

MONETARY POLICY INSIGHTS POLICY FOCUS



THE IT DEBATE: BEST PRACTICE DETAILS

In previous commentaries, we have argued that the FOMC will reach a consensus to adopt a numerical definition of its price stability objective and that this will define a new standard for best practice central banking. As part of the process of achieving the consensus, the Committee will have to turn its attention to the details of the proposal. Relevant issues include what the reference index should be, whether the objective should be stated in terms of core or overall inflation, what the level of the inflation objective should be, whether there should be a range for the index, and whether a time horizon for meeting the objective should be specified. The Committee is unlikely to be satisfied with mechanically converting the implicit so-called comfort zone (1% - 2% for the core PCE) into an explicit objective, but will likely insist on a thorough reconsideration of all the issues mentioned above. These issues turn out to be more interesting and potentially more contentious than might initially appear to be the case. In this commentary, we set out our views on what best practice might be for the details of an inflation objective.

THE REFERENCE INDEX

The debate about the reference index is principally whether it should be the PCE or the CPI. There are advantages and disadvantages to each.

The CPI has the benefit of being more familiar to the public, and this type of a consumer price measure is the choice of virtually every inflation-targeting central bank around the world. Some also see as a benefit the fact that the CPI never gets revised. The PCE has the advantages that it appears to have a smaller measurement bias, has more comprehensive coverage, and has more appropriate weighting across its components. The main disadvantages of the PCE are that it includes imputed prices that we simply do not know how to “impute.”

In our view, best practice would be for the Federal Reserve to use the index that it believes is most accurate and has the smallest bias. The public will come to focus more over time on whatever index the Fed opts for, though the role of the CPI in indexing will always keep it in the public consciousness.

One issue that will have to be considered is that the optimal price index might be neither the PCE nor the CPI. Some on the Committee are skeptical about reliance on the PCE because of its inclusion of imputed prices, while the CPI suffers from greater bias and less

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accurate weighting. Perhaps better “theoretical” choices might be either the chain measure of the CPI (reducing the bias) or the market-based component of the PCE (jettisoning the imputed prices), although those measures are even less familiar to the public than the PCE itself and have their own shortcomings.

The bottom line is that this is a more open competition than might appear to be the case. Inertia may still win the day, with the Committee choosing to use the PCE due to some of its advantages relative to the CPI. However, this outcome will not be decided without a thorough re-consideration of this issue.¹

CORE VS HEADLINE INFLATION

The FOMC publishes its forecast for core rather than overall inflation, highlighting the importance of this measure in the mindset of the FOMC. That view is consistent with our experience inside the Fed and with our empirical confirmation that the FOMC adjusts its policy in response to movements in core rather than overall inflation.² Nevertheless, the choice between core and headline inflation for an explicit, long-run inflation objective is not so clear-cut and could itself generate quite a bit of discussion on the Committee.

If the FOMC defines its long-run inflation objective in terms of the core measure, it needs to clearly explain the logic of this decision to the public. There is clearly a lot of confusion as to why a central bank would target a measure that excludes some important spending categories as opposed to a measure that truly reflects the full range of prices people pay.

The case for core is that it is a better proxy for the underlying inflation trend, as the inflation effects of energy and food price movements tend to be transitory. Indeed, this view is related to how monetary policy should optimally respond to a supply shock. The traditional answer (at least inside the Fed) is that a central bank should “look through” the direct impact (as reflected in headline inflation) and respond only to the secondary or indirect effects, reflected by the pass-through from the supply shock to core inflation. This means that a central bank should be willing to accommodate a one time increase in the price level as long as it can avoid accommodating a more permanent increase in inflation.

The fact that it may be optimal to respond in the near-term to movements in core rather than headline inflation does not, however, necessarily dictate the choice between core and headline inflation for a long-term objective. In the long-run, we expect any initial supply shocks will have dissipated, and we have no basis for judging that core and headline inflation rates will differ. In this case, the simplest option is perhaps to set the objective in terms of headline inflation, a concept everyone understands and appreciates, even if the Committee tends to react to core inflation in the short run.

