Fed Officials Said to Discuss Adopting Inflation Target Backed by Bernanke

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Federal Reserve officials are discussing whether to adopt an explicit target for inflation, a strategy long advocated by Chairman Ben S. Bernanke and practiced by central banks from New Zealand to Canada, according to people familiar with the discussions.

The talks coincide with Fed efforts to spur growth and reduce unemployment without fueling higher prices. An inflation target could help quiet critics of record monetary stimulus and anchor public expectations for consumer prices should the Fed in coming months try to spur the recovery by keeping interest rates close to zero for longer.

"My sense is that this may be a done deal, though not one likely to be implemented soon, and perhaps not until economic conditions return to closer to normal," said Laurence Meyer, senior managing director and co-founder of Macroeconomic Advisers LLC and a former Fed governor. "The chairman is obviously for it, and it is hard to find anybody on the FOMC who now is really opposed to it."

Calls by policy makers for an inflation target have grown in recent months, with Fed bank presidents in Atlanta, Richmond, St. Louis, Philadelphia and Cleveland supporting such a move. Atlanta Fed President Dennis Lockhart said on June 7 said it's time "to reaffirm in explicit terms the central bank's commitment to delivering its piece of the package of fundamentals needed to assure a durable and lasting recovery."

Active, Serious

People familiar with the discussions by Fed officials indicate they are active and serious, beyond the theoretical debates on the topic that the Federal Open Market Committee has had for more than a decade. Discussions could end without a decision in favor as they have in the past. Fed spokeswoman Michelle Smith declined to comment.

U.S. central bankers already have an implicit goal, which they publish quarterly in the form of a range of long-run forecasts. The goal isn't a binding commitment, and it can change, creating uncertainty in financial markets that can lead to higher long-term bond yields, said Marvin Goodfriend, a former Richmond Fed policy adviser.

“There is nothing to be gained by leaving the world safe for higher inflation,” said Goodfriend, now a professor at Carnegie Mellon University in Pittsburgh, who added that improved credibility would allow the Fed to keep interest rates lower, boosting growth in the long term. “It is beneficial for the Fed to go beyond where it is currently and announce an explicit inflation objective.”

Inflation Accelerates

The discussion of a target coincides with an increase in the so-called headline rate of inflation that has been stoked by higher oil and food prices. Consumer prices rose 3.6 percent in the 12 months ended May, the biggest year-over-year increase since October 2008.

Fed officials, who next meet on June 21-22, measure their near-term progress on inflation by looking at prices without food and energy. By that measure, inflation is low, rising 1 percent for the year ending April, according to the so-called core personal consumption expenditures price index. That compares with a five-year average gain of 1.9 percent.

In April, board members and Fed bank presidents said their long-term central tendency estimate for the full PCE index was 1.7 to 2 percent, up from 1.6 to 2 percent in January. The central tendency excludes the three highest and three lowest forecasts. The full range of forecasts was 1.5 to 2 percent.

The FOMC would probably target headline inflation if it moved to an explicit goal, Meyer said. Two percent would be the most likely target, and the time period over which policy makers expect to achieve it will likely be the “medium term,” a vague horizon that makes clear this is not a goal for a one-year period, he said.

Damaging Credibility

James Bullard, president of the Fed Bank of St. Louis, says the central bank’s current focus on prices excluding food and energy risks damaging its credibility with the public.

"One immediate benefit of dropping the emphasis on core inflation would be to reconnect the Fed with households and businesses who know price changes when they see them," Bullard said in a May 18 interview.

Investors' expectations for inflation, as measured by the breakeven rate between Treasury Inflation Protected Securities and nominal bonds, have fallen over the last two months as the price of commodities such as oil dropped and the economic recovery slowed. The expected rate of inflation over the next 10 years fell to 2.26 percent from 2.66 percent on April 11, which was the highest level since August 2006.

Unemployment Rises

While prices have risen, the second part of the Fed's so- called dual mandate, full employment, could be years away. The unemployment rate has averaged 9.5 percent for two years, and stood at 9.1 percent in May amid signs the two-year recovery is slowing. Fed officials have argued that greater clarity on inflation could benefit labor markets by helping the central bank anchor price expectations even when rates are low.

"Within the dual mandate, you'll get better results if you have an explicit inflation target," Bullard said. "And you'll get worse results if you don't have an inflation target, and if people are allowed to wonder out there and create uncertainty out there about what your long-run intentions are."

Atlanta's Lockhart endorsed an explicit inflation target for the first time in a June 7 speech. Adopting such a specific goal wouldn't change what the FOMC is doing now, he said.

"We have been pursuing policies with an eye toward 2 percent or slightly less headline inflation at least since we began publicly reporting our longer-term inflation forecasts," Lockhart told the Charlotte Economics Club.

Never Dissented

Cleveland's Sandra Pianalto, who has never dissented from an FOMC decision, called for a 2 percent target in a March 31 speech. Philadelphia's Charles Plosser and Richmond's Jeffrey Lacker both said in recent weeks that they favor a target as well.

"This point in the business cycle" would be a good time "for us to clarify what we mean by price stability," Lacker told reporters in Roanoke, Virginia June 13.

"I have advocated 1.5 percent but if the consensus -- if the center of gravity on the committee is 2 percent, I will endorse that," Lacker said. "I will support that and get on board with doing monetary policy on that basis."

New Zealand's central bank was the first to adopt a goal in 1990, according to the International Monetary Fund. The Bank of Canada followed in 1991, the Bank of England in 1992 and the Reserve Bank of Australia in 1993. Over 20 central banks, including those in Israel, Mexico, and South Africa, now use the strategy.

As an academic and later a Fed governor, Bernanke became a proponent of inflation targeting.

International Lessons

In 2001, while chair of the economics department at Princeton University, Bernanke published "Inflation Targeting: Lessons from the International Experience" with co-authors Thomas Laubach, Frederic Mishkin and Adam Posen, writing that the technique had been "sufficiently positive" in the countries that adopted targets.

In his November, 2005, nomination hearing for the chairmanship, Bernanke told the Senate Banking Committee that stating an explicit numeric inflation goal would be a step "toward greater transparency."

"We should try to support the chairman and get this done," Bullard said in the interview. "The U.S. is a laggard. Why? We're going to stick with theories from the 1960s on this?"

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