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Inflation Targeting in the USA¹
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The FOMC Sets an Inflation Target

At the January meeting, the Federal Open Market Committee (FOMC) took an important step forward by naming an explicit, numerical inflation target for the U.S. of 2 percent, as measured by the personal consumption expenditures (PCE) price index. In taking this action, the Federal Reserve has joined many central banks around the world that have set explicit inflation targets over the past two decades. This step has been a goal of Chairman Bernanke's since he joined the Fed nearly a decade ago. I want to congratulate the Chairman on this accomplishment, which I believe will serve the nation well for years to come.

In a targeting context, inflation means headline inflation. It does not make sense to ignore some inconveniently volatile prices, like those for gas or food, when discussing the inflation rate actually faced by U.S. households.² By the headline PCE measure, U.S. inflation is running somewhat above target right now, at 2.4 percent measured from one year ago. This rate has been moderating in recent reports. Inflation is up sharply when compared with the autumn of 2010, when PCE inflation measured from one year earlier hit a low of about 1.2 percent. We are double that rate right now.

Inflation targeting emphasizes control over inflation as the key long-term goal of monetary policy. This makes sense because the central bank can only influence inflation and not any real macroeconomic variable in the long run. As is well known, the actions of the FOMC can also temporarily influence the direction of the economy in the short run, but only temporarily. This influence can be used to help mitigate short-run gyrations in economic activity, thus smoothing out an otherwise bumpy ride for U.S. households and businesses. This is often described as monetary stabilization policy. The amount of smoothing that can actually be accomplished through this channel is meaningful, but not particularly large, a fact which is often lost in

¹ Any opinions expressed here are my own and do not necessarily reflect those of others on the Federal Open Market Committee. I thank my staff for helpful comments, including Riccardo DiCecio, Cletus Coughlin, Karen Branding, Chris Waller, Dan Thornton and Marcela Williams.

² For more on this theme, see James Bullard, "Measuring Inflation: The Core is Rotten," *Federal Reserve Bank of St. Louis Review*, July/August 2011, 93(4), pp. 223-233.

contemporary discussions. Putting an explicit inflation target together with a sensible stabilization policy is often called flexible inflation targeting. This is the policy that has been adopted by the FOMC and that follows the practice of many other central banks around the world during the last twenty years.

Flexible inflation targeting enables central banks to conduct a stabilization program and make it as effective as it can be made without departing from the longer-run goal of keeping inflation low and stable. This reflects a conventional wisdom borne of the 1970s, namely, that allowing inflation to rise and accelerate not only is not helpful for the macroeconomy, but is actually very damaging. During the 1970s, U.S. inflation eventually rose to double-digit levels, and this was accompanied by especially poor macroeconomic performance on the real side of the economy. The lesson for U.S. policymakers and many others around the world has been that high inflation just causes problems and does nothing to help address fundamental macroeconomic issues.

To run the flexible inflation targeting program, one needs a concept of where the economy would ideally be operating versus where it is actually operating. This leads us to the topic of output gaps.

Output Gaps: The Wrong Idea

The recent recession has given rise to the idea that there is a very large “output gap” in the U.S. The story is that this large output gap is “keeping inflation at bay” and is fodder for keeping nominal interest rates near zero into an indefinite future. If we continue using this interpretation of events, it may be very difficult for the U.S. to ever move off of the zero lower bound on nominal interest rates. This could be a looming disaster for the United States. I want to now turn to argue that the large output gap view may be conceptually inappropriate in the current situation. We may do better to replace it with the notion of a permanent, one-time shock to wealth.

The key to the large output gap story is the use of the fourth quarter of 2007 as a benchmark for where we expect the economy to be today. The idea is to take that level of real output, assume the real GDP growth rate that prevailed in the years prior to 2007, and project out where the “potential” output of the U.S. should be. By that type of calculation, we are indeed stunningly far below where we should be, perhaps 5.5 percent below, using data through the

fourth quarter of 2011.³ What is more, we have made little progress in closing the gap defined in this way, because real GDP has only grown at modest rates since the recession ended in the summer of 2009. And furthermore, using current GDP forecasts from, say, the Blue Chip consensus, we have little prospect for closing the gap any time soon.

Is this really the right way to think about where the U.S. economy should be? I do not think it is a defensible point of view. Let me give you some of my perspectives.

Most analysts seem to agree that the middle part of the 2000s was characterized by a “bubble” in the housing sector. Housing prices were high and rising fast compared to nominal GDP. It is not prudent to extrapolate a bubble into the indefinite future and claim that such a calculation provides a good benchmark. Yet, that is what we are doing when we extrapolate fourth quarter 2007 real GDP. Furthermore, we normally have the good sense not to do this in other economic situations.

Think about the tech bubble of the late 1990s and early 2000s. The NASDAQ index peaked at about 4800 on a monthly average basis in March 2000. In the month just passed, January 2012, it averaged about 2744, which is 57 percent of its peak value. In fact, with the type of calculation usually done for real GDP, which extrapolates growth rates, the NASDAQ would be miles below its “potential.” Of course, most observers and market participants do not say that the NASDAQ is far below its potential value today. Instead, most say that there was clearly a bubble in the NASDAQ during the late 1990s and early 2000s, and that today’s valuations are more sensible than the ones that were in vogue during the bubble period.

When I put the case this starkly, I think many would agree that establishing a benchmark by extrapolating from the previous peak of a variable, when that variable was clearly influenced by a bubble, is a mistake. It gives a distorted view of the situation.

