The Federal Reserve’s Credibility is at Stake

In recent years the Federal Reserve has issued numerous monetary policy statements and projections, but it has only made one crystal-clear promise, namely, to target an inflation rate of 2 percent, as measured by the price index for personal consumption expenditures (PCE). Fed officials have emphasized that this target serves as the anchor for inflation expectations, thereby fostering the stability of inflation outcomes and enhancing the Fed's ability to promote maximum employment.

In reality, PCE inflation has fallen persistently short of that target ever since 2012 and is currently running at rates close to zero. Nonetheless, policymakers have been reassured by fairly stable survey readings on the inflation expectations of households and businesses, suggesting that the persistent shortfalls in actual inflation had not undermined the credibility of the Fed's target. More recently, however, many surveys have exhibited substantial downward drift in longer-term inflation expectations, indicating that the Fed's credibility is now at stake.

For example, the chart above shows the recent downturn in the inflation expectations of professional forecasters, using the results of quarterly surveys conducted by the Federal Reserve Bank of Philadelphia. In 2013 and 2014, the median forecast for the five-year average PCE inflation rate was very close to the Fed’s target, whereas over the past several quarters that median has declined notably and currently stands at 1.7 percent. Indeed, the interquartile range indicates that the vast majority of forecasters now expect the average inflation rate over the next five years to fall significantly short of 2 percent. In effect, forecasters seem to be reinterpreting the Fed's monetary policy strategy as aimed at keeping inflation below a 2 percent ceiling rather than bringing inflation back to a 2 percent target.
Households' views about the longer-term inflation outlook are also relevant but tend to be much less precise than those of professional forecasters. Moreover, household surveys generally do not refer to any specific inflation measure and hence cannot be directly compared to the Fed's target for PCE inflation. Nonetheless, as shown in the chart above, households' longer-term inflation expectations (computed as quarterly averages of monthly survey data) have moved downward significantly over the past year. The Federal Reserve Bank of New York's survey indicates that the median household’s outlook for inflation over the next three years has dropped a half percentage point, while the University of Michigan's consumer survey indicates that expected inflation over the next five to ten years has declined by a quarter point. Preliminary results from the latest Michigan survey (released on Friday) confirm that consumers' longer-term inflation expectations are now at the same low reached in December 2008.

Unfortunately, inflation expectations may continue to decline over coming quarters, especially if actual inflation remains subdued or drops even further. Thus, at this juncture it is imperative for the Federal Reserve to reframe its policy strategy and shore up the credibility of its inflation target. A promising approach for doing so would be to deemphasize the role of inflation forecasts (which have been persistently wrong over the past few years) and instead to link the timing and pace of policy normalization to actual outcomes for inflation and employment.

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