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Economic Outlook

A Case for Inflation Targets in the United States and Japan

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The central banks of the world's two largest economies are both worried but hopeful about inflation. The Federal Reserve is afraid inflation will increase, but hopes it will decrease. The Bank of Japan is afraid it will decrease, but hopes it will increase. Ironically, the Bank of Japan says it would like to tighten monetary policy more, while the Fed says it would not.

Clearly, the world's leading central banks are struggling with what is happening to prices in their respective countries, what they should say about it, and, more importantly, what they should do about it. Inflation targeting may be a desirable approach to addressing these questions.

Keeping inflation low and stable is the primary goal of the world's central banks. Virtually all have been strongly influenced by the "Great Moderation" whereby low and stable inflation rates have been associated with higher rates of growth and better overall economic performance. The basic reason for this association is the fact that high and volatile inflation rates are disruptive and empirically linked to poorer economic performance.

Approaches to Managing Inflation

Central banks employ different strategies to maintain low and stable inflation. They also work to reassure households and businesses that low and stable inflation rates will continue in the future. Some, like the Bank of England, have adopted specific inflation targets tied to a general index of prices for consumer goods. Others, like the Federal Reserve and the Bank of Japan, have given indications of their inflation target ranges without firmly committing to them. The Fed prefers core measures of inflation, those that exclude food and energy prices, as the criteria for judging the appropriate level of inflation. The Bank of Japan prefers an inflation rate that excludes food but not energy. Needless to say, there are no hard and fast rules as to what particular measure of inflation is most appropriate for central banks to target or at least to pay attention to when judging the appropriateness of the stance of monetary policy.

Not only do the inflation indicators used to gauge monetary policy vary, but the levels of inflation to be tolerated vary as well. For example, the Fed has indicated that it prefers inflation to be in the range of 1 to 2 percent. The Bank of Japan has indicated that it prefers zero to 1 percent. The lower level in Japan is based on the Bank of Japan's perception that the Japanese are used to lower inflation rates and, therefore, have come to associate stability with absolutely low levels of inflation.

Some confusion is emerging with regard to inflation targets and the broader conduct of monetary policy both in the United States and Japan. In the United States, this confusion is probably tied to the approach of a turning point. The Federal Reserve wishes to pause in order to gauge the impact of its 425 basis points of tightening over the two years from June 2004 to June 2006. Simultaneously, Japan is exiting deflation—just barely—based on revised measures of price behavior that appeared in August. That incipient success has been accompanied

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by a withdrawal of liquidity and an initial 25 basis-point increase in the central bank's target interest rate.

Troublesome Inflation Data

An awkward circumstance facing the Federal Reserve and the Bank of Japan is the actual behavior of inflation, which is not necessarily supportive of their current stances.

In the United States, year-over-year core inflation, as measured by the Consumer Price Index (CPI), has been rising steadily. A year ago, in the year ending in August 2005, the U.S. core CPI inflation rate was 2.1 percent; in August 2006, it was 2.8 percent. Other measures of inflation have risen similarly. Most are above the 2 percent inflation "comfort zone" ceiling.

The Fed faces two difficulties tied to core-inflation activity recently and over a longer period of time, especially in view of the central bank's recent decision to stop raising interest rates. Over the last five years—even including 2003, when the core inflation rate reached levels below 1 percent, threatening deflation—the average core CPI inflation rate has been 2.1 percent. That is very close to, but slightly above the top of, the Fed's desired 1 to 2 percent range. In 2004 and 2005, while the Fed was tightening, core CPI averaged 2.2 percent. As already noted, over the last twelve months, core CPI has reached 2.8 percent just as the Fed has decided to pause tightening.

While it is widely agreed that maintaining inflation within a desired target range is the right aim for monetary policy, the actual execution of the policy is a subtle and difficult task, especially when the central bank is trying to keep markets informed of its intentions.

A basic rule of monetary policy, the Taylor Rule, which ties the federal funds rate to deviations of inflation and output from their trend levels, would call for a fed funds rate of about 6 percent today. For its part, the Fed's Open Market Committee suggested in its August statement that the current tightening pause is appropriate based on the idea that "inflation pressures seem likely to moderate over time, reflecting contained inflation expectations and the cumulative effects of monetary policy actions and other factors restraining aggregate demand." The "other factors" include a sharp slowdown in the housing sector, particularly residential investment, which, measured by housing starts, fell 20 percent during the twelve months ending in August. The housing slowdown could take roughly a percentage point off growth if such weakness persists, thereby supporting the Fed's outlook. Complicating the picture, however, is the typically slow response of inflation to lower growth and the possibility that growth may revive to its trend level (about 3 percent). At that level, inflation remains steady at closer to 3 percent than to 2 percent.

