A Short History of Inflation Targeting at the Federal Reserve: Q&A with Marvin Goodfriend

CARNEGIE MELLON UNIVERSITY

Marvin Goodfriend
Professor of Economics
Carnegie Mellon University

The debate on whether the Federal Reserve should adopt an explicit inflation objective is not new. In the 1990s, as the transcripts attest, members of the Federal Open Market Committee (FOMC) discussed the idea at some length. The issue has picked up momentum over the past year, with several Federal Reserve officials calling for a numerical objective, including the Federal Reserve Bank of Cleveland's Sandra Pianalto and Philadelphia's Charles Plosser.

Marvin Goodfriend has been in the thick of the talks on both the inside and the outside. He attended FOMC meetings in the 1990s as the research director at the Federal Reserve Bank of Richmond. In the early 2000s, he engaged in a widely cited exchange with Federal Reserve Governor Donald Kohn about the merits of an explicit inflation goal. Goodfriend was—and is—in favor of it.

Now an economics professor and chairman of the Gailliot Center for Public Policy at Carnegie Mellon University in Pittsburgh, Goodfriend thinks there is a decent chance the Federal Reserve will soon take the long-awaited step of establishing a numerical objective. We contacted him at his office to ask for his thoughts as the debate develops.

Q: *With so many other central banks around the world already having an explicit inflation goal, why do you think the Federal Reserve hasn't adopted one?*

Goodfriend: It's natural for any leader of an organization to worry about restricting his freedom of action in the future. In the language of finance, unrestricted actions in the future have option value; they somehow seem useful. It seems better not to tie your hands.

Another natural concern is that it could be counterproductive not to follow through on a promise, so it seems better not to promise anything in the first place. Also, there are lingering doubts in some quarters about the Federal Reserve's capacity to sustain low inflation without higher unemployment. That was a concern even in the early [former Federal Reserve Chairman] Greenspan years, although experience has shown that once credibility for low inflation is achieved, the economy can actually sustain a lower unemployment rate on average.

Q: *Why do you think the issue has been re-emerging of late?*

Goodfriend: Historically, when the economy comes out of a recession, inflation tends to rise. The Federal Reserve lowers interest rates to fight recessions and has been reluctant to raise interest rates to sustain non-inflationary recoveries. Now we are at the point in the business cycle where rising inflation is a concern again.

Ever since [former Federal Reserve Chairman] Paul Volcker stabilized inflation in the early 1980s, academic theory and practical experience have persuaded many central banks around the world that it's a good idea to have an explicit low inflation objective. The Federal Reserve is behind the curve in this thinking.

Q: *Is an explicit inflation goal consistent with the Federal Reserve's dual mandate of price stability and maximum employment?*

Goodfriend: Yes. Consider the alternative. A central bank that makes the economy safe for higher inflation by not committing to a low inflation objective exposes itself to inflation scares. The central bank gives up control over beliefs about inflation to the markets, and we know what that's done.

My research has emphasized the costs of failing to make low inflation an explicit objective for the Federal Reserve. Exhibit A, in theory and in practice, is that not committing to a low inflation objective exposes central banks and governments to market demands for inflation premia in bond rates; that is, charging extra interest to compensate for high expected inflation. That raises the government's borrowing costs and presents the central bank with a nasty dilemma.

What convinced Volcker to move against inflation in the early 1980s was his recognition that failing to act would be like the movie *Groundhog Day*. The Fed would continue to be subject to the inflation scare problem over and over: The Federal Reserve would have to continue to run the economy below potential time and again, as it had in the 1970s, to maintain some degree of inflation stability. Volcker wanted to put an end to that. Good monetary policy had to start by making low inflation a priority. Making low inflation a priority, as Volcker did, was a first step toward moving to a numerical goal for low inflation.

Q: *Do you realistically expect the Federal Reserve to adopt a numerical inflation target in the near future?*

Goodfriend: I think there is a good chance of that. Inflation targeting has been debated at the FOMC since the mid-1990s. The committee had two extended debates on inflation targeting in 1995 and 1996. Having discussed inflation targeting thoroughly for 15 years, I think there is a good chance the current committee will move ahead. The FOMC has already come as close as possible to announcing an explicit inflation target outright by extending in 2007 its forecast horizon for inflation. Extending its inflation forecast horizon is not the same as announcing an explicit objective, but it's very close.

I think the FOMC would very much like to put an explicit inflation objective in place before it has to move against inflation as the economy recovers. Adopting an inflation objective would be one small step for the Federal Reserve and one giant leap for macroeconomic policy. ■

Interviewed by Doug Campbell.

Recommended readings

Marvin Goodfriend. 2005. "The Monetary Policy Debate Since October 1979: Lessons for Theory and Practice." Federal Reserve Bank of St. Louis, *Review* 87(2, Part 2): 243–62.