

POLITICS & ECONOMICS

Fed Wrestles With Setting Inflation Target

Opinion Moves Toward a Flexible 'Objective' That Gives Weight to Unemployment

By GREG IP

Washington

ONE OF FEDERAL Reserve Chairman Ben Bernanke's top priorities is to improve the central bank's communication with the public, especially about its goals for inflation and growth and how it plans to achieve them. But the more he and his colleagues concentrate on that task, the harder it appears.

Fed officials spent much of last week's meeting discussing communications, a topic that has been the focus of a subcommittee headed by Vice Chairman Donald Kohn, a 36-year Fed veteran. Minutes of that meeting, due out Nov. 15, may offer clues to the discussion. There has been sentiment inside the Fed for change, and some sentiment for unveiling any changes as a package rather than one by one. But the complexity of the issue suggests it could be months before officials agree to anything.

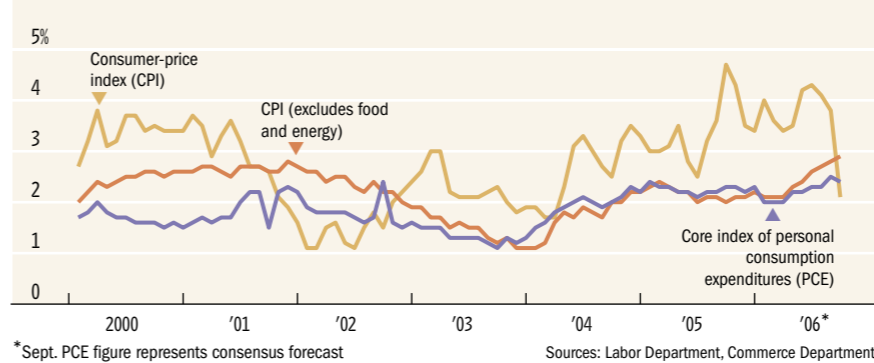
Under former Chairman Alan Greenspan, the Fed resisted the international trend of declaring a numerical inflation target as a way of fostering clarity and accountability for its goals. With Mr. Bernanke, a longtime advocate of numerical targets, at the helm, opinion within the Fed's policy-making Federal Open Market Committee is moving in favor of some kind of numerical "objective." The FOMC is composed of the Fed's six current governors—there is one vacancy—and presidents of its 12 regional banks.

Target advocates, including Mr. Bernanke, have moved toward a flexible target that gives greater weight to restraining unemployment, not just prices. In fact, they prefer to use the softer term, "objective." Meanwhile, Fed officials who have been skeptical of targets increasingly see that their deliberations can be hurt when members are advocating different interest-rate policies because they have different inflation goals.

Agreeing in principle on a target is just the first step, however. Officials would have to pick a number, a yardstick and time period in which to hit their goal. In a 2002 congressional hearing, Mr. Bernanke suggested an inflation target of 1% to 2% using

Debating a Goal

To adopt an inflation target, the Fed would have to pick a number and an index. Year-to-year change in key price indexes:



*Sept. PCE figure represents consensus forecast Source: Labor Department, Commerce Department

the "core" price index of personal consumption expenditures, or PCE, to be achieved "over the medium term, say one to two years." The "core" index excludes the volatile food and energy sectors, which can mask the underlying inflation trend.

Since then, eight of the FOMC's current 18 members have advocated that range or something close to it. But 1% to 2% may not be the preferred target. Gary Stern, president of the Federal Reserve Bank of Minneapolis, says, "There seems to be something of a public perception that that's a semiformal target, and from my perspective there's nothing remotely official about it."

Indeed, the closer some officials look, the more they believe a 1%-to-2% range is too low. At 1% inflation, there is a greater risk a shock could tip the economy into deflation, or generally falling prices. Because nominal interest rates can't go below zero, an inflation rate of 1% or less gives the Fed little room to make the kind of cuts in inflation-adjusted interest rates that might be needed to remedy severe economic weakness.

Research by Fed economist Athanasios Orphanides, Günter Coenen of the European Central Bank, and Volker Wieland of Goethe University Frankfurt concludes the Fed would encounter this "zero nominal bound" on interest rates once every 20 years with a 2% target;

every 10 years with a 1% target; and every five years with a target of zero. This implies "a significant deterioration" in economic performance with an inflation target of 1% or lower, they conclude. Their research finds these risks are insignificant with a 2% target. The ECB's stated target is "below, but close to, 2%."

Some Fed officials are reluctant to voice misgivings about the 1% to 2% range for fear of giving the impression they are moving the goal posts while the Fed is trying to nudge inflation lower. That concern may be unnecessary; Surveys, and yields on inflation-indexed bonds, suggest investors and economists perceive the Fed's inflation goal to be 2% to 2.5%.

The price index that would be used is also uncertain. For years the Fed has preferred the core PCE price index, arguing that its composition better reflects consumer spending patterns than does the popular consumer-price index. Measured by the PCE, inflation generally runs about half a percentage point lower than with the CPI.

