



Fed Harms Itself by Missing Goals

By Betsey Stevenson & Justin Wolfers - Jul 9, 2012

[Ben S. Bernanke](#) has made transparency one of the defining themes of his time at the helm of the [Federal Reserve](#). The virtue of this transparency is that it's easy to evaluate how well the Fed is conducting monetary policy. And it has become transparently clear that the central bank has failed to take the actions its own principles demand.

Bernanke is the first Fed chairman to clearly state a set of principles to guide monetary policy. They recognize the dual mandate set down by Congress -- that the Fed must try to balance low inflation and unemployment -- and articulate goals for each. The Fed is targeting a 2 percent inflation rate and plans to keep [unemployment](#) near its longer-run normal rate, which it currently judges to be between 5 percent and 6 percent. By announcing these goals, Bernanke hopes to reduce uncertainty and anchor the expectations of consumers and companies.

But actions speak louder than words, and the Fed's actions have been too timid. Right now, the Fed's preferred measure of inflation -- the deflator on personal consumption expenditures -- is less than 2 percent, with the most recent estimate showing an annual increase of 1.5 percent. And unemployment remains at 8.2 percent. If monetary policy had been used more aggressively to combat the recession, then unemployment would be lower and inflation would be closer to its target. Even if you believe monetary policy is largely ineffective at lowering unemployment, a more expansionary policy would still have pushed inflation closer to its target.

Predicting Failure

One Fed defense may be that its recent policy choices were appropriate given the imperfect information available at the time. If this is the explanation, then Fed policy needs to adjust, given current information. The Fed's latest projections show that it expects inflation to remain below target, and unemployment to stay above target, at least through 2014. The only reason we can't judge the Fed beyond that horizon is because it hasn't yet issued forecasts for 2015. Moreover, these projections come with a warning that there are "significant downside risks."

So the Fed expects to fail, and to continue failing for the next 2 1/2 years, and there's a significant risk that it may fail by a lot.



Worse, these projections are based on an expectation of “appropriate monetary policy.” That is, the Fed thinks it’s appropriate to run policy in a way that it expects to fail to meet its stated goals for the next few years for no discernible reason. Beyond the macroeconomic failings, the Fed has also botched its goal of being [transparent in explaining](#) what is driving its policy decisions.

It’s not hard to do better. A more accommodative monetary policy -- which could be achieved by quantitative easing, a promise to keep [interest rates](#) low, or attempting to raise inflationary expectations -- would probably nudge inflation toward its target and lower unemployment toward normal rates. Indeed, the Fed’s stated principles seem to demand such a choice.

The point is that the Fed’s usual excuse -- that it’s hard to nail two goals with just one instrument -- doesn’t apply. In normal times, the debate over monetary policy is between “hawks” who want the Fed to emphasize its inflation target, and “doves” who want it to focus on lowering unemployment. But there’s no debate here -- more accommodative monetary policy would help achieve the goals for both inflation and unemployment.

Another common line of debate is between those who want the Fed to take exceptional actions in exceptional times, and those who want it to follow clearly articulated policy rules. But again, both the exceptionally high [unemployment rate](#) and the Fed’s clearly articulated policy principles point to easier monetary policy.

Possible Asymmetry

What then explains the Fed’s behavior? One possibility is that it is asymmetrically willing to risk undershooting, but not overshooting, its inflation target. Certainly, Bernanke’s Fed has shown no willingness to tolerate inflation above a 2 percent ceiling. While the chairman has explicitly denied that there’s any element of asymmetry in the inflation target, the Fed’s choices suggest otherwise.

Setting an inflation target, rather than a ceiling, is the right approach. The reason is that failing to hit the target on either side creates economic risks. Just as the Fed needs to be vigilant against the possibility of inflation sparking a wage- price spiral, it needs to be vigilant in protecting against the possibility of deflation. A clear commitment to keeping inflation near the target, and not just below it, is our best defense against deflation taking hold.

The other possibility is that the Fed is out of ammunition, and while it might prefer to push inflation higher and unemployment lower, it can’t. Again, Bernanke has explicitly denied this, and we think he’s right. An announcement by the Fed that it’s prepared to tolerate a higher inflation rate in order to generate lower unemployment, as Chicago Fed President [Charles Evans](#) has suggested, would surely boost the willingness of companies to invest, knowing that the Fed won’t choke off the incipient recovery.

There are real costs to the Fed's failures. Millions remain unemployed in the service of keeping inflation below its target level. We risk the possibility they may not work again as their skills atrophy and they lose hope. The Fed's confused communications have undermined its own effectiveness and harmed its institutional prestige.

In the long run, a Fed whose word we don't believe, and whose principles it views as optional, is a Fed that will be less able to influence the expectations of consumers and investors, rendering it less effective at pulling us out of the next economic decline.

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