President's Message: Evaluating our inflation objective

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May 06, 2019

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Fostering a strong labor market while maintaining price stability is of course the core of the Federal Reserve's dual mandate from Congress. With the unemployment rate at a historically low level and inflation currently running just under the FOMC's objective, a longer-run policy issue is whether the persistent undershoot of our inflation objective is undermining its credibility and causing inflation to be anchored at too low a level. If inflation expectations fall persistently below 2 percent, the extent we could lower real interest rates by reducing our nominal target for the funds rate would be diminished. This could limit the accommodation we could provide if we were to return to the zero lower bound.

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 PCE inflation has fluctuated in a range of roughly 1.5 to 2 percent, except during 2015 when a strong dollar pushed core inflation somewhat below 1.5 percent.

Should we be concerned about this low level of inflation? 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. I see this reaction to inflation as a good sign, and consider this performance consistent with the definition of price stability that Paul Volcker and Alan Greenspan preferred. Both of them judged price stability as an inflation rate that is sufficiently low (and stable) that it is not considered a key factor in the decisions of businesses or households.

Even so, I supported the FOMC's decision to adopt a 2 percent longer-run objective for inflation in 2012, and I support it today. I believe it has been effective in helping anchor longer-run inflation expectations. Arguably, though, adopting a point estimate instead of a range has placed considerable attention on a precise target and has exaggerated the precision with which monetary policy can achieve this particular numerical target. It would seem reasonable that even somewhat persistent deviations from the objective, if they are limited to, say 50 basis points above or below the objective may be acceptable, depending on broader economic conditions.

I also support the idea that the objective should be symmetric so that deviations below and above the objective should be viewed as costly, taking into account deviations of employment from our employment objective. Consistent with the FOMC's "Statement on Longer-Run Goals and Monetary Policy Strategy," this suggests that when our objectives are not complementary, we follow a balanced approach in promoting them, taking into account the magnitude of the deviations and the potentially different time horizons over which employment and inflation are projected to return to mandate-consistent levels. In current circumstances, with an unemployment rate well below its projected longer-run level, I see little reason to be concerned about inflation running a bit below its longer-run objective. Moreover, I am not convinced that a slight undershoot of inflation below objective requires an offsetting overshoot of the objective. As I mentioned earlier, the current benign inflation outlook gives us the opportunity to test our assumptions about the degree of slack in the economy and the level of the natural rate of interest.

Going foward: Evaluating alternatives

As we look ahead, however, there is a legitimate concern that monetary policy "space" could be limited in the next downturn because of the low level of interest rates. This has led some to argue for a higher inflation target or the adoption of some kind of a price-level target. While I see little value in pursuing a higher inflation target given the credibility we have built over the last decade around 2 percent, evaluating alternative policy strategies is appropriate. Some have promoted the use of a temporary price-level target that takes effect when the federal funds rate target hits the zero bound. Another approach might be an inflation target that is achieved on average over a fixed period of time or over the business cycle. In theory, a price-level target that is fully credible could potentially smooth fluctuations in output and employment, especially at the zero lower bound.

While not pre-judging the potential efficacy of such strategies, I see both fundamental and practical issues to grapple with in moving to such regimes. What works in elegant economic models can have limitations and unintended consequences when put into practice. Fundamentally, an effective price-level target could substantially reduce uncertainty about the price level many years into the future and thereby help households and businesses make long-term plans and commitments. It also could increase the variability of, and uncertainty about, inflation over the medium term. This is because a price-level target would require policymakers to engineer an increase in inflation in response to the price level falling below its target path and engineer a decrease in inflation in response to the price level rising above the target path. These benefits and costs would need to be carefully weighed.

On a more practical level, there are a number of issues to be considered. First, in a price-level targeting regime, choosing the base period can make a big difference. For example, getting back to a 2 percent price-level path that was based in a year just prior to the Great Recession would require a much longer period of above 2 percent inflation than if the base year were set more recently. This is simply because the cumulative undershoot of the 2 percent price path would be so much greater under the earlier base period.

Second, given the difficulty over the last decade in getting inflation up to 2 percent on a sustained basis, it is not clear to me that adopting a price-level target would be any more effective than our current inflation target. And deliberately pushing inflation above 2 percent at a time when the unemployment rate is well below its presumed longer-run level could be costly. It would likely require a further overheating of the labor market with related misallocation of resources, along with increased uncertainty about the future inflation rate and price level.

Third, a price-level targeting strategy is time inconsistent unless policymakers can credibly commit to following it. If the goal is to have inflation of 2 percent on average, a period of below 2 percent inflation would require an equal period of inflation above 2 percent. But once inflation has moved up to 2 percent, policymakers might be tempted to renege on their prior commitment and not allow inflation to go higher. This would undermine the future credibility of the price-level targeting strategy. To the extent the public understood this time inconsistency problem, price-level targeting would not be credible to begin with, absent a commitment device. With regular turnover among members of the FOMC, it would be difficult for one Committee to commit a future Committee to a particular course of action.

Fourth, the timeframe for achieving an average inflation target would be difficult to determine and communicate. "Over the business cycle" is a vague timeframe since business cycles vary in length and recessions are notoriously difficult to predict. Given that U.S. inflation has been below target for seven years, would we need or want seven-plus years of inflation above 2 percent? At what point should bygones be bygones?

Finally, the Federal Reserve's most recent Monetary Policy Report to Congress contained a section on policy rules and systematic monetary policy. It provided an example of a price-level targeting rule that included the gap between the level of prices today and the level of prices that would be observed if inflation had been a constant at 2 percent from a specified starting year (1998). The prescription from that rule would have been to set the target funds rate at less than 1 percent at the end of last year. Of course, it is impossible to judge the counterfactual implications of maintaining the funds rate target at or below 1 percent throughout the recovery. I think it is fair to assume, however, that the potential to generate real and financial imbalances might be substantial, ultimately imposing an even higher cost to the economy than where we are today.

This message was adapted from a speech President George delivered in New York City on March 27, 2019.
