Clarifying the Meaning of Price Stability

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Over the past few years, the Federal Open Market Committee has made great progress in formulating, and communicating, the objectives of monetary policy to the public. In this column, I'll discuss some of that progress and also describe two ideas about how the Committee can make further improvements along these lines. My discussion will build on a speech, "Clarifying the Objectives of Monetary Policy,"[1] that I gave several times in the fall, as well as on information in the recently released minutes from the Oct. 28-29 FOMC meeting.

The framework statement

The natural starting point for any discussion of monetary policy goals is the Federal Reserve Act, the law in which Congress created the Fed and defined its purposes. Through the Federal Reserve Act, Congress requires the Federal Reserve to make monetary policy so as to promote effectively the goals of maximum employment, stable prices and moderate long-term interest rates. Most economists believe that if the Fed achieved the first two mandates (maximum employment and stable prices), it would automatically achieve the third (moderate long-term interest rates). Hence, monetary policymakers in the United States are usually described as having a dual mandate: to promote price stability and maximum employment.

Congress' short overarching description of Federal Reserve objectives is the foundation for current monetary policymaking, but it does not address many specifics. In January 2012, in a key milestone in the evolution of the Fed's communications, the FOMC adopted a longer and more precise description of its long-run goals. I'll call this short but pathbreaking document the "framework statement." It contains a number of important ideas, and indeed I encourage all Americans to read the entire statement.[2]

In this column, I'll stress only what I see as the most important aspect of the statement: It translates the words "price stability" into a longer-run goal of a 2 percent annual inflation rate. Here, the term "inflation rate" refers specifically to the personal consumption expenditures (or PCE) inflation rate. This is a measure of the rate of increase in the prices of all goods and services, including those related to food and energy. The adoption of this explicit 2 percent target means that the American public need

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guess no longer about the Federal Reserve's inflation intentions—either on the upside or on the downside: 2 percent is our goal.

Possible clarifications in the formulation of the price stability mandate

The framework statement was adopted by the FOMC in January 2012. It has been reaffirmed, with only minor wording changes, in January 2013 and again in January 2014. However, the minutes for the January 2014 meeting note that FOMC participants saw the coming year as an appropriate time to consider whether the statement could be improved in any way. I concur: The time is right to consider sharpening the FOMC's statement of its objectives in several ways. In what follows, I'd like to explain, and express support for, two particular clarifications related to the FOMC's formulation of the price stability mandate.[3]

First, I believe the FOMC should be clear that its inflation objective is *symmetric*. Many observers emphasize the need to keep inflation from rising above 2 percent. But in my view, inflation *below* 2 percent is just as much of a problem as inflation *above* 2 percent. The central bank of Canada also has a 2 percent inflation target. Its language about symmetry is pretty clear, at least as central banking communications go: "the Bank is equally concerned about inflation rising above or falling below the target and will act … in order to bring inflation down, or to push it back up, to 2 per cent."[4] In my view, the FOMC should use similar language to characterize its inflation objective.

Why do I see symmetry as important? Without symmetry, inflation might spend considerably more time below 2 percent than above 2 percent. Inflation persistently below the 2 percent target could create doubts in households and businesses about whether the FOMC is truly aiming for 2 percent inflation, or some lower number. This kind of unmooring of inflation expectations would reduce the effectiveness of monetary policy as a mitigant against adverse macroeconomic shocks.

Second, I believe that the FOMC should consider articulating a benchmark two-year time horizon for returning inflation to the 2 percent goal. (Two years is a good choice for a benchmark because monetary policy is generally thought to affect inflation with about a two-year lag.) Right now, although the FOMC has a 2 percent inflation objective over the long run, it has not specified any time frame for achieving that objective. This lack of specificity suggests that appropriate monetary policy might engender inflation that is far from the 2 percent target for years at a time and thereby creates undue inflation (and related employment) uncertainty. Relatedly, the lack of a public timeline for a goal can sometimes lead to a lack of urgency in the pursuit of that goal. I believe that, if the FOMC publicly articulated a reasonable time benchmark for achieving the inflation goal, the Committee would be led to pursue its inflation target with even more alacrity.

Some might argue that this kind of time horizon is impractical. In fact, many central banks incorporate a similar timing benchmark. For example, the Bank of Canada typically makes its monetary policy choices so that the inflation rate is projected to return to 2 percent within two years.[5] I say "typically"—there are certainly situations in which the Bank of Canada chooses policy so that inflation is projected to return to target more slowly (sometimes taking as long as three years) or more rapidly (sometimes as quickly as 18 months). But it continues to treat two years as a benchmark, in the sense that it feels compelled to explain *why* it is choosing a different time horizon.

To sum up: I've suggested that the FOMC clarify that its inflation target is symmetric and that the Committee typically seeks to achieve that target within a two-year horizon. Let me emphasize that these two suggestions represent clarifications, not alterations. The framework statement, as written, is completely consistent with the formulations of price stability that I've proposed. However, a shortcoming with the current statement is that it is also consistent with other interpretations of price stability (such as a 10-year horizon for returning inflation to the desired target).

Discussion at the Oct. 28-29 FOMC meeting

As the minutes from the Oct. 28-29 FOMC meeting reveal, both of these possible clarifications to the framework statement were discussed at that meeting. With reference to the former clarification (symmetry), the minutes from the meeting say that "there was widespread agreement that inflation moderately above the Committee's 2 percent goal and inflation the same amount below that level were equally costly."[6] I am glad to see this kind of FOMC consensus on this important issue.

The minutes go on to say that "many participants thought that this view was largely shared by the public."[7] I am not one of these participants. The public's main reference on the FOMC's monetary policy objectives is the FOMC's framework statement. The statement makes no reference to symmetry. Without such a reference, we cannot expect the public to know that the FOMC views deviations from its inflation objective in a symmetric fashion. I would support including the above clause from the minutes in the framework statement itself. R

Endnotes

[1] Narayana Kocherlakota, "Clarifying the Objectives of Monetary Policy," speech at the St. Paul Rotary, St. Paul, Minn., Nov. 18, 2014, available at minneapolisfed.org/news_events/pres/speech_display.cfm?id=5426.

[2] "Statement on Longer-Run Goals and Monetary Policy Strategy," Board of Governors of the Federal Reserve System, as amended effective Jan. 28, 2014, available at federalreserve.gov/monetarypolicy/files/FOMC_LongerRunGoals.pdf.

[3] In May, I gave a speech at the Economic Club of Minnesota that discussed, without endorsing, the idea that the FOMC should use price level targeting as opposed to inflation targeting. I continue to think that the Committee should consider this change in approach. However, it's a topic that deserves more space than what is available in this column.

[4] "Monetary Policy," Bank of Canada, May 29, 2012, available at bankofcanada.ca/wp-content/uploads/2010/11/monetary_policy.pdf.

[5] "Monetary Policy," Bank of Canada, May 29, 2012, available at bankofcanada.ca/wp-content/uploads/2010/11/monetary_policy.pdf.

[6] "Minutes of the Federal Open Market Committee," Oct. 28-29, 2014, available at federalreserve.gov/monetarypolicy/fomcminutes20141029.htm.

[7] "Minutes of the Federal Open Market Committee," Oct. 28-29, 2014, available at federalreserve.gov/monetarypolicy/fomcminutes20141029.htm.