



Fed Inflation Goal Is More Politics Than Policy: Evan Schnidman

By Evan A. Schnidman - Feb 5, 2012

The [Federal Reserve](#)'s decision last month to set a soft inflation target is the latest in a series of steps the central bank has taken in recent years to improve policy transparency. It's also the most controversial among economists, and with good reason.

In 2004, Frederic Mishkin, an economics professor at [Columbia University](#) who later became a member of the Federal Reserve Board, engaged in a written debate on the issue with Ben Friedman of Harvard University in the journal *International Finance*. Mishkin based his [argument](#) on work he had done with now-Fed Chairman [Ben S. Bernanke](#). Their work contends that inflation targeting increases transparency and doesn't limit policy options for central bankers but rather provides "constrained discretion."

[Friedman](#) countered that if inflation targeting is flexible, then it can't improve transparency, and that if instead the Fed announced a hard target, then it wouldn't have the necessary flexibility to deal with inevitable shocks to the economy. He also pointed out that focusing solely on inflation may signal that the Fed is indifferent to other variables, most notably its mandate to deal with employment.

Despite these objections, the Fed is moving forward with its targeting policy. Not surprisingly, that decision was a hot topic when Bernanke testified before the House Budget Committee on Feb. 2. In response to lawmakers' questions, he indicated that the central bank would still be concerned with employment, so long as inflation remains in check. The chairman's cryptic response supports Friedman's hypothesis that a flexible inflation target does little to improve policy transparency.

Wrong Answer

This new inflation targeting policy, like so much else produced in [Washington](#), is designed (in theory) to make policy simpler and more understandable to the public. The trouble is whether it's monetary policy, [tax policy](#) or [energy policy](#), it's complex for a reason; the world is complex.

Financial instruments are evolving constantly, resulting in an increasingly complicated system of global trade. It should come as no surprise that this intricate web has created the need for increasingly sophisticated financial regulation. Moreover, in recent years, these markets and the problems associated with the financial crisis have created a demand for complex methods of monetary

intervention. Whether it is the new quantitative easing measures or the extension of the maturity of its securities portfolio, dubbed “Operation Twist,” these actions are far from simple adjustments to the [Fed Funds rate](#).

Given that complexity, why should we want or even expect the Fed to make monetary policy in a simpler way? It would be nice to be able to say that keeping inflation at or below 2 percent will provide enough growth to maximize [employment](#) without allowing the economy to overheat. Unfortunately, we learned in the 1970s that the real economy doesn’t work this way. Inflation can run out of control quickly, and employment might not respond positively. Conversely, as we have seen in the last few years, unemployment can remain persistently high even as inflation remains in check.

There are policy alternatives to inflation targeting. The root problem the Fed hopes to solve is that of expectation management. It is betting that a clear and transparent goal will help smooth out the peaks and valleys in the market by reducing uncertainty and surprise. Politically, the Fed also benefits from the cover that an inflation target provides; policy actions are much easier to justify when they are framed as a way to achieve [price stability](#).

Reasonable Arguments

Although expectation management, uncertainty reduction and political cover are reasonable arguments in favor of the new policy, two of these three benefits can be derived from other measures, and the third may benefit the policy makers more than the public.

First, expectations can be managed through better communication. The policy of news conferences by the chairman has only been in place for a few months. Fed personnel should be given time to develop a verbal communication style that does a better job of explaining why policy is moving in a particular direction. This would undoubtedly help manage market expectations.

Second, with better verbal communication, uncertainty and surprise should be reduced. To go further, the Fed should release its internal forecasting data and Open Market Committee presentations. The data will allow market actors to understand where the Fed believes the economy is going. Although some might argue that such a release could harm Fed credibility if the forecasts are wrong, that would be a lesser error than potentially missing an explicitly declared inflation target.

There also are concerns that the release of presentation materials from the meetings would inhibit honest deliberations. If that were the case, then we would also need to eliminate the release of meeting minutes and transcripts.

Third, the Fed shouldn’t expect political cover for its actions. The central bank is designed to be insulated from overt public pressure by the fact that its top officials aren’t elected and it isn’t funded by Congress. This is intended to allow the institution to do what is hard, painful and politically unpopular

for the good of the economy. Just ask [Paul Volcker](#).

In any case, public vilification of Fed policy makers for doing what they believe is best for the economy isn't the way to hold the central bank accountable.

A more reasonable model would be the federal judiciary, where reasonable grievances can be filed by any person in the form of a brief. A similar system could be applied at the Fed: Briefs could be filed or written questions submitted so long as they are representative of a substantial portion of the electorate (determined by signatures) or of a significant portion of the economy (determined by the percentage of gross domestic product covered by the grievance). Such a system could reduce the incentives for the Fed to favor corporate interests and would provide a way for average Americans to air their discontent with particular Fed policies.

Simpler Isn't Better

Inflation targeting may make monetary policy easier to explain to the public and harder for politicians to criticize, but that doesn't make it better policy. The solutions proposed above aren't as simple, but they enhance communication, increase data transparency and provide for direct communication between the public and the Fed. Perhaps most important, they do all of this without the risk of irreparable harm to Fed credibility that could result from any missteps in inflation targeting.

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