No one has been more explicit about this approach than the Bank of Canada. The BOC sets its inflation target in terms of headline CPI but explicitly indicates that it monitors its success in meeting that long-run target by monitoring the behavior of the core measure of inflation in the short run.

¹ Alan Greenspan seemed to be the member of the FOMC most committed to the choice of the PCE compared to the CPI. Most members of the Committee are more open-minded about this choice.

² See our commentary “Does the Fed Focus on Core or Headline Inflation” (June 30, 2005).

SETTING THE LEVEL OF THE INFLATION OBJECTIVE

There are two considerations that potentially come into play when deciding on the appropriate level for the inflation objective. First, it is widely accepted that there should be an adjustment for measurement error. That is, the inflation target should be high enough so that it is consistent with zero “true” inflation. For the CPI, the bias under current methods might be around 0.6 percentage point, while for the PCE it might be something about ½ as big. Second, the inflation objective should also incorporate a buffer or cushion above true price stability to reduce the prospect of slipping into deflation during severe downturns and potentially having the policy rate driven to the zero lower bound.

Most central banks that have explicit inflation objectives have set the target or the midpoint of their ranges at 2% for their measure of the CPI. The discussion at the 1996 FOMC meeting indicated that the overwhelming consensus of FOMC members was that this was the appropriate level and logic for the definition of price stability for the U.S. economy. As the FOMC shifted its focus to the PCE from the CPI, the implicit inflation objective seemed to be translated to 1½% for the (core) PCE, using what was at that time a normal differential between the CPI and PCE measures of inflation (though it has been shaved down by methodological changes to the CPI since then).³

Our reading of the FOMC is that all members believe there should be an adjustment for measurement error and that there is overwhelming consensus in favor of including a buffer (though a couple of members, including Bill Poole, have indicated that they preferred zero true inflation and hence no buffer). The preferred buffer appears to be at least one percentage point.

But there are at least a number of FOMC members who believe that the current comfort zone range is set too low to effectively deal with the risks associated with deflation and the zero nominal bound.⁴ We believe the staff very much shares this concern. Moreover, the Committee’s actions themselves suggest that policy is quite asymmetric in the aggressiveness of its response to movements below and above the mid-point of this range. Specifically, the decline in core inflation towards the lower end of the comfort zone in 2003 prompted an aggressive policy response, including discussions of using “nonconventional” policy actions. However, the breach of the upper end of the comfort zone this year seems to have prompted less policy reaction, suggesting greater tolerance for being in the upper end or even outside the comfort zone.

Indeed, the Committee has displayed a lack of aspiration to put in place a path of the funds rate that would be consistent with moving deliberately back to 1½% for the core PCE. The FOMC forecast instead seems to suggest that the Committee might be content with

³ Interestingly, the Bank of Japan, based on the views of its individual policy board members, reported a range from zero to 2%, with an apparent median of 1%, below the preferred inflation rate in most inflation targeting countries. That decision, they noted, reflected the experience in Japan with lower inflation on average over the last couple of decades and also the judgment of the BOJ that there is no bias in Japan’s CPI.

⁴ Tony Santomero, a previous member of the FOMC, explicitly argued for a 2% mid-point for the range for an explicit inflation objective. Interestingly, Bernanke, in his talk about an optimal long-run inflation objective, also suggested 2% for the optimal level, though he was not explicit about what inflation measure he was referring to.

returning to the upper end of the comfort zone. In part, this could simply be an indication of the inclination to follow an opportunistic disinflation strategy. But we suspect that it also reflects a view that 2% might be the best choice for a long run inflation objective for the core PCE inflation rate. Overall, this behavior suggests that the so-called “comfort zone” is actually set too low.⁵

However, while we tend to agree that the comfort zone is set too low, we must also consider the power of inertia. It is somewhat awkward for the Committee to take a step toward a more disciplined regime with an explicit inflation objective and, at the same time, set the explicit objective higher than the market perceives its implicit objective today. In effect, by setting the explicit objective above its perceived implicit objective, the Committee would appear to be raising its inflation objective to fit the market’s long-run inflation expectations, instead of hoping that, by making their implicit objective explicit, the Committee could encourage a convergence of market expectations to the Fed’s (now explicit) objective.

