Zero Inflation: Goal and Target

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The hallmark of the Greenspan Fed is low and steady inflation. It is not price stability. The Greenspan Fed has reduced the purchasing power of the dollar by over 40 percent in 18 years. This slow and steady debasing of the currency serves no useful purpose. Price stability should be the overriding long term objective of the Fed and zero should be the target for inflation. While there currently is no legislative mandate for targeting inflation, there is nothing keeping the Fed from doing it except its own inertia. The new chairman will have an opportunity to persuade his colleges at the Fed, the public and Congress of the soundness of both a price stability goal and an appropriately measured zero inflation target.

Why Create Inflation? Low and steady inflation is certainly better than high and variable inflation for the economy. No inflation would be even better. Pundits, economists and some Fed officials often talk about the fight against inflation or the battle against it or the need to contain it as if it is some preternatural event. The Fed does not have to battle or contain inflation, it creates inflation. The only choice the Fed has to make is what inflation rate it wants. So when a Fed official says the goal for inflation should be 2 percent, he is explicitly choosing to create that rate of inflation.

No U.S. Monetary Standard . The U.S. currently has no monetary standard.[1] After dropping the last link to the Gold Standard in 1971, the U.S. had no institutional standard

[1] McCallum, Bennett, "The United States Deserves a Monetary Standard", Shadow Open Market Committee, November 12-13, 2000, Washington, D.C.

for the value of the dollar. The Federal Reserve Act, as amended in 1977 simply indicates that the Fed should shoot for maximum employment, stable prices, and moderate long-term interest rates. Fed policy makers choose to interpret that Congressional guidance differently over time. The Burns and Miller Fed sought to buy more employment with higher inflation. They got higher inflation but also sharply higher unemployment and long-term interest rates. The Volcker and Greenspan Fed chose to emphasis lower inflation. They produced lower inflation and were rewarded with lower unemployment and lower long- term interest rates.

The whims of policy makers, at any point in time, determine the inflation rate. There is nothing in the Fed charter that requires it to make price stability its overriding objective. There is nothing in the monetary policy process either by tradition or practice that locks in price stability as the primary objective. In deed, the traditional analysis in the policy process focuses on current economic data and models that imply an exploitable tradeoff between inflation and unemployment. Yet every economist worth his salt knows that over time that the Fed controls only the price level not employment and output. What is needed is explicit recognition of a U. S. monetary standard and that standard should be price stability (price level stability or zero inflation over time).

Price Stability Goal. A market economy achieves maximum production and growth by allowing market prices to allocate resources. Money helps make markets work more efficiently by reducing information and transactions costs, allowing for better decisions and improved productivity in resource use. Stabilizing the price level would make the monetary system operate more efficiently and would result in a higher standard of living for all Americans. Money is a standard of value. Much of our wealth is held either in the form of money or in claims denominated in and payable in money. Money represents a claim on a share of society's output. Stabilizing the price level protects the value of that claim while inflation reduces it.[2]

So why does the Fed still create inflation instead of pursuing a stable price level goal? The main reason is that the Fed tries to avoid recessions or dampen fluctuations in employment and output in the short term. There are two reasons that prevent the Fed

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[2] For further elaboration of the these points see: Statement by W. Lee Hoskins before the Subcommittee on Domestic Monetary Policy of the Committee on Banking, Finance and Urban Affairs, U.S. House of Representatives, February 6, 1990. Washington, D.C.

from using monetary policy to offset non-monetary shocks or surprises. First, it is difficult to accurately predict recessions. Analysis of forecast errors has shown that economists often do not know that a recession has begun until it is well underway. Second, even if the Fed could predict recessions and wanted to vary monetary policy to alleviate them, it still faces a huge problem - monetary policy operates with a long and variable lag. The effect of today's monetary policy actions will probably not be felt for at least six to nine months, with the main influence perhaps two or three years in the future. In its laudable but misguided efforts to dampen employment and output fluctuations, the Fed creates inflation and sacrifices a stable price level goal.

Target Zero. For the Fed to lay the ground work for a credible policy of price stability for the future it needs to make a fundamental change in the policy process so as to build a tradition, practice and culture of price stability that becomes imbedded in the walls at 21st and C. First, it needs to have a long term goal that is consistent with what it can control and what it can control is the price level. Second it needs to impose a rule on itself, tying policy actions to an intermediate inflation target. These changes would shift the policy process away from the focus on the federal funds rate, current economic data and models with ephemeral tradeoffs between inflation and unemployment.

