

## The Fed's Inflation Objective

The Federal Open Market Committee (FOMC) has a long-standing commitment to price stability. Given that, and the widespread acceptance that the Fed can control the long-run inflation rate within reasonable limits, most analysts believe that the FOMC has an implicit inflation objective—i.e., lower and upper limits for the desired long-run inflation rate. The FOMC has never officially stated these limits: They must be inferred from FOMC statements. This analysis argues that FOMC communications in 2003 caused some market participants to revise their estimate of the lower limit of the FOMC's inflation objective and reduced uncertainty about the inflation objective in general.

With core inflation measures declining from already low levels, the May 2003 FOMC press release noted that “the probability of an unwelcome substantial fall in inflation, though minor, exceeds that of a pickup in inflation from its already low level.” This widely analyzed statement was interpreted as suggesting that an inflation rate of about 1 percent was near the lower limit of the FOMC's long-run inflation objective. The minutes of the May meeting reinforced this interpretation: “Members commented that substantial additional disinflation would be unwelcome because of the likely negative effects on economic activity and the functioning of financial institutions and markets, and the increased difficulty of conducting an effective monetary policy.” Moreover, the August, September, and October 2003 FOMC statements all noted that “[t]he Committee judges that, on balance, the risk of inflation becoming *undesirably low* is likely to be the predominant concern for the foreseeable future” (*italics added*). Concerns that inflation would go too low abated by the end of the year, as seen in the December FOMC statement: “The probability of an unwelcome fall in inflation has diminished in recent months and now appears almost equal to that of a rise in inflation.” Concerns over too-low inflation have not been mentioned since.

These statements had an observable effect on an important measure of inflation expectations,

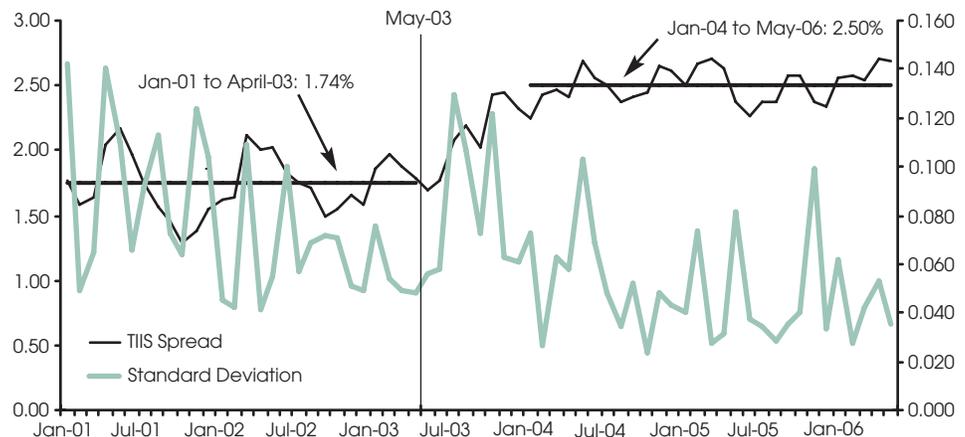
the TIIS spread—the difference between yields on nominal Treasury securities and the corresponding Treasury inflation-indexed security (TIIS). (Nominal yields reflect both a real return and inflation expectations; because TIIS holders are compensated for inflation over the holding period, TIIS yields reflect the real return.)

The chart shows the end-of-month “on the run” (most recent issue) 10-year TIIS spread (left scale) and its within-the-month standard deviation (right scale). The TIIS spread averaged about 1.7 percent from January 2001 through April 2003, began increasing in May 2003, and averaged 2.5 percent from January 2004 through May 2006. The marked jump in inflation expectations suggests that some market participants may have revised upward their expectation of the lower limit of the FOMC's inflation objective, which implies a corresponding reduction in uncertainty about the FOMC's inflation objective because expectations of the lower limit converged. The decline in the within-the-month standard deviation indicates that this occurred.

Measured inflation has increased recently, and several FOMC members remarked at the May meeting “that core inflation was now around the upper end of what they viewed as an acceptable range.” Hence, the FOMC might soon find itself in a position of clarifying the *upper* limit of its inflation objective.

—Daniel L. Thornton

**The 10-Year Treasury Inflation-Indexed Security Spread (TIIS) and Its Intramonth Standard Deviation**



Views expressed do not necessarily reflect official positions of the Federal Reserve System.