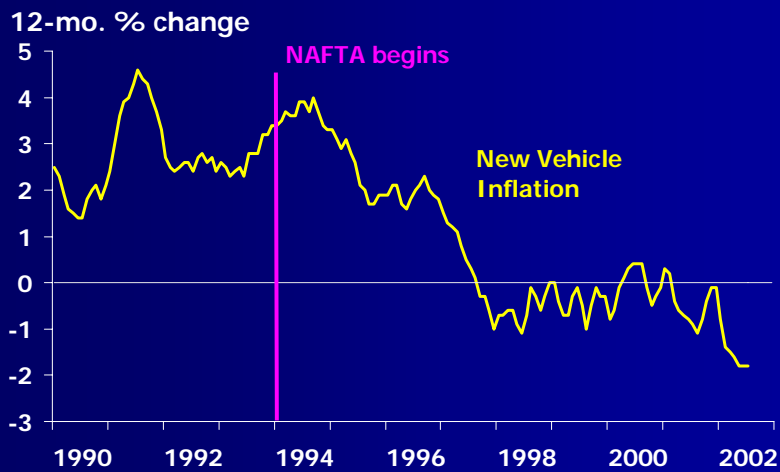
The Phillips Curve

- Declining unemployment implies rising inflationary pressures, other things equal
- But: **Other things are never equal**
- During the 1990s, microeconomic factors overpowered the importance of lower unemployment

NAFTA

- NAFTA became law in 1994
 - Strengthened investment incentives
 - Gave sense of “permanence” to trade relationships
- **BOTTOM LINE:**
 - Encouraged industries to reorganize
 - Enabled least-cost solutions that include Mexico
 - Boosted effective labor force

NAFTA impacts new vehicle prices?



Immigration

- New immigrants filled 5 million jobs in 1990s
- Legal immigrants accounted for 40 percent labor force growth
- **BOTTOM LINE**: Without immigration, inflation pressures would have been severe.

Competition

- Pricing power “disappeared” in the '90s
- Firms adopt new technology because they have **NO OTHER CHOICE**

Inflation paradigm shifted in the '90s

1970s and early '80s

Cost push
↑ cost → ↑ price
Pricing power
Inelastic labor supply
Adopting technology a choice
Regulated oligopoly markets

1990s

Cost compression
↑ cost → ↑ productivity
Absence of pricing power
Immigration & virtual immigration
Adopting technology an imperative
Deregulated, contestable markets
with globalization

Disinflation momentum

- Might have attained price stability by 2004

Today's inflation tug-of-war

Post 9-11 inflation forces

- Homeland security
- Federal deficits
- War on two fronts
- Nationalization
 - Airport security
- Re-regulation (Patriot Act)
- Globalization stalls
 - Increased protectionism
- Restricted immigration
- Monetary policy

Today's inflation tug-of-war

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-
- **Declining dollar**
 - **Oil and natural gas prices**
 - **Sarbanes/Oxley Act**

"Deflationary War"

An oxymoron?
or
A brilliant insight?

Today's inflation tug-of-war (cont)

1990s disinflation forces

- Monetary policy
- Microeconomic factors
 - Globalization/NAFTA
 - Demographics/immigration
 - Deregulation
 - Technology
 - Productivity
 - Competition

Post 9-11 inflation forces

- Homeland security
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BOTTOM LINE: **So far a standoff**

Price stability: Signposts

- Mortgage rates in the low 4s
- Fed changes target Fed funds rate by one-eighth point
- Commonly-used inflation indices around 1 percent
- Flat and low yield curve

A basic principle of economics and finance

- Long-run inflation expectations embodied in long-term interest rates

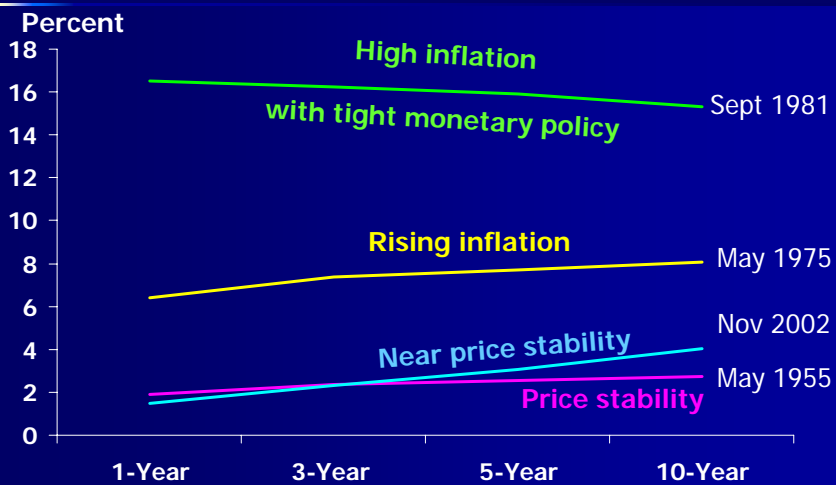
Bond yields follow inflation, with a lag



Mortgage rate in low 4s signpost of price stability



What does this mean for interest rates?



Back to the 1950s?



Mickey Mantle and Yogi Berra