

Inflation expectations and oil shocks

One might assume that the U.S. Federal Reserve sets inflation targets, it being the controller of the Nation's money supply and (according to economists who believe that inflation is a monetary phenomenon) determiner of the Nation's inflation rate.

In fact, although "stable prices" are among its monetary policy objectives, the Federal Reserve does not set official inflation targets. The Fed does not publicly announce a "target" inflation rate and then attempt to guide the actual inflation rate towards the target. Some economists maintain that the Federal Reserve should do so.

According to "Inflation Targets and Inflation Expectations: Some Evidence from the Recent Oil Shocks" (*FRBSF Economic Letter*, Federal Reserve Bank of San Francisco, September 1, 2006) by Bharat Trehan and Jason Tjosvold, inflation expectations in countries where central banks target inflation should differ from expectations in countries where the central banks do not target inflation, given the same inflation-causing event.

The authors look at expectations of future inflation in three countries: the United States (which does not have an official inflation target), Canada, and the United Kingdom (which do). High inflation followed oil price shocks in all three countries during the 1970s, so recent increases in the price of oil are the inflationary event studied. As there is no ready-to-use measure of expected inflation, the authors devise one for each country.

From January 2000 to July 2006, the price of a barrel of oil increased from about \$27 to more than \$70. However, because the U.S. dollar depreciated against the Canadian and British currencies, the increase in the price of oil was not the same in all three

countries; the price of oil increased more in the United States than in Canada or the United Kingdom. One might assume that inflation expectations would change in line with the price shocks. In fact, inflation expectations in all three countries were relatively stable. At least over the 2000–06 period, inflation expectations, as measured by long-term interest rates and interest rate spreads, seem to be well-anchored in all three countries, regardless of whether central banks are inflation targeters.

Why the low-and-stable inflation expectations in the United States? Have U.S. consumers and producers become habituated to low inflation during recent decades? Have financial markets divined an unofficial, unannounced inflation target in Federal Reserve officials' talk of an inflation "comfort zone"? Those questions are unanswered. While there is no evidence of benefits accruing from inflation targeting, there does not seem to be anything wrong with it either.

A tale of four cities

What's special about Elkhart, Indiana; Iowa City, Iowa; Madison, Wisconsin; and Indianapolis, Indiana?

"Looking for diamonds in the rust: Midwest cities and job growth" (*Chicago Fed Letter*, Federal Reserve Bank of Chicago, July 2006) by Michael Munley answers that question.

The Federal Reserve's Chicago District comprises Iowa, and most of Illinois, Indiana, Michigan, and Wisconsin. During the 1990s, this area seemed to shed its unofficial nickname: "the rust belt." But since 2000, employment in this area has declined by a half million. One might generalize about an area that is roughly a tenth of the country, but not all of the 50-some "rust belt" cities that are within the district's boundaries have fared the same over the past 5 years.

Between 2000 and 2005, the percentage change in employment in cities in the area

ranged from -12.0 percent to 8.9 percent. But in addition to asking whether a given city experienced job growth, there is a more interesting question: what was the growth compared with that which could be expected, given its industrial composition.

Determining expected employment growth means assuming that employment in each industry in a given city should grow (or shrink) at the same rate as the national rate for that industry. Each industry's share of city employment determines that city's industrial structure and the weight each industry is reflected in its expected growth rate.

Another factor in a city's expected growth rate is population, which, in turn, affects industrial composition. Large cities, offering more career opportunities, attract workers and offer amenities sought by businesses in service-providing industries. Smaller cities attract employers seeking lower labor costs. Many manufacturers have moved to smaller cities, thus making smaller cities more reliant on manufacturing.

How do these actual and expected employment growth rates compare? The areas' seven large cities fell short of their expected employment growth by 2.3 percent, on average—only one did better than expected. The medium cities saw an average employment growth 1.5 percent less than the expected, but five cities exceeded their expected growth rate. The small cities had an average growth rate 1.3 percent less than expected, yet nearly half did better than expected.

Four cities stand out. Elkhart has a high share of employment in manufacturing. What matters is *which* manufacturing industry. Elkhart is the "RV Capital of the World" and recent years have been good for recreational vehicle manufacturers. Iowa City and Madison, like many university towns, have had steady job growth. Indianapolis, the only large city to post better-than-expected job gains, is known for its "strong competitive environment." □