Commentary:
Inflation Targeting for the United States—Comments on Meyer

Alan S. Blinder, Princeton University

1. Three Versions of Inflation Targeting

Inflation targeting has become something of a religion in certain quarters recently. And like my own religion, Judaism, it comes in (at least) three denominations: orthodox, conservative, and reform. Because of its obvious current importance for Federal Reserve policy, I will use the evolution of Ben Bernanke's thinking to illustrate these three variants of the creed.

Orthodox inflation targeting (henceforth, IT) began with Don Brash and the Reserve Bank of New Zealand in 1990. It started as more or less what we now call "strict" inflation targeting, that is, single-minded devotion to lowering inflation. IT in New Zealand was also accompanied by a fair bit of ritual, including periodic inflation reports and a "contract" between the central bank governor and the treasurer.

For a clearly exposited version of orthodox, though not ultra-orthodox, IT, it is instructive to look back at the 1999 book by Bernanke and co-authors.[1] Their specific proposal for the United States consisted of four key elements[2]:

1. A publicly announced *long-term* inflation target (henceforth, B*) of 2 per cent for core CPI, which was to be set with government involvement. The suggestion was for a point target rather than a range.
2. Clear symmetry around that target, meaning that too little inflation was to be avoided as vigorously as too much (suggesting a quadratic loss function).
3. An annual announcement of a *short-term* inflation target, which might differ from B*, with a commitment to reach the short-term target within 1–2 years (the "horizon").
4. Issuance of a regular Inflation Report.

1. Bernanke et al. (1999).
2. Their actual list (on pages 315–316) has nine elements, but I have collapsed them to four.

This list, plus the book's rhetorical advocacy of "constrained discretion" and "rule-like behavior," captures the views of *Professor* Bernanke when he was an academic.

He became *Governor* Bernanke in 2002, and we can see the beginnings of an intellectual migration, first, towards *conservative* and, then, all the way to *reform* IT in the two quotations offered by Larry Meyer. In July 2002, Bernanke wrote:

> … the efficacy of monetary policy could be improved by an approach known as inflation targeting. The main operational change would be to announce an explicit numerical objective for core inflation over the medium term, say 1 to 2 years. As part of the targeting process, the Federal Reserve would report to Congress its expectations for future inflation, its reasons for any target misses, and its projected trajectory for bringing inflation back to its target.

Notice the use of the term "inflation targeting," the implicit reference to inflation reports, and the 1–2 year time horizon, among other things. This is relatively orthodox IT, although certainly not New Zealand redux.

By October 2003, Bernanke had moved far from the orthodoxy and was pretty much advocating reform IT. He wrote:

> Because neither the horizon at which the inflation objective is to be attained nor the expected path of inflation and output is specified under this proposal, what I am suggesting is not equivalent to inflation targeting. Instead, what is being proposed is an incremental step that I believe would provide important benefits in itself and which would leave the door open for further steps later if that seemed warranted.

Notice the explicit disavowal of the label "inflation targeting," the disappearance of a horizon, and the absence of an Inflation Report.

Reform IT, then, amounts to a public announcement of, and commitment to, a *long-run* inflation target, which can be either a point or a range. Full stop. No time horizon for reaching the target; no interim short-run target; no "contract" with the government; no Inflation Report; and, I should add in the specific U.S. context, frequent and full-throated reaffirmation of the Fed's dual mandate. This is the version of inflation targeting that both Larry Meyer and I believe is coming to the Fed under the leadership of *Chairman* Bernanke. And I don't think it should take the new chairman long to get there. After all, reform IT is not a major departure from where the Fed is now (see below).

2. The Virtues of Reform Inflation Targeting

I'll confess to being a reform inflation targeter myself, and my three main reasons correspond precisely to Larry's. First, making the inflation target precise and explicit is another step in the direction of greater *transparency*. The Fed has been travelling down this road for about a dozen years now, and it still has a long way to go. But translating the vague phrase "stable prices" in its legal mandate into a number is the logical next step.

Second, posting a concrete inflation target would make the central bank more *accountable* for achieving the target—or, what may sometimes be even more important, for explaining why it missed.

