BOARD OF GOVERNORS
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FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

STRICTLY CONFIDENTIAL (FR)
CLASS I - FOMC

TO: Federal Open Market Committee DATE: February 6, 1987

FROM: Normand Bernard NB

Attached are a note from President Black and a memorandum prepared by Mr. Broaddus at the Richmond Bank regarding the possibility of an explicit objective for inflation.

Attachment

STRICTLY CONFIDENTIAL (FR)
CLASS I - FOMC

From

Robert P. Black

TO: Members of the FOMC and Other Reserve Bank Presidents

The enclosed memorandum elaborates on the suggestion I made at the December meeting regarding the possibility of setting an explicit objective for inflation

Bob

February 6, 1987

FEDERAL RESERVE BANK OF RICHMOND

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TO: Mr. Robert P. Black
President

DATE: January 14, 1987

FROM: J. Alfred Broaddus, Jr.

SUBJECT: An Explicit Objective for Inflation

This memorandum sets out in more detail the proposal for an explicit objective for inflation mentioned at the December meeting of the F.O.M.C. The first section of the memo summarizes the rationale for the proposal. The second section suggests a procedure that might be used to implement the proposal.

I. Rationale for the Proposal

Establishing an explicit objective for inflation would help maintain the credibility of the Committee's longer run program to reduce inflation in a period when deregulation and perhaps other shocks have substantially reduced the ability of the monetary aggregates to serve this purpose. The unpredictable behavior of the velocity of M1 in 1985 and 1986 is well known. It is quite possible--indeed, likely--that this unpredictability will persist in 1987. Consequently, it does not appear feasible at present for the Fed to make even a weak commitment to hold M1 within any particular target range this year, although it might wish to establish a monitoring range for M1. While it may be feasible to make a weak commitment[1] to controlling M2 and M3

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[1] As used here the term "weak" commitment means a commitment to try to hold an aggregate within a target range in the absence of concrete reasons for not doing so.

this year, such a commitment does not appear to be a satisfactory substitute for a viable M1 target range. Errors in predicting the velocity of M2 and M3 have also been large in recent years. Further, M2 and M3 have less intuitive appeal to the public as measures of the money supply than M1. Consequently, a case can be made that a commitment to controlling M2 and M3 is not a sufficient basis for maintaining the System's anti-inflationary credibility. It's possible (although by no means certain) that M1A or some other aggregate could do the job, but the Committee appeared to reject this option at the December meeting. An explicit objective for the price level or the inflation rate would enhance the System's credibility by (1) publicly strengthening its commitment to controlling inflation and (2) establishing a more specific basis on which the public can hold it accountable for the actual behavior of inflation.

It is important to recognize that an explicit objective for inflation would act as a benchmark, not as an operational target. It would not be feasible for the Committee to react to short-run deviations of actual inflation from the objective according to some fairly precise, predetermined feedback rule. The lengthy and unpredictable linkages between the instrument variables the Fed can control and the inflation rate preclude any automatic or semi-automatic approach. What is envisioned here is a broad commitment to take discretionary policy actions that appear consistent with achieving the objective for inflation.

The inflation objective could take any of several particular forms with varying degrees of precommitment. The strongest commitment the Committee could make would be to set a point target for the price level at the end of some specific time period such as three years. Such a target would not allow for any base drift from one year to the next because the end-point target would not change. A somewhat more flexible procedure would be to specify objectives for the inflation rate. For example, the Committee might seek a 4 percent inflation rate in the current year, 3-1/2 percent in the following year, and 3 percent in the year after that. A still weaker alternative would be for Chairman Volcker to state briefly in his Humphrey-Hawkins testimony that the Committee would attempt to prevent the inflation rate from rising over some period in the future. The trade-off, obviously, is between the boost to credibility and flexibility: the firmer and less flexible the objective, the greater the gain in credibility, and vice versa.

Whatever specific form the objective took, however, it would be essential that it meet two minimum requirements. First, it would have to be expressed in quantitative terms to be useful. It would not be enough merely to reaffirm the System's long-standing intention to help restore longer run price level stability over some indefinite time period. This would not go beyond what the Committee has already said publicly and therefore would probably do little if anything to increase credibility. Second, the target would have to be expressed in terms of a time period longer than one year and probably longer than two years because of the long lags between a policy action affecting an instrument like borrowed reserves and the impact of the action on inflation.