But the case for using the PCE as a target is no longer clear. In recent years, the PCE has been subject to large revisions. The CPI generally isn't revised except for seasonal adjustment. Many of the features that led it to overstate inflation have been corrected. And it is the inflation measure most familiar to the public.

"Some of my earlier concerns about the core CPI have diminished, in part because my concerns about the core PCE have increased," says Mr. Stern of the Minneapolis Fed.

Some foreign central bankers fault the Fed for focusing on an inflation indicator that excludes food and energy prices. Because energy prices have risen steadily in recent years, they say core inflation has consistently understated actual inflation. But so far, Fed officials appear content with the core indicator. "Historically, headline and core inflation rates have the same average.... The past three years have been anomalous," says St. Louis Fed President William Poole.

Advocates of inflation targets usually argue that a central bank should give a timetable to achieve its target to avoid the temptation to delay action when inflation is above the target. "If a target is going to be meaningful, it will have to have a horizon associated with it," Mr. Stern says. Yet many of his colleagues argue for flexibility to cope with a shock, such as an oil-price surge. A rigid schedule might require sharply higher interest rates, driving up unemployment and compromising the Fed's duty to restrain inflation and unemployment.

"I favor an elastic 'medium term' specification for an inflation target, rather than a specific period such as two years," Mr. Poole says.

Another thorny issue is how detailed an inflation forecast to make public, something generally seen as critical to explaining how the Fed expects to achieve its goals. The Fed currently releases a summary of all the FOMC officials' forecasts; but because those officials may be using differing assumptions for interest rates, oil prices and other factors, the summary of their views may not represent a coherent view, limiting the summary's usefulness. By contrast, the nine members of the Bank of England's policy committee, all monetary-policy experts, release a single forecast with specific assumptions.

The British approach, however, might not work in the U.S., some officials say, because the FOMC is larger, more dispersed, and some of its members aren't experienced forecasters.

Soft Consumer Prices May Keep Japan From Raising Its Low Rates

By YUKA HAYASHI

TOKYO—Since the Bank of Japan in July abandoned its five-year policy of keeping short-term interest rates near zero, the biggest question has been whether the central bank would raise rates again this year. Now, many economists say that is unlikely to happen.

The reason is stubbornly weak consumer prices. Despite growth in the overall economy, Japanese consumer prices have been slow to rise. Prices of consumer goods such as flat-screen televisions and furniture continue to decline. Meanwhile, price increases are limited for most other products as a slow recovery in wages keeps consumers from splurging. Economists say consumer prices will likely remain weak over the coming months because of the recent drop in energy prices and expected declines in cellphone charges amid competition.

On Friday, the government said the nationwide core consumer-price index, which includes energy but excludes fresh food, rose just 0.2% from a year earlier, weaker than the 0.3% figure for August. This surprised economists, many of whom had predicted another 0.3% rise.

The latest CPI result is encouraging the more-cautious market participants to predict that the central bank will maintain its current policy of keeping the target for the overnight call rate at 0.25%—the rate it set in July—at least until early next year. It also is prompting some of the bulls to scale back their prediction that another rate increase will occur in December, or even November.

"The growth in the core CPI remains weak, and if we exclude energy, prices are still declining," says Daisuke Yamazaki, a Goldman Sachs economist in Tokyo. "In this environment, it's obviously very hard for the BOJ to justify a rate increase."

Changes in interest rates have broad implications for Japan's economy and financial markets. (See related article on Page C10.) A higher rate would increase the cost of borrowing for everyone from big corporations and homeowners to hedge-fund managers. And the globalization of financial markets means that these effects are felt well beyond Japanese borders. Soon after the central bank's policy changes earlier this year, prices in various overseas markets, including Icelandic stocks and New Zealand bonds, declined as market participants feared flows of money from Japan to these markets would shrink.

After the release of Friday's CPI data, the yield on the benchmark 10-year government bond declined to 1.735%, down 0.005 point from the previous day, as its price rose slightly. The current level represents a sizable retreat from a recent high of 1.84% reported on Oct. 23, when more market participants were hopeful of a rise in rates before year end.

The yen has been losing ground against other major currencies over the past several months, despite the Japa-

nese economy's strength. During the April-June quarter, Japan's economy grew at an annualized pace of 1%. Economists say the yen is weak because of a continued wide gap in interest rates between Japan and other major markets, which encourages investors to shift money away from Japan.

Still, some say it is too early to give up hope for another rate increase this year. For one, the sentiment in the corporate sector remains buoyant, as indicated in the Bank of Japan's latest quarterly *tankan* survey released in early October. Stock prices in Japan have been on a solid upturn since late September.

The market will likely receive a big clue on the timing of the next rate change tomorrow, when the central bank is to release its semiannual Outlook for Economic Activity and Prices report. In the closely read document, the policy-board members will reveal their latest forecast for economic growth and the CPI for the fiscal year ending March 2007 and the year after that.

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