

Hitting the Target

In January 2012, for the first time in its 100-year history, the Federal Reserve announced an explicit inflation target. Naming an explicit target strengthens the Fed's commitment to maintaining price stability, but it also triggers commentary when inflation deviates from that target — in this case, 2 percent. For most of this year, headline inflation has been relatively low, between 1 percent and 1.5 percent. (Headline inflation includes food and energy prices, which tend to be more volatile than the prices of other goods.) This led to speculation that the Fed would — or should — continue to pursue accommodative monetary policy longer than it otherwise might.

But policymakers don't necessarily change course every time inflation strays from the central bank's target, whether that target is implicit or explicit. Our goal is for inflation to average 2 percent over time (within a narrow range), not for inflation to be exactly 2 percent all the time. That's because the inflation rate in any given period can be buffeted by a variety of factors, some of which may prove to be transitory, such as an increase in the price of oil due to political conflict in an oil-producing country or a rise in import prices due to a falling dollar. But, as Milton Friedman famously described it, monetary policy affects the economy only with long and variable lags. If policymakers overreact to temporary factors, their actions are likely to take effect only after those factors have subsided, leading to policy that doesn't match current market conditions.

These examples involve factors that push inflation above its target level, but similar reasoning applies when inflation is below target. One factor in the low inflation rate earlier this year was an unusually slow rise in the price of medical services, a result of cuts in Medicare reimbursements due to sequestration. Falling energy and import prices also dampened inflation. But these factors appear likely to be transitory.

One way for the central bank to gauge future pressures on supply and demand, and thus on prices, is to monitor inflation expectations. People and firms make decisions based on what they think inflation will be in the future; all else equal, the actions they take then have an effect on actual inflation. The textbook example is a labor negotiation: If union members expected an increase in the inflation rate to 5 percent, for example, they would demand a higher wage increase to compensate. The firm would then raise prices in order to cover its higher labor costs.

If long-term inflation expectations are well anchored, however — if the public believes that the central bank is committed to price stability — it's less likely that people will alter their behavior in a way that affects inflation. Currently, the various gauges of inflation expectations suggest that long-term expectations are stable, and that inflation is

likely to move back up toward 2 percent over the medium term. One indicator is the difference in yield between inflation-indexed Treasury securities and regular Treasury securities. This measure suggests that market participants expect inflation to average close to 2 percent over the next five years and a bit more than that over the next 10 years.



There also are various surveys that ask people directly about their expectations. From one survey period to another, there is some variation in short-term inflation expectations, but long-term expectations are consistent with the Fed's target. Currently, those surveys indicate that economists and businesspeople expect inflation to return to 2 percent within the next year or two, and to average 2 percent over the next decade. Consumers expect inflation to be a bit higher, around 3 percent, roughly the same level they have expected for the past two decades.

The fact that inflation expectations are stable does not imply that policymakers can be complacent. On the contrary, we must constantly monitor a broad range of data for signs that a persistent change in inflation might be in the offing. Indeed, the stability of inflation expectations is strong evidence that market participants anticipate that the Fed will take the actions necessary to keep inflation close to 2 percent over time.

If changes in inflation do appear to be persistent, then we must adopt appropriate policies to ensure that those changes don't become embedded in expectations. As we learned the hard way in the late 1960s and 1970s, once market participants expect higher inflation, it is difficult and costly for the central bank to change those expectations. By acting promptly — but not precipitously — when economic conditions warrant, we will preserve the price stability that is fundamental to economic growth. **EF**

A handwritten signature in black ink, which appears to read "Jeffrey M. Lacker". The signature is fluid and cursive.

JEFFREY M. LACKER
PRESIDENT
FEDERAL RESERVE BANK OF RICHMOND