Reasonable Doubts about the Inflation Outlook

The Federal Reserve has indicated its decision to start pushing up short-term interest rates will hinge on the Federal Open Market Committee (FOMC) being “reasonably confident” that inflation will move back to its 2% target over the medium term. The FOMC hasn’t clarified that phrase, but its implications can be inferred by considering its mirror image: “reasonable doubt.” The notion is quite familiar to anyone who’s served on a jury and listened to the judge’s instructions:

“A reasonable doubt is a doubt based on reason and common sense. ... Proof beyond a reasonable doubt means proof which is so convincing that you would not hesitate to rely and act on it in making the most important decisions in your own lives.” ([http://www.ca6.uscourts.gov/internet/crim_jury_insts/pdf/07_Chapter_1.pdf](http://www.ca6.uscourts.gov/internet/crim_jury_insts/pdf/07_Chapter_1.pdf))

For the FOMC’s deliberations, that standard is highly relevant because a premature interest rate hike could substantially harm the American economy, and mitigating that damage might be practically impossible. Moreover, at the current juncture, there are a host of reasons why policymakers should have reasonable doubts about the contours of the inflation outlook:

**Recent Forecasting Performance.** As shown in the accompanying figure, the FOMC’s inflation outlook has been persistently overoptimistic, even as the underlying trend in core inflation (as measured by the price index for personal consumption expenditures (PCE) excluding food and energy prices) has been drifting steadily downward over the past few years. That forecasting record certainly underscores the rationale for avoiding overconfidence about the current inflation outlook.

![Core PCE Inflation vs. FOMC Target](chart.png)

*Note:* In this figure, the core PCE inflation rate is given by the four-quarter average change in the PCE price index excluding food and energy, and the FOMC’s outlook is given by the midpoint of the central tendency of core PCE inflation projections, as published in the FOMC Summary of Economic Projections at each specified date.

**The Magnitude of Resource Slack.** A number of Fed officials have suggested that their projections of resurgent inflation hinge on the view that the economy is now “close to full employment.” Such a view differs markedly from the recent analysis of the Congressional Budget Office, which estimates the output gap now stands at around 3%—roughly the same as its peak value during the 1991-92 recession. Indeed, this divergence underscores the extent to which various analytical approaches may yield substantially different conclusions about the state of the economy and the likelihood of emerging inflation pressures.
Energy Prices and Dollar Appreciation. In its statement last month, the FOMC characterized the downward trajectory of inflation as “largely reflecting declines in energy prices” and hence likely to be fairly transitory. Nonetheless, that rationale is not readily apparent from the data. As shown in the figure above, core PCE inflation (on a four-quarter basis) was roughly 1.5% two years ago, around 1.4% last year, and close to 1.3% in the latest reading—a pattern that is not readily attributable to last autumn’s sharp drop in energy prices and appreciation of the dollar.

Any one of these factors would seem sufficient to establish reasonable doubt about whether inflation will rise to its 2% target over the next several years. Moreover, it seems hard to imagine that all of these sources of doubt could be dispelled soon enough to warrant an interest rate increase in December. Thus, at its meeting this week, the FOMC should simply indicate that it is prepared to wait substantially longer before reaching any verdict.

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