Panel Discussion

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Inflation Targeting: Prospects and Problems, October 17, 2003

Should the Federal Reserve announce a quantitative inflation objective? Those opposed to the idea have noted, correctly, that the Fed has built strong credibility as an inflation-fighter without taking that step, and that that credibility has allowed the Fed to be relatively flexible in responding to short-run disturbances to output and employment without destabilizing inflation expectations. So, the opponents argue, why reduce that flexibility unnecessarily by announcing an explicit target for inflation?

It would be foolish to deny that the Fed has been quite successful on the whole over the past two decades. Whether the U.S. central bank would have been even more successful, had it announced an explicit objective for inflation at some point, is impossible to say. We just don't know. We can't re-run history; and although empirical cross-country comparisons can be useful, they are far from being controlled experiments.

However, the relevant question at this point is not the unknowable outcome of the historical counterfactual but whether, given the initial conditions we face today, the adoption of an explicit inflation objective might not improve U.S. monetary policy in the future. The Fed's environment today is different from that of the 1980s and 1990s in at least one important respect, which is that price stability is no longer just over the horizon but has been achieved—core inflation rates are currently not much above one percent. Thus, in contrast to the experience of the past 35 years or so, in which there could be little doubt about the Fed's desired direction for inflation, today the risks to inflation are more nearly symmetrical; that is, inflation can be too low as well as too high.

A case can be made, I believe, that when the economy is operating in the region of price stability, public expectations and beliefs about the central bank's plans and objectives, always important, become even more so. First, because the public can no longer safely assume that the central bank prefers lower to higher inflation, expectations about future policy actions and future inflation may become highly sensitive to what the public perceives to be the Fed's "just right" level of inflation. Uncertainty about this "just right" level of inflation thus may translate, in turn, into broader economic and financial uncertainty. Second, at very low inflation rates, the zero lower bound on the policy interest rate is more likely to become relevant, which increases the potential importance of effective expectations management by monetary policymakers. For example, when interest rates are very low, the best way to ease policy may be to explain to the public that the current low interest rate will be maintained for a longer period, rather than simply lowering the current rate. The enhanced importance of public beliefs and expectations about monetary policy in the region of price stability argues, it seems to me, for greater attention by the central bank to its methods of communication with the public in that region.

On the premise that effective communication is even more crucial near price stability, I will focus today on how an incremental move toward inflation targeting, in the form of the announcement of a long-run inflation objective, might help the Fed communicate better and perhaps improve policy decisions as well, <u>without</u> the costs feared by those concerned about potential loss of flexibility. As usual, my views are not to be attributed to my colleagues on the Board of Governors of the Federal Reserve System or the Federal Open Market Committee.

As a preliminary, I need to introduce the idea of the optimal long-run inflation rate, or OLIR for short. (Suggestions for a catchier name are welcome.) The OLIR is the long-run (or steady-state) inflation rate that achieves the best average economic performance over time with respect to both the inflation and output objectives.

Note that the OLIR is the relevant concept for dual-mandate central banks, like the Federal Reserve. Thus it is not necessarily equivalent to literal price stability, or zero inflation adjusted for the usual measurement error bias. Rather, under a dual mandate, a strong case can be made that, below a certain inflation rate, the benefits of reduced microeconomic distortions gained from price stability are outweighed by the costs of too-frequent encounters of the funds rate with the zero-lower-bound on nominal interest rates. (This argument underlies the common view that there should be a "buffer zone" against deflation.) Hence, in general, the OLIR will be greater than zero inflation, correctly measured. Note also that the OLIR is an average long-run rate; variation of actual inflation around the OLIR over the business cycle would be expected and acceptable (Meyer, 2003).