HORIZON FOR THE OBJECTIVE

Another potentially important consideration in the design of an explicit inflation objective is whether or not there should be an explicit horizon over which the central bank commits to return inflation to within the stated range should inflation breach the boundaries. And if there is an explicit horizon, the question becomes how short it should be.

This is an especially interesting issue because Bernanke, when he first joined the Board, indicated that he preferred an explicit horizon, one as short as the Committee would be comfortable with. The central tendency of the Committee, in our estimation, holds a very different view. They see a horizon as a hallmark of the less flexible and more single-minded inflation-targeting regimes around the world and as inconsistent with the Federal Reserve’s dual mandate. Bernanke subsequently has made clear, likely in response to his understanding of the strongly-held position of the rest of the Committee, that the proposal he would now promote would not include a horizon and would be focused only on a long-run objective consistent with the dual mandate. So we see this is an issue that has already been “negotiated” and settled.

SHOULD THERE BE A RANGE, AND, IF SO, HOW WIDE?

Whether to have a range for the objective could be especially contentious because the resolution of this issue could have a direct bearing on the conduct of policy under an explicit inflation objective. The issue here is the interpretation of the range and, specifically, what the boundaries imply about the degree of non-linearity in the policy

⁵ It is interesting to recall how the comfort zone got to be centered on 1½%. In our view, the center of the comfort zone is based, as noted above, on the discussion of the meaning of price stability at June 1996 FOMC meeting (the first meeting Larry participated in). That discussion ended with a strong consensus summarized by the Chairman that price stability meant 2% for core inflation. There was some ambiguity about what price index was being referenced, but it seems likely that the reference index was the core CPI. Give the normal (at least then and for some time after) differential between the core CPI and core PCE measures, the 2% for the core CPI got translated into 1½% for the core PCE. Interestingly, the 5-year average differential has fallen to just 1 or 2 tenths from above ½ percentage point earlier, though the differential weight of OER in the two measures is re-opening a wider differential in higher-frequency measures of the two measures more recently. But if we were to make the same translation today, from 2% for the core CPI to the “equivalent” reading for the core PCE, the comfort zone for the core PCE would perhaps be centered on 2%, not 1½%.

response to inflation. The question that the FOMC will be asking itself is whether such implications are consistent with its current conduct and, more generally, with its Congressionally-mandated objectives.

If the inflation objective is to apply over shorter intervals, a range can provide useful information about how aggressively monetary policymakers will respond to small deviations from the mid-point. A simple way of framing the issue is whether the edges should be “hard” or “soft.” If the edges are hard, a range could imply considerable tolerance of movements in inflation inside the range but an abrupt decline in tolerance for movements that breach the boundaries. In the case of soft edges, the Committee would view a 2.1% rate as virtually the same as 1.9%, and policy would not take an abrupt turn when inflation crossed the boundary lines.

The reason that this issue is potentially so contentious is related to the broader issue of the desirability of having an explicit objective. Skeptics fear that having an explicit range for the inflation objective would inevitably lead to a change in the conduct of monetary policy. That is, while Bernanke frames the issue as being one of transparency and communication, not “policy” itself, some members of the Committee are skeptical that it would turn out that way. A range with “hard edges” (especially a narrow range like the 1 – 2% comfort zone) would likely create a serious tension for those members who believe that it would encourage FOMC members to be more aggressive in returning inflation to inside the range than would have been the case with the prevailing implicit range and therefore would inevitably interfere with the flexible and pragmatic approach to monetary policy that has been the hallmark of its successful policies in recent years.

Proponents, on the other hand, will argue that a point estimate gives the impression that the FOMC has too precise control over inflation and that a range better conveys some of the uncertainty that it faces. It also gives the FOMC some wiggle room for the precise level of inflation it wants to achieve. For example, a range could accommodate the possibility that it might be optimal during the mature stage of expansions to allow the inflation rate to move above the mid-point. This would provide more room for inflation to decline during recessions without fear of slipping into deflation, while still allowing the average inflation rate over the business cycle to be closer to the mid-point. Lastly, a range might simply best reflect the preferences of the Committee, as it may see no difference in the cost of inflation within, say, a 1% to 2% range.

