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Is the Fed's Definition of Price Stability Evolving?

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Few economists have seriously doubted the importance of low inflation in helping to stabilize financial market conditions and improve the efficiency of labor and product markets. Nevertheless, economists and some Federal Reserve officials have long debated the appropriate numerical value or range the Federal Open Market Committee (FOMC) should attach to the term "price stability." Price stability is one leg of the Fed's dual mandate—the other being long-run, sustainable economic growth—so the issue is more than academic. But what, exactly, is the Committee's preferred inflation rate?

Relatively few Federal Reserve officials have publicly indicated what level of the inflation rate corresponds to price stability. Intuitively, a zero inflation rate over time suggests perfect price stability, but ongoing supply and demand shocks cause deviations from what is expected. In addition, errors in measurement bias the calculation of the price level. According to Gordon (2006), the upward bias in the consumer price index (CPI) inflation rate is about 1 percent per year, or perhaps higher. Another complicating factor, which affects the personal consumption expenditure (PCE) price indexes, is the role of data revisions. For example, after the July 2005 annual revision to the national income and products accounts, revised data showed that the annualized growth rate of the core PCE price index from the second quarter of 2003 to the first quarter of 2005 was 0.5 percentage points higher than originally thought. Hence, monetary policy had been more accommodative than previously believed.[1]

With these challenges in mind, a few years ago two Federal Reserve officials—William Poole, former president of the Federal Reserve Bank of St. Louis, and former Fed Chairman Alan Greenspan—put forward their estimates of a numerical value for price stability. Poole made this statement in 2005:

> I have said previously that I favor a goal of zero inflation, properly measured. In practice, because of various statistical problems in measuring prices, that goal translates, approximately, to price changes of something like a 1 percent annual rate of increase in the chain-price index for personal consumption expenditures—the PCE price index for short.

Poole went on to argue that the Fed cannot precisely achieve its inflation target on a year-to-year basis—presumably because of shocks, imperfect forecasting models, and uncertainty about the monetary transmission mechanism. Moreover, because many FOMC members generally choose to focus on a core measure of inflation (excluding food and energy prices), he favored a range for the core PCE inflation rate of 0.5 to 1.5 percent. By this standard, the current core inflation rate (1.2 percent for the 12 months ending in September 2010) is close to the midpoint of Poole's definition of price stability.

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In a similar vein, Chairman Greenspan noted at the July 1996 FOMC meeting that price stability "is that state in which expected changes in the general price level do not effectively alter business or household conditions." When challenged to attach a number to this definition, Greenspan responded that price stability is zero inflation, "if inflation is properly measured."[2] A few years later, on February 25, 2004, Greenspan delivered congressional testimony in which he responded to a question about previous inflation targeting discussions on the FOMC:

> I think it's very difficult to get a specific price index, which you say, "This is exactly where price stability is," but, as I've said many times, I think we're there. Core CPI, for example, is 1 percent. We know there are significant biases remaining in the price indexes we use so that true price stability would be reflected in price indexes which are positive, probably somewhere between 0.5 percent and something a little under [a] full percentage point. So in that regard, I think we are at price stability.[3]

Thus, if the Greenspan measure of price stability is a core CPI inflation rate between 0.5 and roughly 1 percent, then the current core CPI inflation rate of about 0.75 percent is also at the midpoint of the Greenspan range.

It is not clear whether Chairman Bernanke, or any other current member of the FOMC, accepts either of these definitions of price stability. However, before he replaced Greenspan in January 2006, then Fed Governor Bernanke publicly stated in 2005 that his "comfort zone" for core PCE inflation was between 1 and 2 percent. More recently, Bernanke stated that the FOMC's "mandate-consistent inflation rate" is generally judged to be "about 2 percent or a bit below." This judgment, he indicated, is consistent with the longer-run economic projections published quarterly in the FOMC minutes ("Survey of Economic Projections"). Similar views have been registered by other Federal Reserve presidents.[4]

At first glance, then, the views of current Committee members who have expressed a price stability preference, and even the FOMC's long-term projection for PCE price index inflation of 1.5 to 2 percent, seem to be a bit higher than those of two former Fed officials (Greenspan and Poole).[5] It is possible that Greenspan and Poole held views that did not reflect the consensus of the FOMC during their time on the Committee. It is unclear whether this change, however subtle, will have any effect on long-run inflation expectations, which many FOMC members carefully monitor. However, if the economy stages a robust rebound and inflation turns out to be higher than expected, then the risk increases that long-term inflation expectations will drift upward. ■

Further Reading

Bernanke, Ben S. "The Economic Outlook." Remarks at a Finance Committee luncheon of the Executives' Club of Chicago, Chicago, Illinois, March 8, 2005.

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Kocherlakota, Narayana. "Economic Outlook and the Current Tools of Monetary Policy." Speech, European Economics and Financial Centre, London, England, September 29, 2010.

Plosser, Charles I. "Economic Outlook." Speech, Greater Vineland Chamber of Commerce, Vineland, New Jersey, September 29, 2010.

Poole, William. "Tracking Inflation." Speech, Kentucky State University, Frankfort, Kentucky, November 17, 2005.

Wall Street Journal. "Q&A: Chicago Fed's Evans Elaborates on His Call for Aggressive Fed Action." Real Time Economics, WSJ.com, October 5, 2010.

[1] See Kliesen (2005).

[2] FOMC transcript, July 2-3, 1996, pp. 50-51.

[3] Transcript of House Budget Committee hearing on the economic outlook and federal budget ("U.S. Representative Jim Nussle (R-IA) Holds a Hearing on the Economic Outlook and the Federal Budget"), February 25, 2004, Federal Document Clearinghouse.

[4] See recent speeches by Fed presidents Dudley (2010), Kocherlakota (2010), and Plosser (2010). In a recent interview with the *Wall Street Journal*, Charles Evans suggested that the FOMC may want to temporarily raise its inflation target above 2 percent to generate (ex post) declines in the real interest rate to increase the growth of real GDP and to lower the unemployment rate.

[5] Over time, shocks to food and energy prices offset, so that the total and core inflation measures are effectively the same; they differ over shorter horizons. The FOMC's projections are published in the minutes of the June 22-23, 2010, meeting.

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