Panel Discussion

Federal Reserve Bank of St. Louis, 28th Annual Policy Conference:

Inflation Targeting: Prospects and Problems, October 17, 2003

I should start with two declarations. First, the usual disclaimer holds with particular force today--the views I am about to express are my own and not necessarily those of any other policymaker at the Federal Reserve. Second, this conference has been most interesting and informative, but I remain an inflation targeting (IT) skeptic. I will briefly lay out the reasons for my attitude, then address some topics, like communication, that frequently arise in the discussion, and conclude by trying to stress-test my skepticism by speculating on whether IT would have been helpful in some recent episodes related to monetary policy.

Inflation Targeting for the United States

I agree with advocates of IT in several critical areas. Price stability--or its approximation at very low inflation--is the appropriate primary long-term objective of monetary policy, and achieving this objective is the way that policy can best contribute to the long-term welfare of the country. Moreover, in some countries, adopting IT, together with the central bank independence that often accompanies the initiation of IT regimes, has been a major step toward attaining price stability.

The question I would like to address is whether IT would improve economic performance in the United States. That is, would IT be likely to lead to actions by policymakers and private agents that increase the odds on keeping the economy producing at its maximum sustainable level and inflation low and stable. In my view, the verdict on IT for the United States is at least "not proven" and possibly negative--that is, IT might detract from economic performance over time.

I start from the premise that the United States has had a very successful monetary policy over the past two decades. We have achieved price stability, inflation expectations are low and stable, and we have done this with two relatively shallow recessions in twenty years. Many factors have contributed to this economic performance, but monetary policy has been an important element. So for me, the default option is to keep doing what we have been doing--however hard it might be to model or explain. And that is not inflation targeting. I believe that adopting IT, even in its softer versions, would be a slight shift along the continuum of constrained discretion in the direction of constraint, and the benefits of such a shift are unlikely to outweigh its costs. Consequently, I would stick with the status quo.

On the cost side, I believe that under some circumstances central banks do face short-term tradeoffs between economic stability and inflation stability, and I am concerned that IT would result in less-than-optimal attention being paid to stabilizing the economy and financial markets. In its actions, the Federal Reserve has put considerable weight on achieving and maintaining price stability, but it has not been inflation targeting--not even implicitly. IT implies putting a higher priority on hitting a particular inflation objective over the intermediate run than the Federal Reserve has done.

This point is most obvious from 1983 to 1997, in the so-called opportunistic disinflation period. During this time, the Federal Reserve was well aware that inflation was running above levels consistent with price stability but concentrated on keeping inflation from rising, not on reducing it further.

I believe the Federal Reserve also paid more attention to noninflation factors than IT would have suggested in the 1997 to 2003 period, even though inflation outcomes were low and stable. Its broader focus was especially evident in the reaction to the threat to financial stability

in the fall of 1998 and in the very aggressive easing in early 2001. In the latter case, easing continued through the spring even though inflation expectations looked as though they might be increasing, which would have been very difficult for an IT central bank to look through. I recognize that such responses would in theory be available under flexible inflation targeting, but I wonder what would happen in practice. Most IT frameworks put a priority on inflation control and base their communication and accountability structures on inflation forecasts and outcomes. Under circumstances in which short-run conflicts among various objectives are possible, I ask myself where IT policymakers are likely to take their chances.

Moreover, with its concentration on mean inflation, IT seems to be ill-adapted to the risk-management paradigm that Chairman Greenspan laid out in Jackson Hole.[1] That mode of operation, which I believe has been an important factor in the Federal Reserve's success, weighs the skews in the outlook, as well as the central tendencies, and also takes account of the cost of missing on one side or the other--and for more than one objective.

I think that the U.S. economy has benefited from the flexibility that the Federal Reserve has derived by eschewing a formal inflation target. By flexibility I mean not frequent changes in long-term objectives but rather the freedom to deviate from long-term price stability, perhaps for a while. I recognize that such deviations are also possible in models of flexible inflation targeting, but I question whether they can occur in practice.

Against these potential costs, I believe that the benefits of IT in the United States relative to the current regime are questionable.

We do not see evidence in IT economies that inflation is lower or more stable or that output is more stable around potential. On the surface, then, IT appears to produce little or no

gain in hitting goals. To be sure, the evidence on how well inflation expectations are anchored is more mixed. Levin, Natalucci, and Piger at this conference, provided some backing for the idea that long-term expectations in IT economies respond less to incoming information on inflation.[2] But I am also aware that the bulk of the studies show that interest rates and inflation are no more predictable in IT economies than in non-IT economies. The IT economies examined in the studies may have been subject to larger shocks than the non-IT economies studied, but the burden of proof should be on the advocates of IT to show that it would improve economic performance in non-IT economies--by providing either greater cyclical stability or better resource allocation.