To summarize the main points of the rationale, a numerically explicit inflation target would assist the Committee in maintaining the credibility of its longer run anti-inflationary program. In this way, it would help prevent inflationary expectations from rising significantly in 1987, even if there were some increase in the measured inflation rate in 1987 stemming from the end of the downward impact of the decline in oil prices. It would not be feasible for such an inflation objective to be an operational target incorporating a feedback rule. Instead, the practical value of the objective and any support it might lend to the System's credibility would rest entirely on the public's perception that the Committee would take discretionary actions consistent with achieving the objective or something close to the objective. This last point would need to be kept in mind in choosing the specific form of the objective.

II. A Suggested Procedure

If the Committee should decide that it wants to set an explicit, quantifiable, multi-year inflation objective, it would then have to deal with the various details that would arise--the choice of an appropriate time horizon, whether to express the objective in terms of a point target for a price index or in terms of acceptable inflation rates, and other similar matters. The procedure described in the following paragraphs is just one of many possibilities. An effort was made to keep it as simple and direct as possible so that the public could understand the objective immediately, relate to it, and take it seriously. An objective the public doesn't fully grasp would obviously do little to enhance credibility or influence expectations.

The centerpiece of the procedure would be a path for the maximum inflation rate (as measured by the implicit deflator) that the System would find acceptable in each of the next five years. Chart 1 shows one possible path: a 3-1/2 percent maximum in the first two years and a 2-1/2 percent maximum thereafter. While this objective could be expressed equivalently in terms of the level of the deflator, the public thinks of inflation in terms of percentage rates, and any System objective should probably be announced and expressed in terms of rates. The particular path shown here would set what the public would probably regard as a reasonable and feasible objective: reducing the underlying inflation rate about a percentage point from the present rate over the next two years and then maintaining that reduced rate. Assuming the public did regard this path as feasible, it would probably take the objective seriously, at least initially. If the Committee felt this particular path were either too ambitious or not ambitious enough, it could alter the sequence of inflation rates accordingly. It should be repeated that the path refers to the maximum inflation rates acceptable to the Committee year-by-year over the period. Realized inflation rates below the annual maximum rates would be acceptable, but realized rates above them would not be acceptable. Nothing in the procedure, however, would prevent the Committee from attempting to stimulate economic activity if realized inflation below the path occurred in the context of a recession or unacceptably low real growth.[2]

It should be noted that the Committee could still think of the objective in terms of a goal for the price level at the end of the five-year period if it chose to, even though the objective would be expressed in terms of a sequence of annual inflation rates in order to facilitate public understanding. In that event, the Committee could supplement the public announcement of the annual inflation rate objectives with a statement of what the increase in the price level over the period as a whole would be if the

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[2] If it wished, of course, the Committee could also establish a path for the minimum inflation rate it would accept over the period. A path for the minimum rate, however, would weaken the procedure, because it would distract attention from the central purpose of the procedure, which is to reinforce the credibility of the Fed's efforts to keep inflation from rising. If a path for the minimum rate were nonetheless established, the minimum rate should be no greater than zero.

year-by-year objectives were achieved. The 3.5, 3.5, 2.5, 2.5, 2.5 sequence of annual inflation rates in chart 1, for example, would produce a total increase in the price level of about 15 percent. Pointing out this total increase in announcing the objective would make the objective for the full five-year period seem firmer, because it would suggest that if the annual objectives were exceeded in some years, the Committee would expect these overages to be offset in other years.[3]

To see how the procedure would work, consider a situation where the actual inflation rate exceeded the maximum rate in the objective path in the first year of the five-year period. To be precise, assume that the actual rate was 6 percent compared to the 3.5 percent maximum in the path. In these circumstances, the Committee would have to decide whether or not to accept the overage. It could refuse to accept the overage by retaining the original path. Alternatively, it could accept the miss by raising the level of the path for the remaining four years of the five-year period, as shown in chart 2. This would be roughly analogous to the current practice of accepting base drift with the monetary targets. The Committee might want to accept the miss, for example, if some obvious, onetime upward shock to the price level had occurred, such as a major crop failure or an outbreak of war in the Persian Gulf. In any case, the choice of whether or not to accept the overage would be made on an entirely discretionary basis by the Committee. The procedure would not restrict the choice in any way.

