

The Fed Needs a Credible Commitment to Price Stability

Testimony before the
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Marvin Goodfriend¹

Friends of Allan Meltzer Professor of Economics
Tepper School of Business
Carnegie Mellon University

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¹ Former Senior Vice President and Policy Advisor, Federal Reserve Bank of Richmond, 1993-2005.

Introduction

I am pleased to be invited to testify today on "Sound Monetary Policy" before the Subcommittee on Monetary Policy and Trade of the House Financial Services Committee. In the decades since the Fed under Paul Volcker ended the Great Inflation in the early 1980s, central banks around the world have come to understand that sound monetary policy requires a credible commitment to price stability, which in practice has come to mean committing to an inflation target. In January 2012, the Federal Reserve finally followed the global trend when the Federal Open Market Committee [FOMC] adopted a 2 percent inflation target in its "Statement of Longer-Run Goals and Monetary Policy Strategy."

The "Statement" as currently written is a good first start; but the statement stops short of committing the Fed fully to an inflation target, and in some ways it actually undermines the target's credibility. At the end of my testimony I recommend improvements in the "Statement" to lock down the public's belief and confidence in the inflation target. Before doing so, however, I discuss three specific ways in which the Fed's weak commitment to its inflation target creates policy risks for the economy and I explain how the Fed and the economy would benefit from a greater commitment to price stability as embodied in the inflation target.

By failing to secure the credibility of its inflation target, the Fed:

---increases risk inherent in using the federal funds rate to influence longer-term interest rates, and thereby degrades the capacity of monetary policy to stabilize employment and inflation over the business cycle.

---invites a re-emergence of cyclical "inflation-fighting" risk premia in longer-term interest rates with potentially adverse effects on employment and inflation.

---forces households to guard against inflation risk, and thereby greatly increases household financial insecurity over a working lifetime and in retirement.

Weak Inflation Target Credibility Worsens Inherent Interest Rate Policy Risk

The Fed targets the federal funds rate in order to stabilize inflation and employment as best it can. Output and inflation, however, do not respond directly to the overnight federal funds rate, but only to longer-term rates. Hence, the Fed targets the federal funds rate with the aim of influencing longer-term interest rates. It exercises its influence as follows. The federal funds rate controls the level of other short-term interest rates in the economy via a variety of banking and money market arbitrage opportunities. The market then determines longer-term interest rates as the average expected level of short-term interest rates over the relevant horizon (abstracting from a time varying term premium and default risk). For instance, investors with a 10-year time horizon have the option of rolling over 3-month Treasury bills for 10 years or buying a fixed interest 10-year Treasury bond. Hence, the market will determine interest on the 10-year bond so that it returns the expected average 3-month T bill rate over the 10-year horizon plus a term spread.

The Fed manages its federal funds rate target to maximize the influence of target changes on longer-term interest rates, and thereby on the economy. To do so, the Fed waits before changing the federal funds rate target until it is relatively sure that it will not have to reverse field any time soon, and that further changes in the same direction are likely. Markets, in turn, understand that the Fed's interest rate target changes are "highly persistent and seldom quickly reversed." In this way, a change in the overnight federal funds rate target carries expected future short-term rates and longer-term rates with it as well. The Fed's inclination to delay federal funds rate target changes explains why monetary policy has been "behind the curve" more often than not in the past, whether acting against rising inflation or looming recession.

Operational risk inherent in interest rate policy is exacerbated when the inflation target lacks credibility, that is, when the public is unsure of the Fed's commitment to the inflation target. In that case, the Fed may be forced to move more preemptively than otherwise against rising inflation to

assure markets of its commitment to the target. On the other hand, the Fed may be afraid of moving preemptively against recession for fear of having to reverse field against inflation. In other words, lack of a fully credible inflation target raises the risk of moving preemptively and prematurely, undermining the mutual understanding with markets that enables monetary policy to maximize its influence over longer term interest rates and the economy at large. In short, a fully credible inflation target helps mitigate longstanding operational risk inherent in interest rate policy and thereby improves the potential for monetary policy to stabilize both employment and inflation.

Weak Inflation Target Credibility Invites a Re-emergence of Cyclical "Inflation-Fighting" Risk Premia in Longer-term Interest Rates

As discussed above, monetary policy is usually understood to exert its influence over longer-term interest rates via average expected future short-term interest rates over the relevant horizon. By anchoring the short end of the yield curve, the federal funds rate pulls longer-term interest rates up and down to stabilize employment and inflation over the business cycle. Monetary policy also influences longer-term interest rates indirectly via inflation expectations and the price of cyclical risk transfer embedded in bond rates.

During the Great Inflation period from 1965 to 1985 interest rates rose with rising inflation as investors insisted on embedding ever-higher inflation expectations in interest rates as compensation for the rising rate of depreciation of the purchasing power of money.

The Great Inflation period was also marked by four recessions deliberately precipitated by the Fed to contain rising inflation. These "inflation-fighting" recessions were initiated by a tightening of monetary policy that raised interest rates aggressively to collapse aggregate demand and employment until inflation was deemed to be sufficiently contained. Longer-term bond prices, which move inversely to interest rates, would fall sharply during these "inflation-fighting" recessions. Since bond prices would fall sharply just when aggregate employment and income were

depressed, investors required a premium in bond rates on average as compensation for the cyclical "inflation-fighting" risk in bond prices.

