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From inflation targeting to average inflation targeting

The Fed’s new long-run monetary framework

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ECONOMIC DATA | ST. LOUIS FED

CPI **+3.2** % Chg. from Yr. Ago on Feb 2024

Civ. Unemploy. Rate **3.9** % on Feb 2024

10-Yr. Treas. Rate **4.22** % on 2024-03-22

Real GDP **+3.2** %, Comp. Annual Rate of Chg. on Q4 2023

IP **+0.1** % Chg. on Feb 2024

Payroll Employment **+275** Chg., Thous. of Persons on Feb 2024

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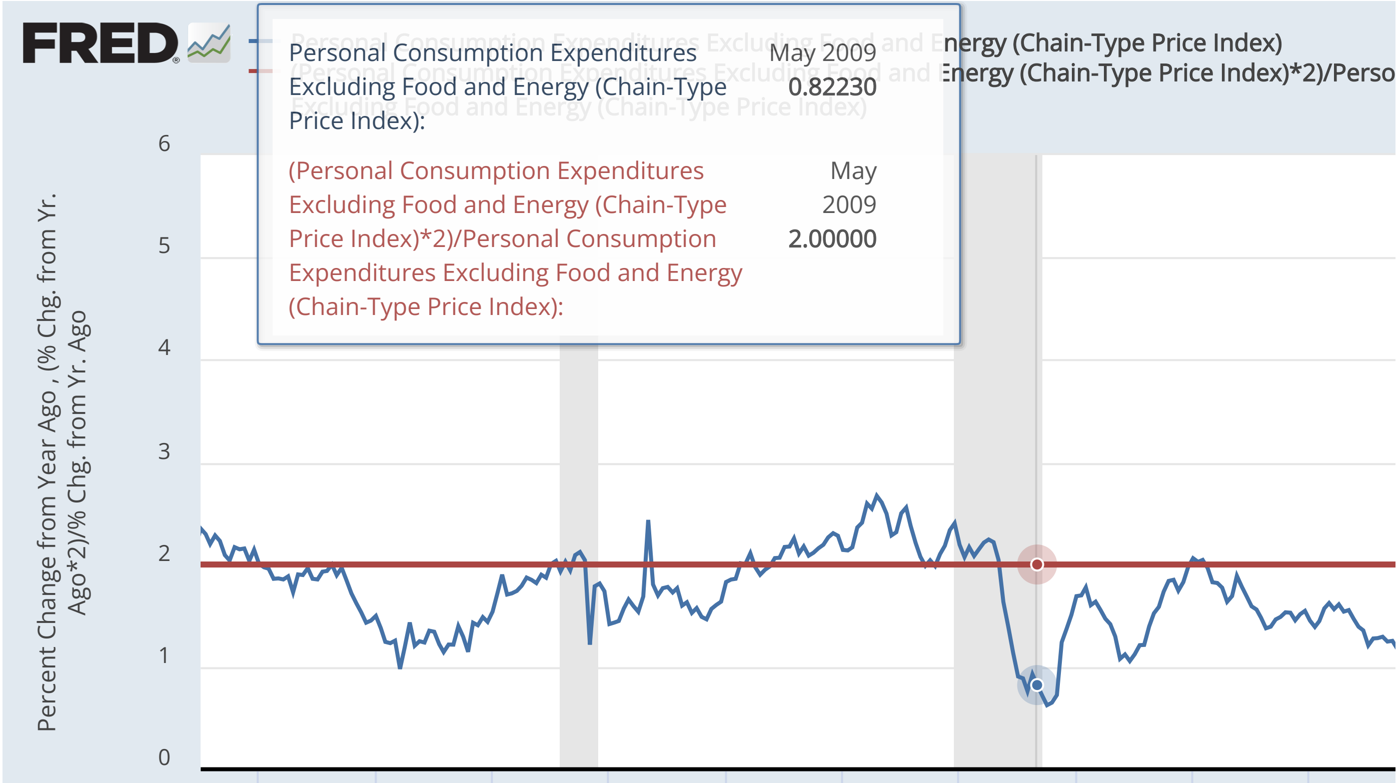

Since 1996, it has been understood among Fed policymakers that the (undeclared) target for inflation was around 2%. In January 2012, Chairman Ben Bernanke made this *implicit* inflation target *explicit* and official, thereby aligning the Fed's inflation target with that of all the major central banks. In this framework, when inflation has approached or exceeded the traditional 2% target, even temporarily as it did in 2018, the FOMC has responded by raising the baseline federal funds rate to combat rising prices.

In August 2020 at the online Jackson Hole conference, Chair Jay Powell announced a revision to the Fed's long-run monetary policy framework by re-framing this goal as an *average* inflation target (AIT) of 2% over the long-run. With this new framework, the FOMC is communicating that it will tolerate inflation above its target for a period of time to offset periods when inflation was below its target. In other words, the FOMC is targeting *average* inflation of 2% in the long run.

So, what does past inflation data say about the feasibility of the new AIT? The FRED graph above plots two lines of data points over the past 25 years:

Archives

- the FOMC's preferred inflation measure, the core personal consumption expenditures index (core PCE), in blue and
- the 2% target in red.

Given the recent asymmetric history of inflation, the concept of a symmetric target would represent a substantial change: Since the Great Recession of 2008-2009, there have been only two brief periods when the preferred inflation rate has exceeded the 2% target.

The FRED graph above also demonstrates how the new AIT guidance on inflation represents a substantial shift in thinking. In the past, the Federal Reserve has rarely tolerated rates above 2% and has raised interest rates whenever approaching the target. This new policy suggests that, if inflation can return to a range above 2%, the Federal Reserve will have to tolerate higher inflation than it has for much of the past 20 years—and tolerate it for significantly longer periods. Yet, given the pandemic, it could be challenging at this time to sustain average inflation above 2%.

How this graph was created: Search for and select "Personal Consumption Expenditures Excluding Food and Energy (Chain-Type Index)." Select the time period January 1995 to the present month. Then select "Percent Change from a Year Ago" as the units. Next, use the "Add Line" tab to search for and select the same series. In the formula box type *(a*2)/a*, which results in a horizontal line of 2% for the target.

Suggested by Matthew Famiglietti and Carlos Garriga.

View on FRED, series used in this post: PCEPILFE