A frequently used argument for IT in the United States is that it will help to extend the good performance of monetary policy as leadership changes--that is, it will protect against persistent increases or decreases in inflation under a new Chairman. In my view, however, considerable safeguards against these outcomes are already in place. The law mandates price stability. Without exception, everyone now on the Federal Open Market Committee (FOMC) agrees with this mandate, and it enjoys wide acceptance in the public and in the Congress as well as in the academic community. Moreover, FOMC members have diverse views and the Committee has been operating in an environment in which members are free to express those views--in sharp contrast to some earlier eras. Any Chairman gets deference, but a new Chairman would not have the clout of Alan Greenspan, at least initially. A further safeguard is provided by

---

[1] Alan Greenspan, "Monetary Policy under Uncertainty," remarks given at a symposium sponsored by the Federal Reserve Bank of Kansas City, Jackson Hole, Wyoming, August 29, 2003. www.federalreserve.gov/boarddocs/speeches/2003/20030829/default.htm

[2] Andrew Levin, Fabio M. Natalucci, and Jeremy M. Piger, "The Macroeconomic Effects of Inflation Targeting," paper given at the conference Inflation Targeting: Prospects and Problems, Federal Reserve Bank of St. Louis, October 16, 2003.

the greater amount of public discussion and media attention to monetary policy currently than in the 1960s and 1970s.

Of course there is a risk, however small, that incompetence or political motivations in a new leader might foster new trends or greater variability in inflation, and IT might help counter any such tendencies. The question is whether insuring against this remote outcome is worth paying the cost. IT prevents some bad results, but it tends to foreclose very good results as well.

Special Topics

Communications and transparency

IT does provide a clear framework for communicating with the public if communication is framed around the behavior of inflation relative to the target. But does it help produce better policy and economic outcomes? For flexible inflation targeters who are paying attention to other objectives as well as inflation, communication tends to be clear but not especially transparent. Other goals are downgraded. In practice, IT communication does not even mention varying time periods for achieving price stability much less the reason for those periods to vary. Those other goals are the tough messy stuff that does not fit into the IT framework very well. That they get so little attention is not surprising because accountability is usually framed in terms of inflation and the reports are elements in the accountability framework. But if, in fact, the goals of economic and financial stability are factored into policy decisions, they are often poorly acknowledged in IT communication. There is also a risk that communication will drive policy, and so those goals end up with less-than-optimal attention. For the most part, the manifestations of better transparency--reduced variability and greater predictability of inflation and interest rates--are not readily apparent in IT economies.

I am not arguing that the Federal Reserve cannot communicate better. But I am saying that IT is not a cure-all for communication problems, that it might not even help much in the markets where it really counts, and that if simplicity of communications drives policy, IT might lead to inferior economic outcomes.

Political legitimacy

In his paper this morning, Larry Meyer was right to emphasize the importance of the Federal Reserve's interactions with the political system.[3] One of the major values of IT is its role in forcing the people and their representatives to think through carefully what they can and cannot expect or demand from a central bank. This benefit would be lost through unilateral adoption of IT by the Federal Reserve.

The Federal Reserve is in a more complex position within the government relative to the central banks of many other countries, and this position both complicates any consultative process and elevates its importance. The checks and balances of our system mean that unlike most other central banks, which operate in a parliamentary system, we do not have a "government" to interact with. The paradigm of goal dependence-instrument independence so common in IT regimes is effectively blocked for us. If we moved toward setting a goal for ourselves, perhaps even if we just defined price stability, we would need to consult carefully with both houses of the Congress and the Administration and would need to judge what, short of legislation, constituted a veto by any of the people with whom we were consulting. This process would be subtle and difficult--but absolutely essential to protect our independence and preserve our democratic legitimacy.

---

[3] Laurence H. Meyer, "Practical Problems and Obstacles to Inflation Targeting," paper given at the conference Inflation Targeting: Prospects and Problems, Federal Reserve Bank of St. Louis, October 17, 2003.

Defining price stability

By "defining price stability," I mean publishing a number or a reference range that makes more concrete our long-term inflation objective, without making a commitment to achieve that objective in any given time frame, which could be as long as a few years. Individual FOMC members are increasingly stating their numerical definition of price stability, but the Federal Open Market Committee has not done it. In some respects, such a specification is an appealing idea. In concept, it might allow the United States to realize some of the benefits of inflation targeting without some of the costs. The theory would be that putting a numerical value on long-term price stability could reduce uncertainty about longer-run price tendencies without constraining our actions to stabilize the economy or financial markets over shorter periods.

I am still trying to make up my mind on the balance of costs and benefits of taking this step. As I have already noted, most evidence does not suggest a lot of private uncertainty about longer-term price trends in the United States, and so the benefits, if any, would be limited. Spreads between nominal and indexed 10-year bonds have fluctuated narrowly around 2 percent since 1999, and survey measures of long-term inflation expectations have barely moved in recent years. Nonetheless, further evidence supporting the inference of Levin, Natalucci, and Piger that IT would result in even more firmly anchored expectations would be important in this equation.