By some estimates the cyclical inflation-fighting risk premium in bond rates ranged as high as 4 percentage points in the early 1980s before the Fed under the leadership of Paul Volcker ended the Great Inflation. Since then, the public has become increasingly confident of the Fed's commitment to low inflation. For now, inflation expectations conform to the Fed's 2 percent target, and the risk premium for holding bonds has declined to around 1 percentage point or so, roughly where it was before the onset of the Great Inflation period.

The problem for monetary policy today is that the credibility of the Fed's 2 percent inflation target is about to be tested for the first time. The slow recovery from the Great Recession of 2007-09 has nearly returned inflation to the Fed's 2% target and the US economy to its sustainable level of employment. That raises the possibility of a re-emergence of cyclical "inflation-fighting" concerns, which have the potential to elevate risk premia in longer-term interest rates suddenly and sharply, effectively tightening monetary policy, depressing output and employment, and presenting monetary policy with an uncomfortable short-run tradeoff between stabilizing employment and inflation.

The Fed's history of falling behind the curve on inflation is cause for concern. The last "inflation-fighting" scare in 1993-94 saw a 2 percentage point jump in the long bond rate even without a prior increase in inflation expectations, apparently reflecting a jump in bond investors' concern about a return to an era of cyclical "inflation-fighting" risk. That didn't happen. The jump in bond rates quickly reversed, and inflation remained low, in part, because of a timely rise in productivity growth in the United States in the second half of the 1990s. Whatever happens now, the Fed and the economy would be better off if the credibility of its inflation target were secured more firmly.

Weak Inflation Target Credibility Increases Household Financial Insecurity

If in years past the Fed had been fully committed to price stability as embodied in an inflation target, retirees would be in a much better position today. Years ago, households would have been advised and willing to hold a significant share of their lifetime savings in long-term nominal bonds paying a safe nominal rate of interest. Households could have counted upon the fact that the nominal return would have been locked in purchasing power terms. The promised nominal interest rate, having incorporated a 2% inflation premium to offset the steadily depreciating purchasing power of money at the Fed's inflation target, would have delivered a safe long-term real return upwards of 3% per annum.

Instead, the Great Inflation called the Fed's commitment to price stability into question as it decimated the real return on long term nominal bonds. Responsible households have since steered away from saving in long-term nominal bonds to protect themselves from inflation risk. To avoid inflation risk, households have shortened the maturity of their interest-earning savings and reached for more return in equity products, forced to accept the risk of ultra-low short-term interest rates and volatile equity prices in the bargain.

Decades after the Fed under Paul Volcker ended the Great Inflation and five years after having adopted the 2% inflation target in 2012, the public still regards inflation risk in long bonds as prohibitive, seeing the Fed as only weakly committed to its longer-run inflation target. By not moving definitively to foreclose its inflationary discretion, the Fed greatly increases household financial insecurity over a working lifetime and in retirement.

Securing the Fed's Inflation Targeting Credibility via the "Statement of Longer-Run Goals and Monetary Policy Strategy"

The Fed took a major step in securing the credibility of its commitment to low inflation by adopting an explicit inflation target for the first time in the January 2012 "Statement of Longer-Run Goals and Monetary Policy Strategy," announcing a 2 percent inflation objective for PCE inflation

over the longer run as "most consistent with its statutory mandate." The FOMC promoted its 2 percent inflation goal by asserting another principle in its "Statement," saying that an explicit inflation goal "helps keep longer-term inflation expectations firmly anchored," which would "enhance the Committee's ability to promote maximum employment in the face of significant economic disturbances." Importantly, the statement also acknowledged that employment in the long run is largely determined by non-monetary factors, and that it would not be appropriate for the Fed to specify a fixed goal for employment. In setting monetary policy, the FOMC would seek to keep inflation close to its 2 percent target and mitigate fluctuations of employment around a level assessed to be sustainable.

It is commendable that the FOMC accepts the abovementioned principles and the 2 percent inflation target in its "Statement." But the "Statement" should be improved to secure the credibility of the Fed's inflation target.

First of all, the "Statement" should be modified to make clear that its roots lie in the mistakes and successes of past Fed policy. The full power of the FOMC "Statement"--the case for really committing to the principles surrounding the inflation target--can only be appreciated by understanding that its reasoning is rooted in historical Fed experience. The "Statement" should be linked to the historical narratives that inform the principles underlying the inflation target to help convince the public of the Fed's commitment to the target, and thereby help lock down the public's belief and confidence in the target.

Second, the statement ends saying that the Committee intends to reaffirm these principles and to make adjustments as appropriate at its annual organizational meeting each January. The open-ended invitation to "reaffirm these principles" is counterproductive in a document that purports to be about longer-run goals and monetary policy strategy based on a century of lessons

from Fed history. At a minimum the annual renewal should be circumscribed tightly so as not to undermine the credibility of the Fed's "Statement" in general and its inflation target in particular.

Finally, the FOMC should declare its intention in the "Statement" to invite the legislature to accept the inflation target to further enhance its credibility. And the FOMC should declare its intention to strengthen the legislative oversight process to help enforce the systematic pursuit of monetary policy, that is, the period-by-period mitigation of fluctuations of inflation around its 2 percent target while keeping employment close to its sustainable level over time. To do so, the Fed should include in the "Statement" its intention to improve legislative oversight by presenting the FOMC's independently chosen monetary policy decisions against a familiar Taylor-type reference rule for monetary policy.