What is the OLIR for the U.S. economy? A fairly extensive recent literature has attempted to quantify the OLIR. (See, e.g., Coenen, Orphanides, and Wieland, 2003, and references therein.) Because direct measures of the benefits of low inflation are not available, in practice papers in this literature estimate the OLIR to be the lowest inflation rate for which the risk of the funds rate hitting the lower bound appears to be "acceptably small." Interestingly, the results using this approach seem fairly consistent across models and specifications, with several papers (including work using the FRBUS model, see Reifschneider and Williams, 2000) having concluded that the risk of hitting the zero bound seems to decline sharply once the long-run average inflation rate rises to about 2 percent. In addition, other studies of the costs of very low inflation (such as the supposed effects of downward nominal wage rigidity on the allocation of labor) have found that these costs are also largely eliminated at inflation rates of about 2 percent (Akerlof, Dickens, and Perry, 1996; see also Altig, 2003).

Fortuitously, then, it may be the case that something in the vicinity of 2 percent is the optimal long-run average inflation rate for a variety of assumptions about the costs of inflation, the structure of the economy, the distribution of shocks, etc. However, before we embrace that number, many details remain to be filled in. For example, in practice, much might depend on the specification of the inflation index, on assumptions made about the steady-state value of the real interest rate, and other factors. Also important would be getting a better sense of the range of uncertainty around this number. More research on this issue would be highly worthwhile. As the economy seems currently to be moving toward a sustainable expansion path, with a stabilizing rate of inflation, having an estimate of the OLIR likewise seems crucial to making good policy in the next few years. The issue is one that, in my view, the FOMC and the staff should be looking at carefully.

Suppose, as I believe would be feasible, that the FOMC were able to agree on a value or central tendency for the OLIR, based on the results of staff research and discussion among Committee members. Of course, the value of OLIR would only be a rough approximation to the "truth", but one cannot avoid making such approximations in policymaking, whether implicitly or explicitly. Should the FOMC then take the next step and announce this number to the public? Some have argued that such an announcement would be unnecessary because the Fed's implicit inflation objective is already well understood by the market. I am skeptical. Publicly expressed preferences by FOMC members for long-run inflation have ranged considerably, from less than 1 percent to 2.5 percent or more. Long-run inflation expectations implicit in the pricing of inflation-indexed securities vary significantly over time, and the apparently high sensitivity of long-term nominal interest rates to Fed actions suggests some uncertainty about the Fed's long-run inflation target (Gurkaynak, Sack, and Swanson, 2003). Gavin (2003) points out that the range of private-sector forecasts for inflation is typically higher for the U.S. than for inflation-targeting countries.

If announcing the OLIR does not constrain short-run policy unduly, I really cannot see any argument against it. To reassure those worried about possible loss of short-run flexibility, my proposal is that the FOMC announce its value for the OLIR to the public <u>with the following provisos</u> (not necessarily in these exact words):

(i) The FOMC believes that the stated inflation rate is the one that best promotes its output, employment, and price stability goals in the long run. Hence, in the long run, the FOMC will try to guide the inflation rate toward the stated value and maintain it near that value on average over the business cycle.

(ii) However, the FOMC regards this inflation rate as a long-run objective only and sets no fixed time frame for reaching it. In particular, in deciding how quickly to move toward the long-run inflation objective, the FOMC will always take into account the implications for near-term economic and financial stability.

As you can see, stating the OLIR with these provisos places no unwanted constraints on short-run monetary policy, leaving the Committee free to deal with current financial and cyclical conditions as the Committee sees fit. In this respect, the proposal is very similar to one recently advanced by Governor Gramlich (2003).

To be clear, because neither the horizon at which the inflation objective is to be attained nor the expected path of inflation and output is specified under this proposal, what I am suggesting is not equivalent to inflation targeting as commonly understood. Instead, what is being proposed is an incremental step that I believe would provide important benefits in itself and which would leave the door open for further steps later if that seemed appropriate. In the language of Faust and Henderson (2003) at this conference, my objective is to get the mean of inflation right while leaving the determination of the variance open for future discussion and debate.

Without any fixed time frames for reaching the optimal long-run inflation rate, would an announced value for the OLIR carry any credibility? I think it would, for the important reason that the OLIR is not an arbitrarily selected value. In particular, because this inflation rate would have been judged by the Committee to be the one under which the economy operates best in the long run, the FOMC would have an incentive to try to reach it eventually, <u>even if it were not an announced long-run objective of policy</u>. Thus, despite the lack of a time frame, the OLIR should have long-run credibility, that is, it should be the best (lowest-forecast-error) answer to the question: "What do you expect the average inflation rate in the United States to be over the ten-year period that begins (say) three years from now?"