Third, an explicit numerical inflation target, officially adopted by the FOMC, would serve as a useful touchstone that adds clarity and *coherence* to both the committee's internal deliberations and its external communications. Internal coherence is rarely mentioned in this context, except by people like Larry and myself who have served on the FOMC. But to put the point bluntly, there is something a little weird about debating the proper setting of monetary policy without prior agreement on what monetary policy is trying to accomplish. A clear example arose when core inflation was well below 2 per cent in 2003. People in the financial markets—and, I daresay, people at the Fed—did not even know whether the FOMC wanted inflation to be higher or lower. That's a problem.

3. What's in a Number?

Since picking the number is "the whole ball of wax" under reform inflation targeting, let me take a curmudgeonly moment to dispute Larry's apparent satisfaction with what seems to be the Fed's likely choice: a 1–2 per cent range for core PCE inflation. I object to this choice for two main reasons, neither of which is earth-shattering.

The first pertains to the technical arguments for preferring the core PCE deflator to the core CPI. In fact, the case for the superiority of the PCE deflator as a measure of inflation is by no means clear-cut.[3] How could it be when most of components of the PCE deflator come from the corresponding components of the CPI? To cite just two other reasons why we should not except the Fed's ranking so quickly, the PCE deflator (a) includes a lot of imputations and (b) is subject to frequent revisions. Just imagine the public reaction the first time the FOMC failed to meet its target in real time, but then was announced to have met it as a result of data revisions.

My second reason for preferring the CPI is the opposite of technical; it's familiarity, and the greater transparency that breeds. Central bank transparency, in my view, must extend beyond the narrow domain of professional Fed watchers to the broader public (and its elected representatives), whose welfare, after all, is affected by the Fed's decision. While John and Jane Doe, of course, do not know how the CPI is calculated, they have at least heard of the index; they see it reported monthly on the TV news; and they may even have their wages or Social Security benefits (or something else, such as interest on TIPS) linked to it. It is therefore familiar, sort of like an old shoe. The PCE deflator, on the other hand, is a strange creature that only a small circle of experts has ever heard of. For this reason alone, I'd give the edge to the CPI unless the PCE deflator was vastly superior—which it is not.

Finally, if we are stuck with the Fed's choice of the core PCE deflator, I'd enter a minor objection to the specific numerical target range, which, as Larry says, seems to be 1.5 per cent ± 0.5 per cent. Let's remember that the Fed got to the 1.5 per cent figure by starting with a 2 per cent target for the core CPI and then subtracting 0.5 per cent, which was the historically average gap between the two inflation measures. Lately, however, that gap has been closer to 0.25 per

3. On this, see Steindel (1997) and Rich and Steindel (2005).

cent, which suggests that the PCE target should be adjusted upwards to 1.75 per cent.[4] Beyond that, examination of the two time series shows that the gap between the two measures moves around quite a bit over time. So I'd prefer a plain vanilla 2 per cent target for core CPI.

Of course, these considerations are just minor quibbles. The important thing to us reform inflation targeters is that the Fed post an *explicit numerical* target for all to see. As Hillel might have said, all the rest is commentary.

4. "If It Ain't Broke, Don't Fix It."

I have not always been of the inflation-targeting persuasion. One reason is that I have long believed in the "if it ain't broke, don't fix it" principle, and that seemed to provide a good reason to oppose IT at the Federal Reserve. After all, the Fed has been highly successful under the leadership of Paul Volcker and Alan Greenspan without any numerical target. By contrast, most central banks that have adopted IT did so either under duress (e.g., after failing to control inflation) or because some institutional change was required (e.g., after the collapse of a fixed exchange rate regime).

