Inflation Objective and Policy Credibility: A Potential Problem for the FOMC

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The Federal Reserve massively expanded its balance sheet by increasing lending to depository institutions in the wake of the announcement by Lehman Brothers in mid-September 2008 that it was filing for bankruptcy. As financial market conditions improved and some loans were repaid, the Federal Open Market Committee (FOMC) decided at its March 2009 meeting to further expand the balance sheet by purchasing $1.75 trillion in mortgage-backed securities and agency and Treasury securities. At the November 2010 meeting, the Committee announced its intent to purchase an additional $600 billion in longer-term Treasury securities, again expanding its balance sheet. The size of the Fed’s balance sheet has led many analysts and policymakers, including several FOMC members, to be concerned that inflation could rise above the FOMC’s objective. This essay reviews the inflation rate relative to the Fed’s inflation objective since 2000 and the likelihood that higher inflation is a problem policymakers may face in the coming months.

The FOMC’s inflation objective is often characterized as “2 percent or a bit under.” Fed Chairman Ben Bernanke confirmed this at his first post-FOMC-meeting press conference on April 27, 2011. He noted that the central tendency for the FOMC’s forecast for personal consumption expenditures (PCE) inflation for 2011-13 was 1.7 to 2.0 percent. The Chairman noted that “these longer-run projections can be interpreted as indicating the inflation rate that Committee participants judge to be most consistent with the Federal Reserve’s mandate to foster maximum employment and stable prices.”

The chart shows the year-over-year PCE inflation rate and the FOMC’s target for the federal funds rate over the period January 2000 through August 2011. The chart clearly shows that more often than not the PCE inflation rate has exceeded the FOMC’s 2 percent inflation objective. However, the chart also shows that the FOMC generally raised the target rate when inflation was high and/or rising relative to its objective and reduced it when inflation was low and/or declining relative to its objective. Hence, the policy actions were broadly consistent with a commitment to achieve the Committee’s longer-run inflation objective. The exception occurred in August 2007 when the FOMC began reducing its funds rate target even though PCE inflation had been at or above the inflation objective. The Committee’s reductions of the funds rate target continued based on concerns about the effects of the financial crisis even while inflation continued to accelerate. The chart
shows that the Fed’s easing of policy had no deleterious effect on inflation, which was likely partially due to the 2007-09 recession. However, it may also reflect the public’s faith that the FOMC would continue to conduct monetary policy in a manner consistent with achieving its longer-run inflation objective, thus affirming the FOMC’s inflation credibility.

Inflation has accelerated during the past 18 months. The year-over-year PCE inflation rate in August was 2.9 percent, and the monthly annual inflation rate has averaged 2.2 percent since the recession ended. The recent rise in the inflation rate may not currently concern the public because the FOMC has indicated that it expects “inflation will settle, over coming quarters, at levels at or below those consistent with the Committee’s” inflation objective and that it would “continue to pay close attention to the evolution of inflation and inflation expectations.”

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In order to maintain its credibility, however, the FOMC will need to take actions consistent with achieving its stated inflation objective. When the FOMC was targeting the federal funds rate, the public could determine whether the Committee’s behavior was consistent with its inflation objective by observing changes in the funds rate target relative to the behavior of inflation. With the funds rate target at zero and the FOMC effectively committed to maintaining a zero rate until mid-2013, the public will look for other actions to judge the FOMC’s commitment to its longer-run inflation objective should the inflation rate remain significantly above that objective or, worse, accelerate further. Possible FOMC actions could include (1) outright sales of securities or temporary reverse repurchase agreements (repos) to reduce the size of the balance sheet, (2) increasing the interest rate it pays on excess reserves, or (3) issuing term deposits at competitive interest rates. Such actions would be necessary to slow the growth of the money supply to reduce inflationary pressures. Failure to take significant actions in the face of high or rising inflation could cause the public to question the FOMC’s resolve to meet its inflation objective.

Weakening of the FOMC’s credibility would significantly undermine its ability to control inflation. Consequently, the FOMC would have to do what it did in the late 1970s to regain its credibility: Conduct monetary policy that is sufficiently restrictive—and ultimately successful—to restore the public’s confidence in the Committee’s commitment to achieving its inflation objective. As Narayana Kocherlakota, president of the Minneapolis Fed, has noted, such a policy response “would generate substantial losses of employment.” Indeed, the losses could be much larger than the employment gains achieved by maintaining an excessively easy monetary policy in the face of a marked and persistent rise in inflation. If inflation remains high or accelerates, analysts will be watching to see how the FOMC handles this difficult balancing act.

5 M1 growth has already accelerated significantly since the Fed began expanding the size of its balance sheet. For example, monthly average M1 growth is 16.4 percent since August 2008 compared with 0.7 percent for an equivalent period before September 2008.