THE FEDERAL RESERVE'S STRATEGY REVIEW: TOWARDS A TARGET RANGE FOR INFLATION?

As part of the Federal Reserve's strategy review, the introduction of a target range for inflation is being discussed. Such a range could provide flexibility in the conduct of monetary policy. It could also take into account past shortfalls in inflation. Introducing a range when inflation is below target runs the risk of being perceived as not being bothered by the inflation shortfall. This would call for an asymmetric range but this increases the risk of market turbulence when a tightening cycle starts.

Are financial market participants expecting too much from the Federal Reserve's "review of monetary policy, strategy, tools, and communication practices", in short, the strategy review? Given the scale of the year-long effort, it is natural to count on some big announcements, bringing change in the way that monetary policy is conducted, e.g. by modifying the inflation target.

The FOMC minutes which were published this week are a reminder of the complexity of the task. Consider the question of a target range for inflation, which was discussed during the January meeting. In theory, it looks simple. Rather than having a precise numerical target for inflation (2%), a range would offer some flexibility: being a bit below or above would not be considered as problematic. Hence, it would calm down expectations of policy easing or tightening as soon as inflation strays from the target. Clearly, in doing so, the communication problem has merely been shifted from a specific target to the width of the range.

The Fed staff's briefing actually discussed not one but three ranges. Given the variability of inflation, there is an uncertainty range. Within that range, no action would be warranted because of the noise in the measurement of inflation. There is also an operational range: the FOMC could, under certain circumstances, prefer to be above its longer-term target, e.g. to make up for a past period of very low inflation. Finally, there is an indifference range, whereby deviations of inflation from target would not trigger a policy response. Considering that the three ranges could co-exist, one immediately sees the challenges in communicating about the monetary policy stance. For that reason, *"some participants suggested that it was not clear that introducing a range would help much in achieving the Committee's inflation objective; they noted that introducing a range could make that objective less clear to the public."*[1]

If the central bank were nevertheless to move to a target range, this would raise other issues as well. Introducing a symmetric range when inflation is below target *"could be misinterpreted as a sign that the central bank was not concerned about inflation remaining below its stated goal, a situation that could lead to inflation expectations drifting down to the lower end of the range."* To address this issue, some FOMC meeting participants had put forward the idea of an asymmetric operational range for a time, with 2% being at or near the lower end. Even more so than in the case of a symmetric range around 2%, such an approach would create expectations that the current federal funds rate would be maintained for a lot longer, given the time it would take for inflation, which is below 2% to start with, to move outside the upper end of the range. However, it would bring in another source of complexity: when and on what basis would the central bank decide to switch back from an asymmetric to a symmetric range? Getting closer to such a tipping point would cause an increase in bond yields, reflecting an anticipation of policy rate hikes, which in turn could trigger market volatility with a possible detrimental effect on the economy. Over the past 30 years, the common thread of inflation targeting, forward guidance, publication of meeting minutes, press conferences has been to make monetary policy decisions easier to interpret. That way, market expectations, as reflected in the yield curve, are more in line with what the central bank is aiming for. This achievement limits the changes that can be made to the central bank's objectives and the communication that goes with it. Some tweaking thus looks more likely than a major overhaul.

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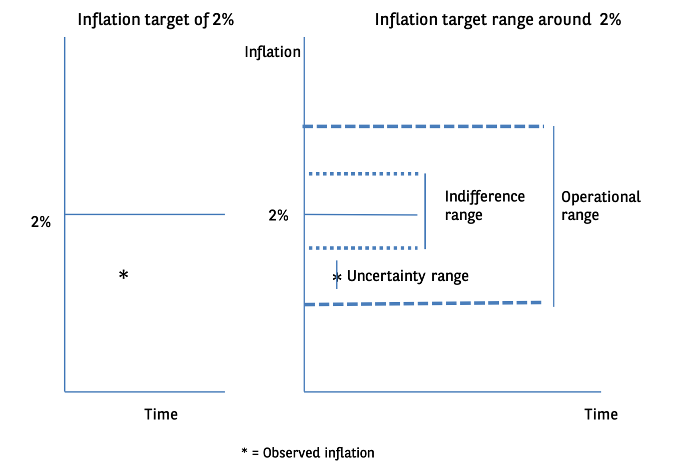
1. Source : Federal Reserve Board, Minutes of the Federal Open Market Committee, 28-29 January 2020

INFLATION (RANGE) TARGETING



SOURCE: BNP PARIBAS

Given the scale of the year-long effort, it is natural to count on some big announcements following the Fed's strategy review. However, over the past 30 years, central banks have increasingly tried to make monetary policy decisions easier to interpret. This achievement limits the changes that can be made to the Federal Reserve's objectives and the communication that goes with it. Some tweaking thus looks more likely than a major overhaul.