It should be clearly recognized, however, that the usefulness of this procedure would be quickly eroded if the Committee were to accept

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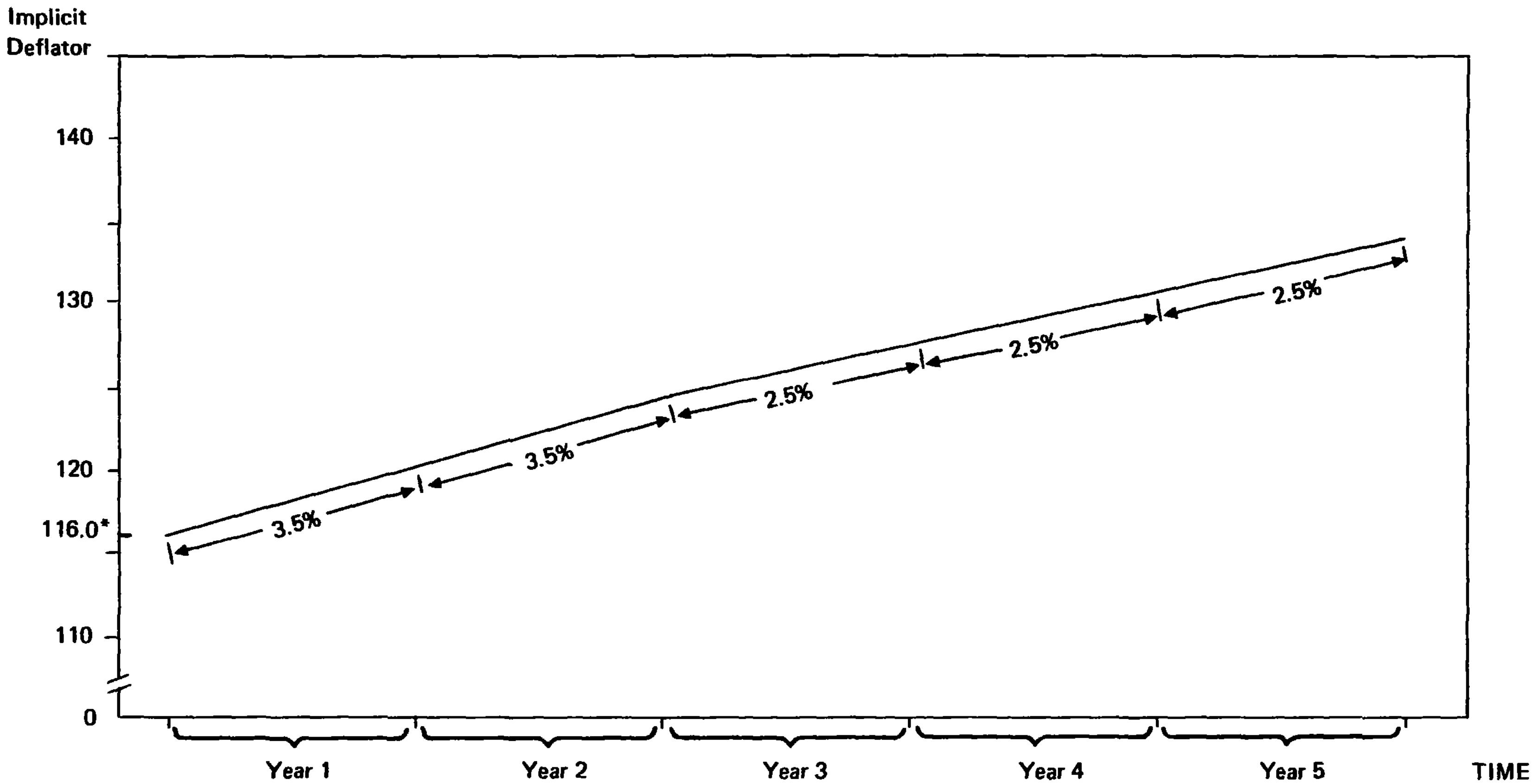
[3]The general question of whether or not to allow "base drift" within the five-year period is addressed in the next paragraph.