Our own view is that having a range for the inflation objective is hard to justify when the objective is really to be interpreted as a long-run goal. Ranges inevitably give the impression that the short-run policy response changes at the boundary—that is, it is hard to get completely away from the “hard edges” interpretation above. For this reason, a preferred approach may be to specify a point estimate and emphasize that the FOMC attempts to meet this objective only over the intermediate-term. Based on these considerations, Meyer’s 2001 proposal for an explicit numerical inflation objective in the context of the dual mandate did not allow for any range.⁶

⁶ Laurence H. Meyer, “Inflation Targets and Inflation Targeting,” Federal Reserve Board, July 17, 2001.

If there is a range, the width may depend on some of the same considerations that are relevant to setting the level of the inflation objective, specifically concern about deflation and the zero nominal bound. If the mid-point were as low as 1½% for the core PCE, it seems unlikely the Committee would accept an inflation rate as low as ½% as a boundary for the comfort zone. In this case, if the Committee wanted a range, it would likely opt for a narrow one, giving us the 1% – 2% comfort zone.⁷ In addition, if the objective were clearly seen as a long-run goal, this might diminish any concern about it being too narrow.

In the end, it is not clear how the Committee will view “best practice” with respect to a range. Our best guess is that the FOMC will end up with a narrow range, but it would not be entirely surprising if there turned out to be no range at all.

TIMING AND CONTEXT

Core inflation has now moved outside the implicit comfort zone. Could the prevailing level of inflation itself now potentially affect the outcome of the decision about whether to move to an explicit objective, the timing of such a move, or the details of an explicit objective? We think it could.

The fact that inflation is running above the upper end of the implicit comfort zone, and is expected to continue to do so for some time, could increase the resistance within the Committee to move to an explicit inflation objective or range, or at least delay any move in this direction. The most important argument against moving to an explicit objective would be that doing so would encourage a change in the conduct of monetary policy away from the flexible and pragmatic approach that members of the Committee believe has worked very well.

In the current circumstances, Committee members will ask themselves whether the Committee would be more inclined to tighten more aggressively today if there was an explicit objective with an upper boundary of 2% for the core PCE. We suspect that an inflation objective announced in the proper manner—with an emphasis on the fact that it is a long-run objective in the context of a dual mandate—would not force the Committee to change its near-term reaction function. But that is the issue for the FOMC to debate.

A minority of proponents could argue that the objective *will* change the conduct of policy in a way that will be advantageous. Their case would be that it will impose some discipline in the policy response to inflation, in that the Committee would not be able to allow core inflation to linger too long above the comfort zone. These members could point to current circumstances for supporting their argument. However, we believe that this group will be the minority, and that most of the supporters of the proposal will instead rely on the argument that having an explicit target is a vehicle for continuity, not change.

THE BOTTOM LINE

We initially thought that inertia would lead the Committee to adopt the 1% - 2% range for the core PCE that we have taken as the implicit comfort zone as its explicit long-run inflation objective. This still seems like a possible outcome, but it is not an obvious one.

⁷ This interaction likely encouraged Santomero to call for a 2% mid-point, as he also favored a wider range, 1 percentage point on either side of the mid-point.

BEST PRACTICE DETAILS



We believe that the Committee will give full consideration to all of the details discussed above, with another round of staff analysis and extensive internal discussion by the Committee. The Committee may be willing to deviate from the details of the current implicit comfort zone because it feels that it has to “get it right,” given the importance of this issue and the fact that the Committee will likely have to live with its decisions for a long time.

Each of the issues discussed here—the reference index, the choice of core or headline inflation, the level of the objective, the horizon, and the range—will generate intense discussion and debate. And, of course, since the devil really may be in the details, what we still see as a consensus in favor of the “vision” of an explicit objective may not be as strong once the details of the proposal come into better focus.

In our view, the best proposal is one in which the objective is specified in terms of overall PCE inflation, as a longer-run objective with no horizon specified, with a point estimate around 2% and no range specified. Of course, we do not get a voice at the table. But perhaps the same arguments that lead us to this view will also influence the decision of the Committee.