True. But the Fed is almost a reform inflation targeter already. When a central bank forecasts the inflation rate, say, three or six months ahead, its proclamation is truly a *forecast*—analogous to a forecast of the weather—because there is nothing monetary policy can do to affect inflation over such a short time horizon. But when a central bank "forecasts" inflation two years ahead, as the FOMC is currently doing, it is tacitly revealing its (interim?) inflation *target* because monetary policy has a great deal to do with inflation two years ahead. To move from where the Fed is now to reform IT, the FOMC needs to add only one small piece of ritual: *announcing* its explicit numerical target rather than *disguising* it as a forecast. That certainly is not a big step. Furthermore, as I noted earlier, announcing B^* is the logical next step along the road to transparency.

The retirement of Alan Greenspan makes this a natural time for the Fed to adopt an explicit inflation target. While Greenspan ruled, U.S. monetary policy was firmly on "the Greenspan standard," which meant that the federal funds rate was whatever Alan Greenspan thought it should be.[5] Greenspan adamantly opposed adopting a numerical target, or anything else that would constrain his discretion. And since he was performing admirably, why change? But now Greenspan is gone, and we have a new Fed chairman. Not only is there no "Bernanke standard" as yet, but the new chairman clearly favours a numerical inflation target—as does the majority of the FOMC. So the relevant rhetorical question now seems to be: Why *not* change?

5. What's in a Name?

As Larry Meyer, Lars Svensson, and many others have emphasized repeatedly, all modern inflation targeting is *flexible* IT, which means minimizing the expected discounted value of:

$$L = (B - B^*)^2 + 8(y - y^*)^2 \quad (1)$$

4. Notice that the FOMC's current two-year-ahead inflation forecast is 1.75–2 per cent for the core PCE.
5. For an exploration of the Greenspan standard, see Blinder and Reis (2006).

for some positive 8. I agree. But why should central banks that minimize this objective function be called *inflation* targeters rather than, say, *output gap* targeters? Isn't doing so a step away from transparency? It seems to me that the *rhetoric* one often hears emanating from inflation-targeting central banks does not match up very well with their *actions*. And such mismatch is a gross violation of transparency.

One answer to this question that is frequently offered is this: Since all the experts understand that the term "inflation targeting" really means minimizing (1), who cares what we call it? That is true, but parochial. What about the 99.9 per cent of the country that is (at least potentially) confused by the misleading label? As I said earlier, transparency should apply beyond the narrow confines of professional Fed watchers; [and] the great unwashed does not know that *flexible* inflation targeting means minimizing (1). To them, it sounds like what we experts call *strict* inflation targeting ($8 = 0$).

This nomenclature issue is particularly important to the Federal Reserve because of its dual mandate to promote *both* "stable prices" *and* "maximum employment." That may be why Ben Bernanke, while a Fed governor, decided not only to drop the IT name, but to state categorically that "what I am suggesting is not equivalent to inflation targeting." That was a wise decision on his part. In the U.S. context, the term "inflation targeting" is a political and public relations burden and is therefore best dispensed with. For example, the Fed should continue to issue its "Monetary Policy Report" rather than switching to an "Inflation Report."

6. Summary

To summarize briefly, the version of inflation targeting that is coming to the Fed consists of little more than announcing a numerical inflation target—which is not much of a change from the FOMC's current procedures. If the Fed were to adopt this mild form of IT, it would at once become more transparent, more accountable, and more coherent. In all this, I agree completely with Meyer. However, I am not convinced that the core PCE deflator, which is the apparent front runner, is the best price index to use for this purpose. Nor is the name "inflation targeting," which is misleading in any case.

References

Bernanke, B., T. Laubach, F. Mishkin, and A. Posen. 1999. *Inflation Targeting: Lessons from the International Experience*. Princeton, NJ: Princeton University Press.

Blinder, A. and R. Reis. 2006. "Understanding the Greenspan Standard." In *The Greenspan Era: Lessons for the Future*, 11–96. Proceedings of the 2005 Jackson Hole Symposium, Federal Reserve Bank of Kansas City.

Rich, R. and C. Steindel. 2005. "A Review of Core Inflation and an Evaluation of Its Measure." Federal Reserve Bank of New York, Staff Report No. 236, December.

Steindel, C. 1997. "Are There Good Alternatives to the CPI?" *Current Issues in Economics and Finance*, Federal Reserve Bank of New York, April.