The tricky problem of gauging the appropriate degree of tightening (increasing the fed funds rate) to slow the economy to trend growth has forced the Fed to adopt a "forward looking" approach to monetary policy. Specifically, although current levels of growth and inflation would suggest a fed funds rate of 6 percent, the Fed is, in effect, shooting at a moving target: its expected levels of growth and inflation perhaps a year in the future. Many at the Fed have suggested that aiming at the current inflation rate would result in over-tightening and a sharp growth slowdown that would sacrifice too much output and employment in the name of price stability.

However, if the Fed delays tightening and inflation displays its well-known persistence, reaching levels of say 3 percent, the Fed risks a rise in inflation expectations and an accompanying rise in the necessary rate increases required to sustain actual and expected price stability. So far, inflation expectations have been well behaved, remaining by most measures close to 2.5 percent. Here again, one could observe that stable expected inflation rates at 2.5 percent, or about half a percentage point above the Fed's desired target range of 1 to 2 percent, suggest that the Fed already faces a modest credibility problem with respect to maintaining inflation expectations consistent with that target zone. That said, if U.S. growth slows, as the Fed expects it to do and as it appears to be doing in the third quarter, the public's inflation expectations may at least stabilize and start to come down gradually, thereby buying the Fed more time for inflation expectations to converge back toward 2 percent.

These many considerations suggest that, while it is widely agreed that maintaining inflation within a desired target range is the right aim for monetary policy, the actual execution of the policy is a subtle and difficult task, especially when the central bank is trying to keep markets informed of its intentions. The reality is that the Fed is uncertain about the appropriate level of its instrument—the fed funds rate—to keep inflation from rising much further and eventually to cause it to fall. To its credit, the Fed

has said as much and clearly indicated that it sees some inflation risks remaining and that it will do whatever is necessary to address those risks should they increase.

Communication Problems

The communication problems are illustrated by the fact that while the Fed seems to be trying to tell markets that it is pausing and patiently waiting for new information, markets have concluded that the Fed has finished tightening and will start cutting rates during the first half of 2007. This benign interpretation of the Fed's intentions is a potential complicating factor. In the event that growth should fail to slow, or should inflation persist, the Fed will actually have to raise rates further. In markets expecting rates to fall, there will be some disruption. However, the Fed has made it clear that the potential for market disruption if investors have misjudged the Fed's intentions will not stay its hand if it thinks that further rate increases are needed to assure price stability.

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Japan's Deflation Struggle

The Bank of Japan has a somewhat different problem than the Federal Reserve. Japan has been stuck in deflation for much of the past five years. Unfortunately, that five-year period began when the Bank of Japan last increased rates by a mere 25 basis points in a move that proved to be premature. Japan fell into a sharp economic slump with continuing deflation. Japanese growth recovered to positive levels by 2002, but deflation persisted until earlier this year.

This March, the Bank of Japan judged that the deflationary period was over and that a zero policy rate was too low to avoid the risk of overstimulating the economy and eventually creating a return to inflation. In its fight against deflation, the Bank of Japan had adopted a very aggressive monetary stance, which involved injecting large amounts of money into the banking system to reassure banks, households, and businesses that it was committed to fighting deflation. Before the Bank of Japan could regain its control over its policy interest-rate instrument, much of that liquidity had to be withdrawn. Accordingly, from March through June of this year, the Bank of Japan withdrew extraordinary amounts of liquidity from the banking system. Then the Bank of Japan boosted its policy interest rate from zero to 25 percent to restore normal functioning of its overnight money markets and thereby to reestablish its primary instrument of monetary policy.

Somewhat awkwardly for the Bank of Japan, in August of this year, the government released its rebasing of inflation data, an exercise undertaken every five years to allow for shifting weights of different components in the inflation index. Without rebasing, most inflation indices overstate inflation because they assign fixed weights to different components of the market basket. If the price of electronics equipment is falling rapidly, then its share in market baskets increases, while the share of items whose prices are rising decreases. The rebasing of Japan's index of consumer prices took the midyear core inflation rate down from a year-over-year rate well above 0.5 percent down to virtually zero, thanks largely to a heavier weighting of mobile phones and other electronic equipment. Excluding food and energy, Japan's year-over-year inflation rate actually fell a tenth of one percent during July at a time when the central bank had, in effect, determined that deflation was over while charting a course of steady policy rate increases over the coming year.

The Bank of Japan's struggle with the transition to normal monetary policy and positive inflation is complicated by two other factors. The Japanese economy appears to be slowing modestly at midyear, with second quarter annualized growth at one percent, down from 3.3 percent in the first quarter. Indications are that third quarter growth may be close to 2 percent.