The costs, given my views on IT, would arise from any tendency for this definition to morph into a target that unnecessarily constrained actions--that did not effectively permit outcomes outside the range or away from the target under some circumstances. Resisting such a tendency would be difficult, I think, once the number was given. And the pressure to elevate price stability over economic stability, even in the short-term, would be accentuated because the latter goal would not have a numerical value. However, ways of mitigating this tendency might

be found--for example, by giving a fairly wide range and making it clear that the midpoint had no special meaning and that the edges were soft. Critical to maintaining useful flexibility would be the understanding, believability, and sustainability of the "provisos" that the Federal Reserve would give outlining the circumstances under which it would not seek to achieve its price stability objective.

Stress-Testing My Skepticism--Would IT Have Improved Economic Performance in Recent Years?

1. Would IT have contributed in any way to damping the boom and bust since the mid-1990s? I have already voiced my opinion that it would not have helped and might even have hurt in the reaction to emerging weakness in 2001. But another part of the question is, Would IT have constrained the previous upswing in a way that also would have lessened the subsequent weakening?

A number of observers believe that a little more policy tightening a little earlier might have damped the fluctuations in financial markets and the economy. Personally, I doubt that, given the strong forces at work. But I also do not think an IT framework would have helped, even if such an outcome were possible. Inflation was edging lower through much of this period. To be sure, forecasts were consistently missing on the high side, so a forecast-based IT framework might have run a slightly tighter policy--but I do not think you want to rest a case for changing policy regimes on persistent forecast misses.

The arguments usually given for tighter Federal Reserve policy in the mid- to late-1990s reference developments in asset prices--specifically in the equity market--and the judgment that too-low interest rates fostered an intertemporal misallocation of resources in the form of an excessive buildup of capital and, hence, raised the amplitude of longer-term economic fluctuations. IT is especially poorly adapted to deal with these sorts of issues, however, since it

tends to emphasize the performance of inflation in consumer goods and services over the succeeding few years. For those, like me, who are skeptical about the ability of central banks to deal with swings in asset prices or with longer-term resource allocation issues, this aspect of inflation targeting is not negative. Nonetheless, it is also evident in speeches and commentary that policymakers in IT countries right now are wrestling with the tension between IT frameworks and the suspicion that economic imbalances and disequilibriums in house or other asset prices are developing that could disrupt the economy at some point down the road.

2. Would ongoing IT or even a numerical definition of price stability have damped the bond market volatility of this spring and summer?

Long-term interest rates fell steeply in May and early June and rebounded even more sharply in late June and July. The decline got under way in earnest after the FOMC statement of May 6. What was the news that day? First, the FOMC thought that inflation could be below a level consistent with satisfactory economic performance over time and that the current rate of inflation was close to that excessively low level. Second, the FOMC was worried that the lower limit would be breached--it thought inflation was more likely headed down than headed up from the already low level. In response, 10-year Treasury rates fell 8 basis points the day of the announcement and another 12 basis points the next day as the import of the announcement sank in.

In my view, most of this immediate 20-basis-point decline in longer-term rates came not in response to the clarification of the inflation objective but rather to the revelation that the FOMC was worried about the trend of inflation. Moreover, much of the information on the latter point was quite recent, reflecting what seemed to be a lack of a rebound in the economy after the Iraq war and a steep decline in recent inflation readings. In these circumstances, had we had an

inflation target for a while, rates might have been lower before the announcement, but most of that decline would have filtered into the markets only over the preceding few weeks, and rates would have been just as low a few days after the meeting.

The next 70 basis points of rate decline occurred by mid-June in response to further indications of weakness in activity and prices and to statements by Federal Reserve officials that they were thinking about how to conduct policy in the remote contingency that a deflation threatened to take hold. I do not see how this response would have been different in an IT framework. My judgment in this regard is reinforced by the fact that rates in many IT countries over this same period of May and June fell by a similar magnitude. Weakness in the world's most important economy and declines in its exchange rate should lead rates overseas to decline, but the extent and similarity of the decline is surprising. This occurrence has led me to conclude that the rate drop in the United States was caused by the downward shocks to expected prices and activity, not by the policy framework.

The IT countries did experience somewhat smaller rate increases relative to the United States in July and August. They did not have some of the special factors pushing U.S. rates up--revised expectations about bond purchases and mortgage hedging activity. Perhaps more importantly, their economies, though strengthening, did not demonstrate the surprising degree of rebound that seems to be occurring in the United States.

In sum, this is a striking episode in which misunderstandings between the central bank and the markets probably contributed to an extraordinary volatility in financial markets. But these misunderstandings did not stem from the absence of inflation targets in the United States; volatility would have been damped only a little, if at all, under inflation targeting.

Conclusion

I recognize that I am at risk of being interpreted as saying that something good--the policy regime of the past twenty years--cannot be made better or that there are not downside risks to highly judgmental, flexible policy with an imprecise price stability objective. That is not what I think. I am open to alternatives that promise improvements or that raise the odds on good policy continuing in the future without incurring much in the way of current costs. But I do believe that those who propose changes from a good system have a high burden of proof. The marginal benefits from improving a good regime by definition are not likely to be high. And any change must deal with the uncertainties created by the law of unintended consequences. I have yet to be convinced that for the United States inflation targeting has jumped those hurdles.