Such changes would make for a credible, predictable and transparent policy process that would not only anchor inflation expectations but also would provide a monetary standard that did not systematically debase the currency.[3] Both of these outcomes enhance the environment for sustained economic growth.

Most major central banks already use some form of inflation targeting and there is a good chance that the Fed will follow suit. So what should be the Fed's target for inflation? The Shadow Open Market Committee members have recommended, at various times, targets that range from zero to two percent. At the last meeting the committee agreed that the target rate should be one percent because of the difficulties of properly measuring inflation.

Conceptually, zero is the appropriate target because it focuses policy actions on achieving the long term goal of price level stability. The target should be multi-year so

[3] For a more detailed discussion of the arguments for and against inflation targeting in the U.S. see: McCallum, Bennett, "Inflation Targeting for the United States," Shadow Open Market Committee Meeting May 18-19, 2003, Washington, D.C.

that the Fed need not act on monthly inflation numbers. The Fed would aim to hit an average of zero inflation over a three or five year period. That means if the Fed created an inflation rate of one percent in the first year, it would have to seek a slight decline in the price level over the next several years in order to average zero inflation. For example, if the Fed temporarily accommodated price shock and produced inflation, then the Fed would have to take back that inflation later. Some shocks have a positive impact on the economy and could lead to deflation unless the Fed acted to offset it. The Fed would achieve its goal of price level stability over time while preventing both sustained inflation and deflation.

The Politics of Inflation Targeting. There appears to be no legal issue keeping the Fed from adopting an inflation target. Congress leaves the conduct of monetary policy pretty much up to the Fed. Even when Fed policy produced major disasters for the economy and financial system, the Great Depression and the Great Inflation, Congress did little to punish the policy makers or alter the Fed's charter to reduce its independence. Alternatively, the Fed could seek a congressional mandate for an inflation target in the form of a joint resolution or an amendment to the Federal Reserve Act.

The Fed faces a number of internal political issues that must be resolved if it is going to adopt inflation targeting. First, Ben Bernanke, a supporter of inflation targeting and heir apparent to Greenspan, can not impose it on the FOMC. He must achieve a consensus for it. A simple major vote could impose inflation targeting but would next years FOMC, with its change of four voting members, support it? Bernanke would need near unanimous support among members of the FOMC for inflation targeting to be feasible. At least one governor, Donald Kohn, is on record in his opposition to inflation targeting.[4] The views of other governors and reserve bank presidents are less well known.

The second issue has to do with picking inflation as a dominant objective or having a dual objective - price stability and maximum employment.[5] Bernanke in his recent confirmation hearings indicated he favors the dual objective. Other members of the

[4] Ibid.

[5] For discussion of this issue see: Gramlich, Edward, "Politics of Inflation Targeting," presented at the Euromoney Inflation Conference, May 20, 2005 and Meyer, Lawrence H., "Inflation Targets and Inflation Targeting," presented at the University of California of San Diego Economics Round Table, San Diego, July17, 2001.

FOMC may not. Many inflation targeting central banks favor a low inflation rate as the dominant objective.

Third, what should be the inflation target? Some members may want a wide range. Others may want a particular rate, say one percent, as a target. Achieving a consensus on this issue may result in an inappropriately wide range.

Four, how should the Fed relay information about its approach to inflation targeting to congress and the public? The Fed could treat inflation targets like it treated monetary targets and report to congress twice a year on them. It could publish monthly or quarterly reports explaining its actions and giving explicit inflation forecasts. Again, a consensus must be reached.

None of these issues should block the Fed from adopting inflation targeting on its own. An alternative approach would be for the Fed to seek a congressional mandate. This approach has appeal because it would lock into law inflation targeting. The problem of course is that the Fed may get more than it asked for. Targets for employment or output could be imposed and the independence of the Fed could be altered.

Just Do It. The Fed has done little to prepare congress or the public for price stability as the dominant objective of monetary policy or for explicit inflation targeting. Only congressman Jim Saxton of New Jersey seems interested in the issue. The public has little chance to understand the inflation process since the Fed does not explicitly take responsibility for creating it. Fed adherence to the dual objective also gives the public the impression it can and should manage the real economy. Over the course of the next year, Bernanke, with his clear exposition and stated desire to keep his testimony focused on monetary policy, may be able to educate congress as to the value of inflation targeting and the limited influence the Fed has on output and employment growth. For now, the best option is for the Fed with respect to inflation targeting is to take to heart the Nike add and "just do it."