Meanwhile, leadership in Japan is changing hands. Japan's remarkably successful prime minister Junichiro Koizumi will be succeeded by Shinzo Abe early in October. Mr. Abe is strongly committed to assuring Japan's emergence from sub-par growth and deflation. As a result, he has indicated some reservations about the Bank of Japan's intention to raise rates, especially in light of the revised inflation data.

For its part, the Bank of Japan has indicated that the inflation revisions make very little difference to its policy path toward raising interest rates in order to assure price stability. That said, the bank has indicated that it will carefully watch the performance of the economy and the behavior of inflation before deciding on further rate increases. Markets are expecting that the next increase in

Japanese interest rates will probably not come until the first quarter of 2007 instead of, as previously supposed, the fourth quarter of 2006.

Some convergence between monetary policy and inflation rates in the United States and Japan is likely.

When the history of the Bank of Japan's remarkable exit from its extraordinary zero interest rate policy is written, some may suggest that the bank was a little too hasty to start raising rates. Clearly, the Bank of Japan knew that the inflation data would be revised downward in August and wanted to have transitioned away from its zero interest rate policy by that time. Consequently, the liquidity withdrawal and the first rate increase may have been slightly hurried. With all that said, the Japanese economy will probably continue to grow as inflation rises gradually with the help of a still-accommodative policy from the Bank of Japan.

Contrasted with the U.S. experience, Japan's experience is illustrative of the difficulty of identifying a neutral policy interest rate—one that is consistent with growth at about the trend level, that is, the level that engenders neither inflation nor deflation. In Japan, a policy rate of 25 basis points, which equates to a real policy rate of somewhere between zero and 50 basis points depending upon which measure of inflation is used, is consistent with growth averaging 2 to 3 percent—about Japan's sustainable trend growth rate. In the United States, with a nominal fed funds rate of 5.25 percent and expected inflation of about 2.5 percent, the current real fed funds rate, which the Fed hopes is neutral, is 2.75 percent, far above the neutral Japanese rate. The reasons for this vast difference are complex and varied and indicative of the highly complicated task of conducting monetary policy in today's global economy.

Inflation Targeting

Some convergence between monetary policy and inflation rates in the United States and Japan is likely. The Fed has indicated the desire to stop tightening monetary policy at a time when inflation rates are above target and inflation expectations are stable but also above the top of the Fed's desired inflation range. If U.S. growth slows below trend, as the Fed expects, and core inflation rates stabilize and start to come down within a year, the Bernanke Fed will have achieved a soft landing in the face of formidable challenges and monetary policy will have enhanced the chances for continued stable U.S. growth.

At the opposite end of the inflation spectrum, if the Bank of Japan patiently waits for inflation measures to rise while Japanese growth is sustained, it too will have achieved a remarkable feat of monetary policy, a successful exit from deflation.

Alternatively, if U.S. growth picks up and/or inflation persists, the Fed will have to tighten further, and markets, while becoming more volatile, will have to adjust to less support from lower interest rates. The Bank of Japan faces the more difficult challenge. Should growth slow or deflation return, the Bank of Japan has only 25 basis points of rate cuts it could execute. More seriously, Japanese politicians would become less patient with a central bank that, for a second time, tightened prematurely and threw a fragile economy back into a period of deflation.

The unusually high level of uncertainty regarding the appropriate future paths of monetary policy in America and Japan underscores the desirability of adopting inflation targets at the Federal Reserve and the Bank of Japan. Uncertainty, while not eliminated, would be reduced if each central bank identified a desired range for year-over-year changes of inflation. The Fed would probably choose to target 1 to 2 percent year-over-year core inflation, using either the CPI or the Personal Consumption Expenditures deflator, but different measures or ranges could be used.

The current Fed tightening pause with core CPI rising at 2.8 percent year-over-year does raise doubts about whether the currently unstated inflation target range has been shifted upward. Otherwise, it is hard to explain the markets' embrace of rate cuts next year. An inflation target with triggers for explanation of persistent divergences from the target would provide the Fed with a framework for clarifying its tactics.

In contrast, the Bank of Japan would face less risk of deflation with a credible inflation target, preferably one above zero. The last inflation revision underscores the tendency toward an upward bias on inflation data and therefore the desirability of a positive, low target for measured inflation.

Inflation targeting is not a cure-all. However, it is a useful tactic within a central bank strategy of maintaining low and stable inflation to enhance growth. It also helps to anchor inflation expectations as a means to enhance the effectiveness of central bank policy actions by minimizing their cost in terms of either lost output or employment. Both the Federal Reserve and the Bank of Japan could add to their already substantial contributions to global growth and stability by moving toward adoption of inflation targeting.

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