Chart 1

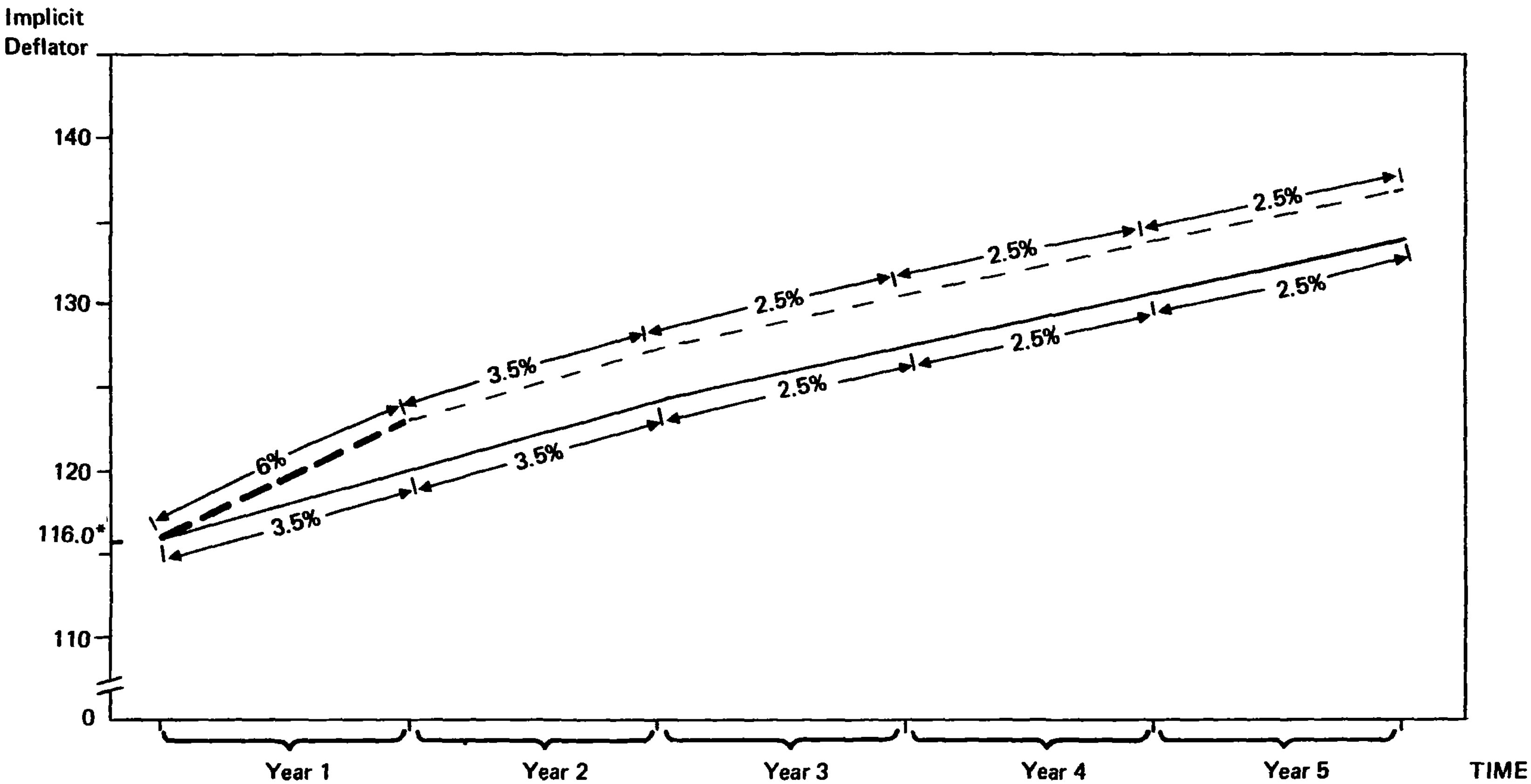
ILLUSTRATIVE TARGET PATH FOR INFLATION AND THE PRICE LEVEL



*Assumed 4Q 1986 level.

Chart 2

ILLUSTRATIVE TARGET PATH: FIRST YEAR OVERAGE



*Assumed 4Q 1986 level.

overages by raising the level of the path two or three years in succession. As emphasized above, the value of the procedure is wholly dependent on public confidence in the System's commitment to the path. Such confidence could not be maintained in the face of persistent overages. The relatively long five-year time frame for the path was chosen in part to make it easier for the Committee to retain the initial path, at least in the first one or two years in the period. Even taking account of the potentially long lag between a System action and its effect on inflation, four years should be long enough for the Committee to offset an overage in the first year of the period without taking action strong enough to risk a recession. A two- or even three-year horizon might not be long enough.

III. Concluding Comment

It might be worthwhile to conclude this memorandum by recognizing that an explicit objective for inflation may be resisted by some members of Congress and others, even though it might significantly increase the credibility of the Fed's anti-inflationary program and help sustain that credibility. Critics may object to what they perceive to be an increase in the emphasis on controlling inflation compared to stimulating the growth of employment. They may also claim that setting an explicit objective for inflation could risk damaging the economy in 1987 in view of the sluggish growth many forecasters are predicting for the first half.

Valid responses to these questions and objections exist, even though they may not satisfy all the critics. First, the inflation objectives are designed to supplement the targets for the aggregates in order to help maintain the public's confidence in the System's longer run strategy at a time when technical problems have reduced the usefulness of monetary targeting at least temporarily. Second, there is no compelling reason to believe that achieving an inflation objective like the one outlined above would necessarily be incompatible with growth in employment and output at an acceptable rate. On the contrary, price stability and public confidence that it will be sustained would probably enhance the performance of the real economy over time. We have little doubt that Chairman Volcker could make this case convincingly.