



President's Message: Is low inflation a problem for the United States?

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As central banks have done in other countries, the Federal Reserve last November announced its plans to review its monetary policy strategy, tools and communications practices. This review strikes me as appropriate given the changes that occur over time in our economy, but it may be especially important now in a low-interest-rate environment. I look forward to the ideas that may come forward as part of this review, even as I offer a few thoughts of my own here on the Federal Reserve's price stability mandate and the Federal Open Market Committee's (FOMC) inflation objective and policy strategies.

The balanced approach

Fostering a strong labor market while maintaining price stability is the core of the Federal Reserve's dual mandate from Congress. With the unemployment rate at an historic low level and inflation currently running under the FOMC's objective, a longer-run policy issue is whether the persistent undershoot of the inflation objective is undermining its credibility and causing inflation to be anchored at too low a level. Some have expressed concern that if inflation expectations fall persistently below the 2 percent objective, that the extent we could lower real interest rates by reducing our target for the federal funds rate—the Fed's key policy tool—would be diminished.

This could limit the accommodation we could provide in a future downturn because interest rates cannot fall below a lower bound of roughly zero percent.

At the time the FOMC adopted its 2 percent inflation objective in 2012, monetary policy was highly accommodative, unconventional policy tools were being deployed and inflation was running above 2 percent. Since then, inflation has run persistently below 2 percent. I have not viewed this as a major concern given that, aside from the effects of wide fluctuations in energy prices, inflation has remained low and relatively stable. Since 2012, core personal consumption expenditures inflation has fluctuated in a range of roughly 1½ to 2 percent, except during 2015 when a strong dollar pushed core inflation somewhat below 1½ percent.

As long as inflation was below its objective and unemployment was above its longer-run level, it was appropriate to run an accommodative policy to promote the movement of both variables back toward their longer-run sustainable levels.

Accommodative policies tend to lower unemployment and, generally speaking, increase inflation.

But with the unemployment rate now below its longer-run level, should we still be concerned about inflation running slightly below target? As I listen to business and community leaders around my region, I hear few complaints about inflation being too low. In fact, I am more likely to hear disbelief when I mention that inflation is as low as measured in a number of key sectors.

This leads me to the observation that inflation as experienced by households and businesses is fundamentally different from inflation as viewed by financial market participants and many economists. Households see the prices of everyday goods such as food, energy, rents and health care rising and don't understand why the Fed would be concerned that inflation is too low. Their short-run expectations for inflation are driven largely by changes in retail gasoline prices while their longer-run expectations, as measured by the University of Michigan, have been fairly stable.

Businesses see their labor and other input costs rising, and with limited pricing power, see their profit margins squeezed. For them, the product prices they charge are determined by structural factors such as global competition and technological disruption that don't necessarily respond to monetary policy, while their costs are driven by tight labor and commodity market conditions.

In contrast, financial market participants see inflation and inflation expectations as key drivers of monetary policy decisions. They look at past, current and expected future inflation relative to target to form a view about the policy path that they then use to price financial market instruments.

If they perceive the 2 percent inflation objective as a line in the sand that the Fed does not want to overshoot, they may come to expect inflation to run below 2 percent over the longer run. This concern has led to calls for the Fed to ease rates to push inflation and inflation expectations higher in an effort to maintain the credibility of the target and preserve policy space. But even if such a policy were effective, how is policy space preserved if rates have to be cut to boost longer-run inflation expectations?

Context for FOMC decisions
