March 28, 2018

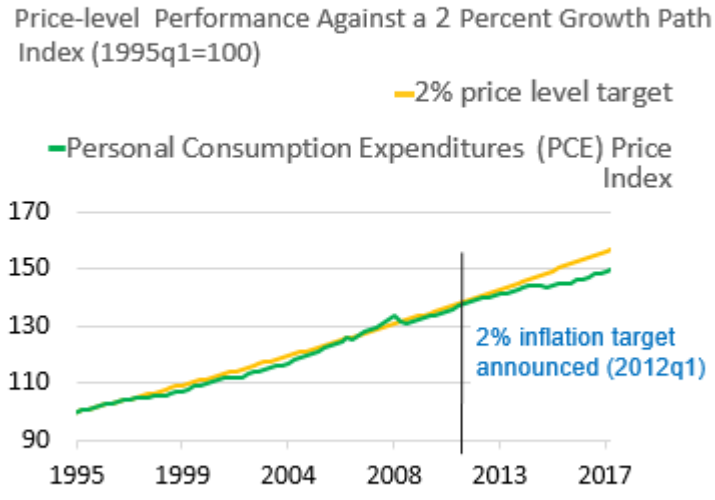
Thoughts on a Long-Run Monetary Policy Framework, Part 3: An Example of Flexible Price-Level Targeting

I want to start my discussion in this post with two points I made in the previous two *macroblog* posts (here and here). First, I think a commitment to delivering a relatively predictable price-level path is a desirable feature of a well-constructed monetary framework. Price stability is in my view achieved if people can have confidence that the purchasing power of the dollars they hold today will fall within a certain range *at any date in the future*.

My second point was that, as a matter of fact, the Federal Open Market Committee (FOMC) delivered on this definition of price stability during the years 1995–2012. (The FOMC formally adopted its 2 percent long-run inflation target in 2012.)

If you are reading this blog, you're almost certainly aware that since 2012, the actual personal consumption expenditures (PCE) inflation rate has persistently fallen short of the 2 percent goal. That, of course, means that the price level has fallen increasingly short of a reference 2 percent path, as shown in chart 1 below.

Chart 1: The Actual Path of the Price Level, 1995-2017

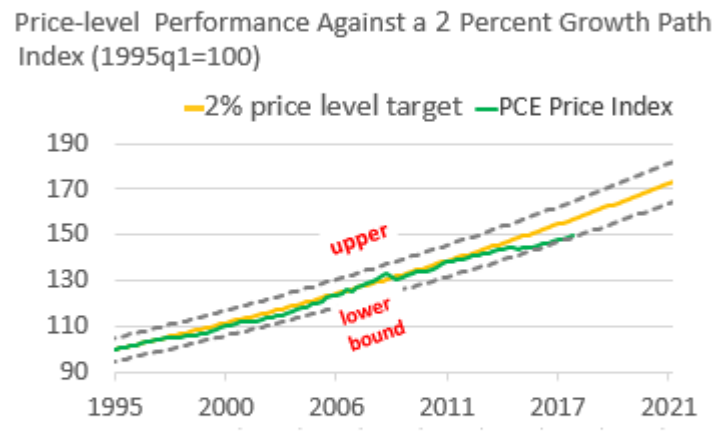


Sources: U.S. Bureau of Economic Analysis, Atlanta Fed calculations, Haver Analytics

Is this deviation from the price-level path a problem? The practical answer to that question will depend on how my proposed definition of price stability is implemented.

By way of example, let's suppose that the FOMC commits to conducting monetary policy in such a way that the price level will always fall within plus-or-minus 5 percent of the long-run target path (which itself we define as the path implied by a constant 2 percent inflation rate). This policy—and how it relates to the actual path of PCE price inflation—is illustrated in chart 2.

