

Making Up Is Hard to Do

BY JOHN WEINBERG

Since March, discussions of the economy and Federal Reserve policy have been dominated by the effects of the COVID-19 pandemic. But it is worth remembering that starting last year and continuing into the beginning of this year, the Fed had been conducting a broad review of the strategy, tools, and communications practices it uses to pursue its dual mandate of maximum employment and price stability. That review was taking place at a remarkable moment in the history of U.S. monetary policy. When I arrived as a research economist nearly 30 years ago, the Fed had not yet completed its historic conquest of the Great Inflation. The ultimate success of that long campaign firmly established the institution's anti-inflationary credentials — so much so that, by now, it has become widely perceived that the Fed faces an altogether different challenge.

One of the greatest concerns for policymakers in recent years has been the strong tendency for the Fed to undershoot its 2 percent inflation target, which it introduced in January 2012. Since then, the Fed's preferred inflation measure, based on the core personal consumption price index, has ranged between 1.2 percent and 2.1 percent. These asymmetric outcomes relative to the 2 percent target have occurred despite repeated Fed statements that its target is symmetric — meaning it is equally concerned about overshooting or undershooting the target. Policymakers have worried that the persistent undershooting will further solidify expectations of low inflation and encourage households and businesses to behave in ways that reinforce those expectations and may in fact cause inflation to drift even lower.

A major worry is that persistently low inflation expectations, coupled with low interest rates, may hamper the Fed's ability to conduct countercyclical monetary policy. In particular, secularly low interest rates can limit the Fed's room to cut the federal funds rate before hitting the rate's lower bound, which is generally believed to be around zero. The current crisis is a case in point, as the Fed quickly took interest rate policy to the lower bound with successive federal funds rate cuts in early and mid-March. In fact, the Fed went further, introducing new rounds of quantitative easing and opening a range of special credit facilities. An assessment of the Fed's response to the crisis is an important topic — but it's one for another day.

Most economic models tell us that changing expectations can do a lot of the work toward changing actual inflation outcomes. Consequently, there appears to be a lot of agreement on the need to nudge inflation expectations upward to the point where market participants believe that inflation is just as likely to overshoot as undershoot the 2 percent target.

One prominent idea that has been under consideration by Fed policymakers is some sort of “makeup” rule whereby an intermediate-range inflation target would be set higher than the long-term 2 percent target after periods when realized inflation has been lower than 2 percent (and vice versa). In this way, the makeup policy would attempt to produce inflation outcomes that, over the long haul, are symmetrical around the long-term 2 percent target.

Any makeup policy should take into account some important guiding principles. One is that policy actions should be visibly consistent with policy goals. Another is that policy rules need to be credible. For instance, it may be problematic to specify an intermediate-range inflation target according to a strict historical average because such a formula may dictate policy actions that policymakers are ultimately unwilling or unable to implement. Following a sustained period of recession and zero inflation, for example, the amount of inflation needed to achieve the 2 percent average in a reasonable time frame may strain credibility. Consequently, rather than employing a strict formula, a central bank that targets average inflation may prefer an approach that preserves flexibility, such as general statements like “policy will attempt to achieve inflation outcomes that compensate for past misses.”

But history has shown that it has often been difficult to change inflation expectations, at least in the desired direction. For example, the victory over the Great Inflation — initiated by Fed Chair Paul Volcker in the late 1970s — did not come easy. A cogent analysis of the battle was provided by the late Marvin Goodfriend, my former colleague who left a big imprint on the Richmond Fed and the economics of central banking more generally. According to his account, the Fed was able to successfully subdue inflation expectations only after aggressively responding to recurring “inflation scares” with interest rate hikes on multiple occasions over an extended period of time.

And little comfort is provided by Japan's efforts to increase inflationary expectations. The Bank of Japan's long-standing policy of low interest rates and its more recent program of substantial quantitative easing, while they may have raised inflation some, have failed to achieve the stated goals.

The process of guiding inflation expectations higher is not likely to be easy. Indeed, the historical record suggests that making up for periods of below-target inflation will be challenging. **EF**

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