

In Support of an Explicit Inflation Target

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Key points

Lockhart said **low and stable inflation** is one of the underlying fundamentals that will shape the country's economic performance over the coming quarters and years. The concept of core inflation is part of the FOMC's policy discussion, not because it is an objective of monetary policy but because it is often an informative statistic. However, the objective of policy in the end has to be **defined in terms real people experience**—that is overall, or headline, inflation.

According to Lockhart, **he would not hesitate to support an exit** from the FOMC's current policy stance if he believed the headline inflation number of the past six months **was indicative of the underlying trend inflation rate**. He doesn't believe this to be the case. He said he is **wary of tightening monetary policy** in the face of quite ambiguous economic circumstances unless doing so is absolutely necessary to meet the FOMC's price stability mandate.

The language the FOMC uses to explain its inflation forecasts **can, at times, get in the way** of effectively communicating its ultimate inflation objective. One way to deal with this tension (an approach employed by many central banks around the world) is **to set an explicit numerical objective for inflation**, also known as an inflation target. He supports the FOMC setting such a target.

According to Lockhart, the specifics of an inflation target would need to be worked out by FOMC participants. But a few principles for an effective inflation target would be stating it in terms of **some measure of overall, or headline, inflation** and **making it achievable** over a realistic time frame. An appropriately constructed inflation target would not be in conflict with the FOMC's mandate to support employment.

I have to express some frustration with this economy. Like you, I'm sure, I've wanted the recovery to come along steadily and decisively. Instead we've gotten inconsistency, hesitancy, unevenness. A word I've used recently is halting.

Today I want to talk with you about the current economic situation and outlook and the right monetary policy mix for the situation we're facing. And I will put my support behind a further communications enhancement that I think could help assure that the recovery continues. I'm going to call for an explicitly declared inflation target.

But first, let me say I'm honored to be here in Charlotte today speaking to such a well-informed audience. I first came to Charlotte in the late 1970s. The city was then a regional banking center and one of the southern hubs of the textile industry. Had someone in those days hit me with the prediction that Charlotte would become one of the nation's top two or three banking centers, I would have been a bit dubious. Indeed, that's what has happened. You are proud, I'm sure, of Charlotte's exceptional standing among the country's business capitals, and rightfully so.

I don't need to tell you the Federal Reserve is on the ground here in Charlotte. Fed offices around the country are putting increasing emphasis on economic intelligence from the trenches. In my Fed district, we have feet on the ground in six cities. I know the Charlotte Branch of the Federal Reserve Bank of Richmond makes use of contacts in this city—including many of you in this room. In that regard, I want to acknowledge Charlotte Regional Executive Matt Martin, who is a member of this club.

Finally, by way of preliminary comments, let me emphasize today's remarks are my personal views. They may not be shared by Matt and his boss, Jeff Lacker in Richmond, or my colleagues on the Federal Open Market Committee (FOMC) or within the Federal Reserve system overall.

A quick review of two years of recovery

The recovery is now about two years old. It's a good time to take stock and review how the economic story since the summer of 2009 has unfolded. Rather than cite all the statistics, I'll just characterize the strength and direction of three broad aspects—growth, unemployment (with it, job creation), and inflation.

The growth story began pretty strong in the last two quarters of 2009. The strength carried over into early 2010. The economy slumped in the middle quarters of last year, but then picked up in the final quarter. The first quarter of this year was a disappointment. The expectations of most economists that the solid year-end rate of growth would carry over and build in 2011 have not materialized. As this year's data have been reported, private forecasters have steadily revised down their 2011 growth predictions.

A few months after the recovery officially began in the summer of 2009, unemployment peaked above 10 percent. Significant improvement in the labor market has been slow to come. Since the beginning of 2010 the unemployment rate is down a percentage point from its peak, but if you were to chart it, you'd show most of the progress occurred from November of last year through January of this year. Since then, the unemployment rate has leveled off. Looking at employment from the job creation perspective, last Friday's employment report was clearly disappointing. Job creation was well off the 200,000-plus number we estimate is needed to make significant progress on unemployment.

Prices have also presented a confounding picture. As economic weakness developed in the middle months of last year, disinflationary trends persisted. Alarming, measures of inflation expectations slumped, and concern about deflation rose. The FOMC reacted with a second round of large-scale asset purchases, commonly known as QE2. Headline inflation has reversed course rather sharply over the last few months. Core inflation measures have risen fairly sharply as well. The speed of the reversal of price behavior has been swift, and there has been a lot of concern expressed recently about the risk of persistent inflation.

What are we to make of the vacillating character of the postrecession and postcrisis expansion? What to make of the two-steps-forward, one-step-back experience of the last two years?

Recoveries rarely play out smoothly. Economic fluctuations are to be expected in a dynamic economy like ours, even in the absence of externally originated shocks and scares, of which there have been several. There's the on-again, off-again, and now on-again sovereign debt saga in Europe. There are the momentous events in North Africa and the Middle East with their effect on oil prices. And there are the

earthquake and tsunami in Japan that have disrupted supply chains, especially in the important auto manufacturing sector.

