Congress should push Powell on policy sea change

Tate Lacey

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The Federal Reserve is becoming increasingly concerned with their inflation-rate target, according to the minutes from the latest Federal Open Markets Committee meeting, the last chaired by Janet Yellen.

Jay Powell testifies for the first time as Fed chairman Tuesday, giving members of Congress an opportunity to ask Powell about a targeting shift. Legislators ought to ask about moving away from inflation-rate targeting toward alternative targets.

Indeed, the Fed should move toward a more sensible option: a nominal-GDP-level target.

Nominal-GDP-level targeting is simply keeping the current dollar size of the economy — which is the value of all goods and services uncorrected for inflation — growing on a stable trend line. To explain its superiority over inflation-rate targeting and why the Fed should adopt a nominal-GDP-level target requires a little recent history.

Since adopting their explicit 2-percent symmetric target, the Fed has undershot it almost without exception. These asymmetric misses have been headwinds for the recovery from the Great Recession.

Over the years, to explain persistently missing their target, the Yellen Fed continually cited "transitory" factors holding inflation below target: movements in oil prices, declining import prices, a strengthening dollar, falling energy prices, and the low costs of wireless plans and prescription drugs.

Finally, in her last testimony before Congress as Fed Chair Janet Yellen summarized inflation data as "surprisingly subdued" and "puzzling" — a perspective that Powell shares.

This confusion over inflation dynamics show the weakness of inflation-rate targeting.

Properly administered inflation-rate targeting requires the Fed to respond to supply- and demand-driven price changes differently. A central bank does not have much, if any, control on supply side factors; i.e., demographics, productivity or technological advancement.

When prices fall due to an increase in productivity, for example, the Fed ought to let consumers enjoy those lower prices rather than easing monetary policy, which could overheat the economy. In economics jargon, they are “looking through” the shock.

But when prices are low because of factors affecting demand in the economy, that’s when monetary accommodation is needed. The tendency to confuse supply and demand shocks under inflation-rate targeting is increasingly common — and particularly harmful because it can make central bank policy "procyclical," potentially amplifying economic downturns.

Distinguishing between the two types of price changes in real time requires a clear understanding of inflation dynamics. In theory, this is not an issue. But in recent practice, as the Fed’s growing list of transitory inflation headwinds proves, it’s more complicated.

To be clear, central banking is harder than some of the Fed’s critics acknowledge. So, let’s give the Fed the benefit of the doubt and assume that, at times, it’s too difficult to differentiate between supply-side prices and demand-driven inflation in real time. The Fed then needs a new target, one that gives the Fed clear information about how to act.

This is the case for nominal-GDP-level targeting. It is the only target currently being considered that can be successfully pursued without differentiating between supply- and demand-driven inflationary pressures.

By targeting the level of nominal GDP, the Fed would be stabilizing overall spending in the economy. With this target, the Fed would be monitoring aggregate demand, the economic space over which it has some control, and have a clear signal about the stance of monetary policy.

When nominal GDP falls below target, it would signal policy was overly tight and that the Fed should ease. Above-target nominal GDP would signal the need to tighten. Why prices were rising or falling would not matter — the appropriate monetary policy response would be indicated by the level of nominal GDP.

Following a nominal-GDP-level target minimizes the risk of the Fed being procyclical — they would be far less likely to overreact to various price changes. Monetary policy would be more stable, and the Fed’s commitments would be more credible under this target.

Nominal-GDP-level targeting would give the Fed the ability to reliably hit its target. The actual stance of monetary policy would be clear, increasing the Fed’s accountability for achieving its target. Chairman Powell should give nominal-GDP-level targeting a serious hearing, as should members of the House and Senate.

Tate Lacey is a policy analyst with the Cato Institute’s Center for Monetary and Financial Alternatives