Additional reasons that the announcement would carry weight are the accumulated credibility of the Fed and the fact that we are presumably starting from a point near the optimal inflation rate, so that a period of costly disinflation will not be needed to reach the OLIR. In other words, this relatively unconstrained approach might not work for other central banks, and it might not have worked for the Fed at other times (e.g., when we were at early stages of the disinflation process); but given the current configuration of circumstances, it should work now.

I have argued that announcing the OLIR would not have significant costs. What are the benefits? In my view, the announcement of the OLIR should serve as a useful clarification of the long-run objective of the Fed and would thereby provide a long-run "anchor" to monetary policy. Among other benefits, the announcement of the OLIR should help participants in financial markets price long-term bonds and other financial assets more efficiently; help to lower inflation risk in financial markets and in other forms of contracting; and tend to stabilize long-term inflation expectations more broadly, which in turn would make short-run stabilization policy more effective (Orphanides and Williams, 2003). Although the announcement of the OLIR would not constrain short-run policymaking in undesirable ways, it would nevertheless also help the market make inferences about the likely timing and extent of tightening and easing cycles, since all else equal the FOMC would want the inflation rate to move "asymptotically" toward the long-run desired level. For example, if the current inflation rate were known to be below the OLIR, that fact would convey some information about how long it will likely be before the Fed begins its tightening cycle.

Because some of the principal benefits of announcing the OLIR would arise from the reduction of uncertainty in financial markets and in the economy more broadly, I prefer the announcement of a single number for the OLIR, or at least a number with a surrounding tolerance range that is as narrow as the Committee can live with. I acknowledge that the OLIR cannot be determined precisely. Nevertheless, to the extent that the FOMC is fairly indifferent over a modest range of long-run inflation rates, there would be a positive benefit to choosing a single number within that range and trying to coordinate public expectations on that number.

Agreeing on and announcing a value for the OLIR might improve policymaking more directly, at least on the margin. In particular, the stated inflation objective would help guide policy during periods, like now, in which the economy is (we hope) returning to a sustainable growth path; at all times, it would also serve as a reminder to policymakers to keep one eye on the long run at the same time that they are reacting to current developments in the economy. But, to reiterate, it seems likely that the biggest gains would be in the area of communications. Sharing the OLIR with the public would address the most important information asymmetry in the system: namely, the public's imperfect knowledge of the FOMC's objectives. I believe this step would help to reduce the reliance of the Fed on complex and easily misinterpreted qualitative language in its communications with the public.

I conclude with a word on the politics of this proposal. One concern frequently expressed about announcing an inflation objective is that the Congress would interpret the introduction of an inflation target as a repudiation of the dual mandate. This would be a misinterpretation, but I understand why some legislators might draw the wrong conclusion.

However, it seems to me that the recent attention to the risk of deflation changes the political calculus. There now exists a broad awareness that an inflation rate that is too low, by raising the probability of deflation and a binding zero bound on the nominal interest rate, poses a threat to output and employment stability. Therefore the connection between the announced OLIR and the real side of the economy will be much more apparent to non-economists. Indeed, the entire rationale for the OLIR can be expressed in terms of jobs and growth. The FOMC might say to Congress: "We don't want long-run inflation to be too high, because low inflation promotes growth and productivity. On the other hand, inflation shouldn't be too low, because we want to have all the room we need to respond to the dangers that deflation poses for output and employment. We pose the objective in terms of inflation only because that is what the Fed can control in the long run." It does not seem to me to be such a difficult case to make in terms of the existing dual mandate. In addition we would have the explicit proviso that important short-run economic and financial goals will not be sacrificed in order to reach the long-term inflation objective more quickly. Although it would be important to vet these ideas thoroughly with the relevant Congressional committees before proceeding, I am hopeful that a change of the type I am proposing would be acceptable to Congress as being within the spirit of existing legislation.

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