A Level Shock

A better interpretation of the behavior of U.S. real GDP over the last five years may be that the economy was disrupted by a permanent, one-time shock to wealth.⁴ In particular, the perceived value of U.S. real estate fell substantially with the 30 percent decline in housing

³ This value can be calculated based on the Congressional Budget Office potential output series.

⁴ Macroeconomists like me often use the word “permanent,” even though nothing is really permanent. Think of permanent as “exceptionally persistent.”

prices after 2006. This shaved trillions of dollars off of the wealth of the nation. Since housing prices are not expected to rebound to the previous peak anytime soon, that wealth is simply gone for now. This has lowered consumption and output, and lower levels of production have caused a significant disruption in U.S. labor markets.

So what's the point, you ask? Well, to me, the important difference is what happens after the shock.

For those who take the "large output gap" view, the expectation is for real GDP to grow rapidly after the recession comes to an end, as the economy catches up to its potential. It is like a rubber band, there is supposed to be a bounce back period of rapid growth. In fact, most analysts have been looking for exactly this effect since the summer of 2009. It has not happened. This has led to a lot of analysis concerning special factors and headwinds that might be inhibiting the "bounce back" effect.

The wealth shock view puts a different expectation in play. The negative wealth shock lowers consumption and output. But after the recession ends, the economy simply grows from that point at an ordinary rate, neither faster nor slower than in ordinary times. It is more like an earthquake which has left one part of the land higher than another part. There is no expectation of a "bounce back" to a higher level of output after the recession ends. This is closer to what has actually happened since mid-2009. Output has grown at a moderate rate, but not a rapid rate, since the recession ended.

In the wealth shock view, there is no "large output gap" rationale for keeping interest rates near zero. There is only an economy growing at normal rates following a large shock to wealth.

I mentioned that a wealth shock significantly upsets labor market relationships. This is because output declines, so less labor is required. It takes a long time for those displaced by the shock to find new working relationships. I would expect to see high unemployment and only slow improvement in labor markets following the wealth shock.

One might say that the peak in U.S. housing prices represented an overvaluation, and in my view, that would be right. Valuing the physical capital stock of the nation is always a tricky proposition. The entire stock, on the order of three times GDP, or \$45 trillion, cannot meaningfully be marketed all at once. Still, we do observe bits and pieces of the physical capital stock being bought and sold at any point in time, and those prices can help us notionally value the entire portfolio. Those prices of bits and pieces could be driven by beliefs alone—such as the belief that housing prices only go up—and become temporarily detached from

fundamental supply and demand factors. This may make it appear that real estate is worth more than it really is, and lead many to make what in retrospect are poor economic decisions, such as taking on too much debt and consuming too much.

Many prices in the economy may at times seem to be far away from anything that could be rationalized purely by supply and demand. But housing prices are special in that they represent valuations on a significant fraction of the wealth of the nation, defined as the value of the physical capital stock. To have those prices fall hard and stay down without much prospect for rapid recovery is a one-time, permanent wealth shock. This is a different type of shock than the ones that have caused previous postwar U.S. recessions.

The Costs of Near-Zero Rates

I have argued that the large output gap view may be keeping us all prisoner—tethering our expectations for output, in effect, to the collapsed bubble in housing. It is setting a very high bar for the U.S. economy, one that may not be appropriate given the nature of the shock that the economy has suffered. Importantly, it may influence the FOMC's near-zero rate policy far into the future, since output is continually viewed as falling short of the high-bar benchmark.

But the near-zero rate policy has its own costs. If we were proposing to remain near-zero for a few quarters, or even a year or two, one might argue that such a policy matches up well with the short-term business cycle dynamics of the U.S. economy. But a near-zero rate policy stretching over many years can begin to distort fundamental decision-making in the economy in ways that may be destructive to longer-run economic growth.

In particular, the lengthy near-zero rate policy punishes savers in the economy. Because of life cycle effects, most of the asset holding in the economy is done by older Americans. Recent readings from the TIPS market suggest a 10-year real rate of return of minus 30 basis points or so, and a five-year real rate of return of about minus 120 basis points. These are extraordinarily low—substantially negative—real rates of return over very long time scales, and they are driven in part by FOMC policy.

These low rates of return mean that some of the consumption that would otherwise be enjoyed by the older, asset-holding households has been pared back. In principle, the low real interest rates should encourage younger generations to borrow against their future income prospects and consume more today. However, this demographic group faces high unemployment rates

and tighter borrowing constraints, which may limit its ability and willingness to leverage up to finance consumption. Consequently, the consumption of the older generations may be damaged by the low real interest rates without any countervailing increase in consumption by other households in the economy. In this sense, the policy could be counterproductive.

Again, these broader effects of a low real interest rate policy might not be so critical in an environment where the low yields last for a few quarters, but they may be significantly more important as the length of time is stretched out over many years.

Conclusion

The FOMC has adopted an explicit, numerical inflation target. This is an important development, as it may prevent the U.S. from repeating the mistakes of the 1970s, in which a misreading of the size of the output gap led the Fed to maintain easy monetary policies for far too long.

Inflation targeting in the U.S. will be flexible, matching a desire to keep inflation low and stable in the long run with the challenge of providing some business cycle stabilization in the shorter term. One of the key issues in stabilization policy is the benchmark against which economic performance is measured.

I have argued that the “large output gap” benchmark, in which current economic performance is continually compared to the bubble-influenced mid-2000s, may not be realistic. Instead, one may want to interpret the recent U.S. experience as a one-time, permanent shock to wealth.

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