Why is the Fed's Inflation Target 2%?

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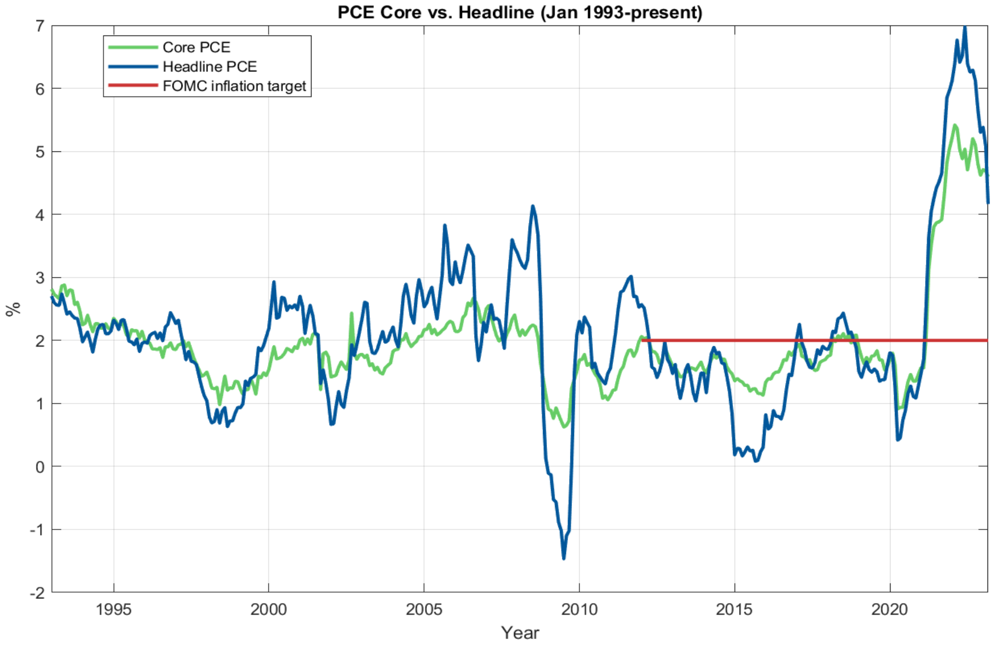
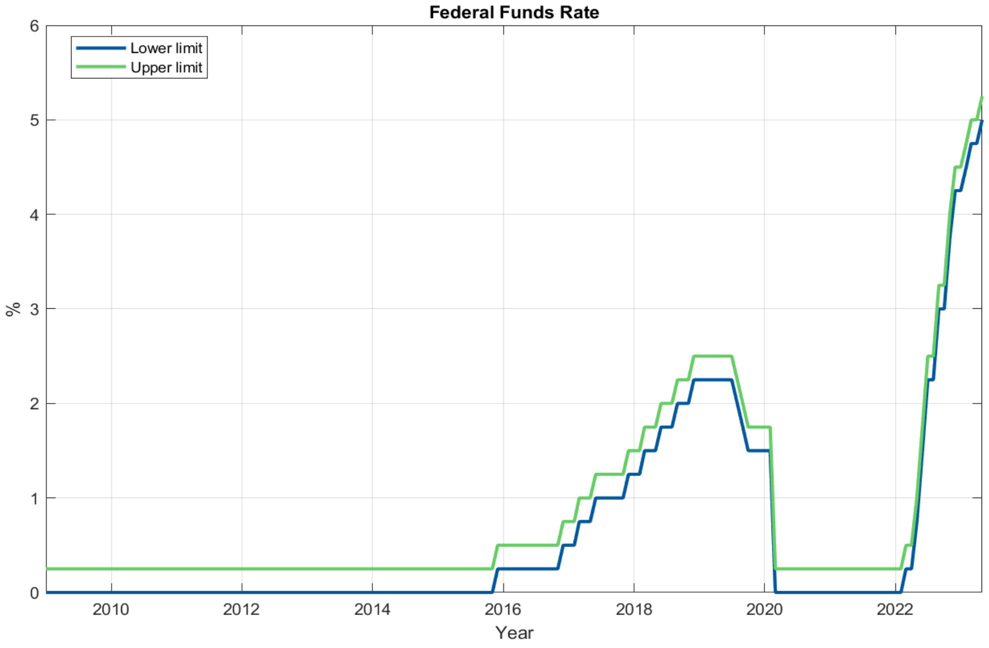
*The views expressed here are my own and do not necessarily reflect those of the Federal Reserve Bank of New York or any other part of the Federal Reserve System





- Establishing the inflation target
- Challenges: ELB and undershooting: reasons to raise the target?
- Post-pandemic: Still reasons to raise the target?

