The Fed Should Put Its 2% Inflation Goal to Work

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In January 2012, "[f]ollowing careful deliberations at its recent meetings," the Federal Open Market Committee reported that it had "reached broad agreement on the following principles regarding its longer-run goals and monetary policy strategy."[1] The statement goes on to say that "[t]he Committee intends to reaffirm these principles and to make adjustments as appropriate at its organizational meeting each January." Emphasizing the time and effort put into developing the statement, the broad agreement, and its forward-looking nature, the FOMC signaled that its statement of principles and goals would provide fundamental guidance for monetary policy in the future.

The statement of principles begins with the requisite commitment to fulfill the congressional mandate "to promote maximum employment, stable prices, and low long-term interest rates." The FOMC then pledges "to explain its monetary policy decisions to the public as clearly as possible," to facilitate "well-informed decision-making," "reduce economic and financial uncertainty," and "enhance transparency and accountability, which are essential in a democratic society." Transparency in monetary policy is favored by central bankers today, and, not surprisingly accepted by the FOMC too.

Next, the FOMC acknowledges that "the inflation rate over the longer run is primarily determined by monetary policy, and hence the Committee has the ability to specify a longer-run goal for inflation." These principles themselves are not news, far from it. They merely acknowledge formally what monetarists led by Milton Friedman and Allan Meltzer have long argued, and what Paul Volcker and Alan Greenspan as Fed chairmen have proven.

Nevertheless, that acknowledgment probably required "careful deliberations at its recent meetings" because with it the FOMC accepted responsibility for determining inflation on average over time. The FOMC's principle of transparency then called for informing the public of the precise inflation objective that the Fed employs internally for analysis and deliberation.

The FOMC did not shrink from that logic and announced in its January 2012 statement of principles an explicit 2% objective for PCE inflation over the longer run as "most consistent with its statutory mandate." That announcement was stunning because the FOMC had debated whether to adopt an explicit inflation target at least since 1995.

The FOMC promotes its 2% inflation goal by asserting another principle, saying that an explicit inflation goal "helps keep longer-term inflation expectations firmly anchored," which would "enhance the Committee's ability to promote maximum employment in the face of significant economic disturbances."

The key question is how the FOMC proposes to deal with <u>fluctuations</u> of inflation and employment? The FOMC statement of principles recognizes that the "maximum level of employment is largely determined by nonmonetary factors…" which "may change over time and may not be directly measurable." Importantly, when the objectives for employment and inflation are not complementary, the FOMC says that "it follows a balanced approach to promoting them, taking into account the magnitude of the deviations and the potentially different time horizons

[1] Minutes of the FOMC Meeting of January 24-25, 2012, pp. 7-8.

over which employment and inflation are projected to return to levels judged consistent with its mandate."

This is all well and good. But what do the FOMC's words mean in practice? We found out on September 13, 2012 when, in addition to its intention to keep interest rates near zero for three more years, the FOMC announced that it would begin to add $40 billion of reserves to the banking system every month by acquiring agency mortgage backed securities until the labor market improves substantially. To reinforce its policy accommodation, the FOMC added that "a highly accommodative stance of monetary policy will remain appropriate for a considerable time after the economic recovery strengthens." And all this stimulus comes after the Fed has generated $1.5 trillion of excess reserves.

Inflation appears as an afterthought in the September 13 policy statement. The Fed appears willing to tolerate higher inflation in an effort to facilitate a reduction in unemployment with monetary policy. The only way one can read the September 13 FOMC policy statement is that the Fed plans to continue its highly accommodative monetary policy until inflation becomes a concern.

Why do I say that? Both headline and core PCE inflation are running around 1.7% this past year. The FOMC says in its September 13 policy statement "that inflation over the medium term likely would run at or below its 2 percent objective." But what if inflation doesn't follow the Fed's script? All the FOMC says in its September 13 policy statement is that it intends to continue its highly accommodative policy actions "in a context of price stability." Incredibly, the FOMC appears to be walking away from its explicit 2% inflation goal only months after first adopting it in January 2012.

Why not adhere to its principles, reassure markets, and tie down inflation expectations firmly by reiterating its intention to target 2% inflation on average over time? Failure to reiterate the 2% longer-run inflation goal only months after its announcement undermines its credibility, and defeats its professed purpose of anchoring inflation expectations to improve the flexibility of monetary policy to act against unemployment.

The market is left to wonder, how much inflation is the FOMC willing to accept and for how long? What is to be gained by matching open-ended reserve creation with an open-ended tolerance range for inflation and open-ended horizon over which a departure from 2% inflation would be tolerated? Might not that lack of clarity destabilize inflation expectations and facilitate the uncertainty so detrimental for employment?

Why is the FOMC unwilling to include bounds on its tolerance range for inflation in its policy statement? Does the Fed believe that monetary policy can only be effective against unemployment if inflation rises first, or that inflation must be allowed to rise after the fact for monetary policy to bring unemployment down? Even so, the Fed must recognize a tension between short run flexibility on inflation and the stabilization of inflation expectations that would call for some mention of bounds on its tolerance for inflation.

Perhaps the Fed believes that there is little risk of its highly accommodative policy causing inflation to rise if unemployment stays high. But in this case the Fed must believe that adding bank reserves indefinitely will have no inflationary consequences as long as unemployment remains elevated. Theory and history would say otherwise.

Lack of clarity on inflation in the September 13 policy statement suggests that the Fed is willing to pursue highly accommodative monetary policy to bring unemployment down until inflation becomes the public's concern. This is a trap. By the time that inflation becomes the public's concern, pricing decisions will already embody rising inflation expectations. And the Fed may need to precipitate a recession with high interest rates to bring inflation and inflation expectations back down.

Rather than risk the above fate, the FOMC should put its January 2012 statement of principles to work. The FOMC should assert in its policy statements the 2% longer-run inflation objective. Moreover, the FOMC should discipline its monetary policy actions by including in its policy statements an explicit range and a horizon beyond which it would not wish to tolerate a departure from 2% inflation.