Chart 2: A Hypothetical *Flexible* Price-Level Target

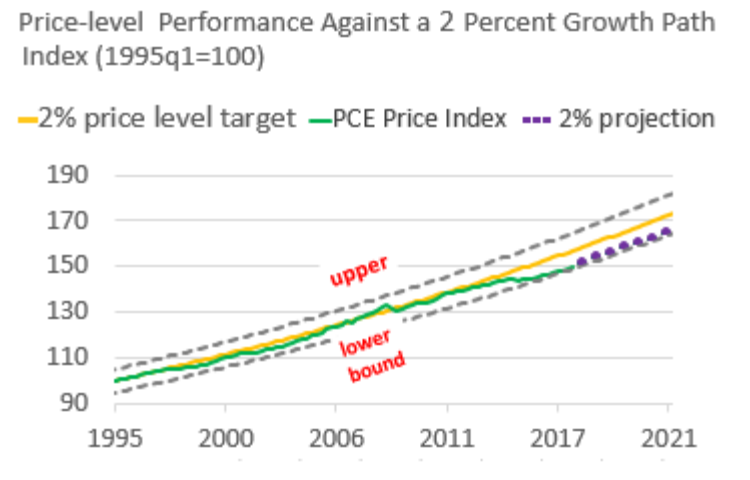


Note: Upper and lower bound are illustrated as plus or minus 5 percent of a 2 percent price-level target.

Sources: U.S. Bureau of Economic Analysis, Atlanta Fed calculations, Haver Analytics

So would inflation falling short of the 2 percent longer-run goal be a problem if the Fed was operating within the framework depicted in chart 2? In a sense, the answer is no. The current price level would be within the bounds of a hypothetical commitment made in 1995. If the central bank could perpetually deliver 2 percent annual inflation, that promise would remain intact, as shown in chart 3.

Chart 3: A Hypothetical *Flexible* Price-Level Target



Note: Upper and lower bound are illustrated as plus or minus 5 percent of a 2 percent price-level target.

Sources: U.S. Bureau of Economic Analysis, Atlanta Fed calculations, Haver Analytics

Of course, chart 3 depicts a forward path for prices whose margin for error is quite slim. Continued inflation below 2 percent would, in short order, push the price level below the lower bound, likely requiring a relatively accommodative monetary policy stance—that is, if policymakers sought to satisfy a commitment to this framework's definition of price stability.

Central bankers in risk management mode might opt for policies designed to deliberately move the price level toward the 2 percent average inflation midpoint in cases where the price level moves too close for the Committee's comfort to one of the bounds (as, perhaps, in chart 3). It bears noting that in such cases there are a wide range of options available to policymakers with respect to the timing and pace of that adjustment.

This scenario illustrates the *flexibility* of the price-level targeting framework I'm describing. I think it's important to think in terms of gradual adjustments that don't risk whipsawing the economy or force the central bank to be overly precise in its short-run influence on inflation and economic activity. A key feature of such a policy framework includes considerable short- and medium-run flexibility in inflation outcomes.

But the other key feature is that the framework limits that same flexibility—that is, it satisfies the principle of bounded nominal uncertainty. Suppose you and another person agree that you will receive a $1 payment in 10 years in exchange for a service provided today. If the inflation rate over this 10-year period is exactly 2 percent per year, then the real value of that dollar in goods and services would be 82 cents.

In my example (the one with a plus-or-minus 5 percent bound on the price level), monetary policymakers have essentially committed that the agreed-upon payment would not result in real purchasing power of less than 78 cents (and the payer could be confident that the real purchasing power relinquished would not be more than 86 cents).

The crux of my argument is that a "good" monetary policy framework limits the degree of uncertainty associated with contracts involving transfers of dollars over time. In limiting uncertainty, monetary policy contributes to economic efficiency.

The 5 percent bound I chose for my illustration is obviously arbitrary. The magnitude of the acceptable deviations from the price-level path would be a policy decision. I'm not sure we know a whole lot about what range of deviations from an expected price path contributes most consistently to economic efficiency. A benefit of the framework I am describing is that it would focus research, discussion, and debate squarely on that question.

This series of posts is going on hiatus for a few days. Tomorrow, the Atlanta Fed is going to release its 2017 Annual Report, and I certainly don't want to steal its thunder. And Friday, of course, will begin the Easter weekend for many people.

But I want to conclude this post by emphasizing that the framework I am describing is more of a refinement of, and not a competitor to, many of the framework proposals I discussed in Monday's post. This is an important point and one that I will turn to in the final installment of this series, to be published next Monday.

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