Establishing the inflation target

- Statement on Longer-Run Goals and Monetary Policy Strategy, Jan 24, 2012
  - *"The Committee judges that inflation at **the rate of 2 percent**, as measured by the annual change in the price index for personal consumption expenditures, is most consistent over the longer run with the Federal Reserve's statutory mandate."*
  - Target consistent with participants' projections for the 'longer-run' of inflation, elicited since 2009 in the SEP
- Is 2% an optimal target?
  - We examined the implications of higher target inflation in a GNK, which incorporates a positive long-run rate of inflation (Ascari-Sbordone, 2014)
    - Higher trend inflation increases price dispersion and lowers productivity
    - Makes inflation less sensitive to current economic conditions and more responsive to future conditions
    - Tends to un-anchor inflation expectations, enhance macroeconomic volatility and lower welfare
  - Results consistent with the literature on optimal long-run inflation rate (see Schmitt-Grohe and Uribe, 2011)
- While the optimal rate is generally close to zero, practical considerations (measurement errors, 'greasing-the-wheels' of the labor market) lead to adopt rates in the vicinity of 2%

ELB and undershooting: reasons to raise the target?

- *"The zero nominal interest rate bound has proven costly…. Higher average inflation, and thus higher nominal interest rates to start with, would have made it possible to cut interest rates more, thereby probably reducing the drop in output…"*

  (Blanchard et al, 2010, propose a 4% target)

- Does the ELB constraint alter previous considerations about the optimal long-run inflation rate?
  - The distortions associated with the higher target will remain also when out of the ELB
    - Does the cost of having higher inflation *all the time* offset the benefit of having more monetary policy space when at the zero bound?
  - It depends on the assessment of how likely it is for the ELB to be hit: no conclusive evidence
    - Results sensitive to model specification and parametrization of the shocks (Chung et al, 2012; Coibion et al 2012) and may over- or under-estimate the ELB costs

Alternative policies to mitigate the ELB constraint

- Rather than raising *permanently* the inflation target, commit to easier policy in the future, when the ELB constraint is no longer binding (e.g. Eggertsson-Woodford, 2003)
  - Such policies imply inflation rises only *temporarily* above the target
    - The Fed 2020 flexible inflation targeting strategy is consistent with this approach.

- 2020 Fed's Framework Review: Same inflation target, new strategy
  - *The Committee reaffirms its judgment that inflation at the* ***rate of 2 percent*** *…. is most consistent over the longer run with the Federal Reserve's statutory mandate*.
  - *In order to anchor longer-term inflation expectations at this level, the Committee seeks to achieve inflation that averages 2 percent over time, and therefore judges that, following periods when inflation has been running persistently below 2 percent, appropriate monetary policy will likely aim to achieve* ***inflation moderately above 2 percent*** *for* ***some*** *time.*
  - *"…*could be viewed as a *flexible* form of *average inflation targeting."* (J. Powell, JH)

Post-pandemic: Still reasons to raise the target?

- Rationales for reconsidering the target
  - Some of the previous arguments may still apply
    - Demographic reasons to expect chronically low r*
  - Short-run: lower cost in terms of unemployment

Sources: Holston, Laubach, and Williams (2017); Organisation for Economic Co-operation and Development (OECD).

- Contrary considerations
  - Not obvious the long-run outlook is still for a very low r*
    - Since the pandemic, more acceptance of (or demand for) expansionary fiscal policy
  - Increasing the target *now* would be especially damaging to credibility
    - It allows people to think that the target can (and maybe will) always be adjusted upward whenever there is an inflationary shock
    - Thus, increasing the target to 4 percent right now would be a very different thing from having set it at 4 percent back in 2012.