Add to these a number of domestic factors—some regional, some national—such as the oil spill, certain weather events, the continuing severe weakness of the housing sector, and our own version of fiscal uncertainty.

Inflation dialogue

So, to repeat, the fluctuating nature of economic performance is not really a surprise. The numbers will bounce around a bit from month to month and quarter to quarter. Recent disappointing incoming data are not a reason to panic, in my view. In fact, the economy has shown pretty impressive resilience through a litany of what are hardly ordinary and predictable developments.

Still I'm troubled by what you might describe as a lack of conviction in this economy. As I step back and take stock of today's economic situation and the path ahead, I conclude that certain underlying fundamentals will greatly influence the country's economic performance over the coming quarters and years. I would emphasize three fundamentals that I believe will be formative. I'll put these in affirmative terms. They are 1) the restored health of the financial—especially banking—sector, 2) stabilized public sector fiscal underpinnings at all levels of government, and 3) sustained low and stable inflation.

The Federal Reserve shares supervisory responsibility over banks and now other financial firms, and so has a big influence on the first of these fundamentals. But it is the third—low and stable inflation—where the central bank bears near-exclusive responsibility and, ultimately, control. I'd like to devote the remainder of my remarks to the question of how the Fed conducts the dialogue with the public about inflation.

There is an interval of roughly six or seven weeks between FOMC meetings. During that time, my colleagues and I must take on board the limited amount of incoming data and make any adjustments to our working forecast for the economy as the basis for our recommendation on policy action. The process is as much art as science. This dynamic is certainly true of price data, which are exceptionally volatile.

Consider the retail price numbers since last November. Annualized, the overall consumer price index (CPI) is up over 5 percent, well above the Federal Reserve's longer-term de facto objective of 2 percent or a little less.

Lately I've been wrestling with this question: How should the behavior of the CPI over the past six months inform my outlook? More precisely, are we still on the inflation path that eventually delivers price stability?

Over very long horizons, and also during periods of dramatic change, most price statistics are nearly equally informative. But in the short term, the various price measures can give very different assessments of the inflation environment. And it isn't always clear which measures you should trust and which to ignore. In real time, the best we can do, I think, is to estimate inflation from a wide collection of statistics.

There seems to be a lot of controversy lately about one particular statistic, the so-called "core" inflation measure, which subtracts food and energy goods from overall prices.

The concept of core inflation is part of the policy discussion, not because it is an objective of monetary policy but because it is often an informative statistic. The objective of policy in the end has to be defined in terms real people experience—that is overall, or headline, inflation. This is because any inflation objective that does not include all of the relevant consumer prices can confuse and frustrate the public.

But, at the same time, saying nothing about the behavior of the “core” measures does not solve the communications problem faced by central banks. There are times when central banks ought to look through the volatility of certain elements in headline inflation.

Here’s the essence of the debate: Are the recent outsized increases in headline inflation the best signals of the inflation trend going forward? Or are other statistics—like core inflation or measures of inflation expectations—yielding a truer picture of what lies ahead?

The answer matters a lot. And it certainly weighs heavily on my thinking. I would not hesitate to support an exit from our current policy stance if I believed that the headline inflation number of the past six months is really indicative of the underlying trend inflation rate. I don’t believe this to be the case. And I am wary of tightening monetary policy in the face of quite ambiguous economic circumstances unless doing so is absolutely necessary to meet the FOMC’s price stability mandate.

Still, I acknowledge that the language we use to explain our forecasts of inflation can, at times like these, get in the way of effectively communicating our ultimate inflation objective. One way to deal with this tension (an approach employed by many central banks around the world) is to set an explicit numerical objective for inflation, also known as an inflation target. I support the FOMC doing this.

Inflation target principles

The specifics of an inflation target would need to be worked out by FOMC participants. But let me offer a few general thoughts about what would make for an effective inflation target.

First, it would be stated in terms of some measure of overall, or headline, inflation.

Second, the target must be achievable over a realistic timeframe. That time horizon should be short enough to serve the real interests of the public and short enough to serve as a verifiable check on central bank performance.

But since monetary policy actions do not have an impact on the economy instantaneously, the time horizon should be long enough for the objective to be realized at an acceptable cost. I also accept that there will be times we must allow short-run deviations from the targeted rate of headline inflation, and the stated objective should be constructed with this in mind.

I do not think the establishment of an inflation target would produce much change in how the Federal Reserve conducts policy. 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.

And I don’t see an appropriately constructed inflation target as being in conflict with the FOMC’s mandate to support employment. Low and stable inflation over a medium-term horizon is fundamental to my way of thinking, and in the absence of solid fundamentals, job creation will be inhibited. Now is a good 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.

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