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Research US

The subtle push for price level targeting continues

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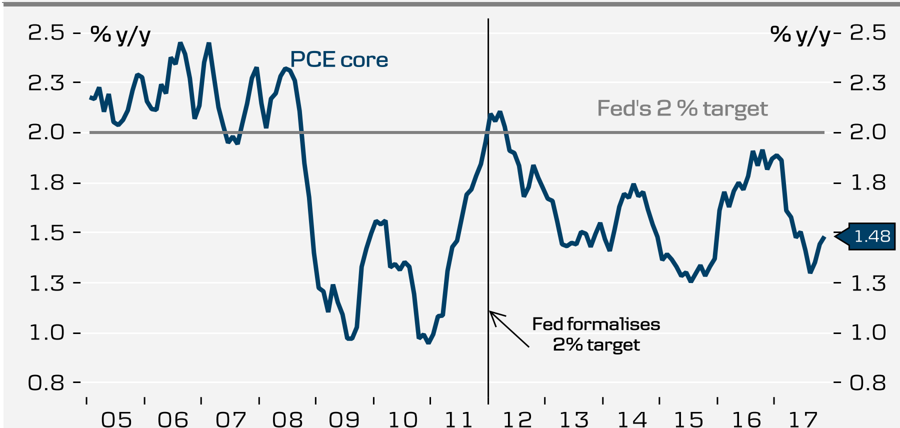
- **The Federal Reserve's persistent undershooting of its inflation target sparked comments about a move to price level target at the past two FOMC meetings.**
- **In our view, introducing a price level target would help the Federal Reserve return inflation to 2%, but it would face some operational hurdles.**
- **At the current stage we put 15% probability of the Federal Reserve adopting a price level target in the coming years and in 2019 at the earliest.**
- **The introduction of a price level target would have a negative impact on the USD.**

Momentum for a shift to price level targeting is building

The Federal Reserve continues to struggle to meet its 2% inflation target, which it has undershot since the target was formally introduced in 2012 (see Chart 1). In the *Minutes from the December FOMC meeting* the idea of introducing a price level target to solve this issue was mentioned again (see quote from Minutes below). It was first mentioned in the November FOMC Minutes and former Federal Reserve chairman Ben Bernanke also discussed it last autumn (see for instance his blog *here*).

'Due to the persistent shortfall of inflation from the Committee's 2 percent objective, or the risk that monetary policy could again become constrained by the zero lower bound, a few participants suggested that further study of potential alternative frameworks for the conduct of monetary policy such as price-level targeting or nominal GDP targeting could be useful.'

Chart 1. The Fed has missed its inflation target almost every single month since the financial crisis



Source: BEA, Federal Reserve, Macrobond Financial

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Need to know about price level targeting

The Federal Reserve discusses and votes on the *'Longer-Run Goals and Monetary Policy Strategy'* at its first meeting each year (usually in January). If it wants to change its policy strategy it would likely have been discussed publically in advance, while the decision will be taken in connection with the vote. In our view, the start of 2019 would be the earliest time for a decision.

It would force a symmetric reaction to inflation movements

The Federal Reserve's statutory mandate is to achieve maximum employment and stable prices. It currently interprets the latter as being a (symmetric) 2% inflation target, but the persistent undershooting of the inflation target since 2012 (in fact, PCE core inflation has only been at or above the 2% target for five months since October 2008) has called into question whether it in fact is a symmetric target.

The Federal Reserve would be free to interpret its price stability mandate as, e.g., a price level targeting a 2% rise per year. Such a target would commit it to react to deviations on both sides of the target as it would be the price *level* and not the price *change* that matters. In practice this would force it to implement a reaction symmetrical to inflation above and below 2%. Bygones would no longer be bygones as with the current inflation target.

This point can be seen from the example in Chart 2. It shows that, if it had adopted a price level target in 2012, it would now have to commit to holding inflation above 2% in a period in order to return the price level to target and correcting the present 2.4% undershoot.

We believe that if the Federal Reserve shifts to a price level target, it would most likely say that it would be valid from that point and look past previous misses. Furthermore, since it is de facto targeting core PCE inflation (and not headline PCE inflation, which is the officially targeted measure) we would expect a price level target to be based on the level of the core PCE index. We expect such a level targeting regime to be flexible in the way that the Federal Reserve can take the situation in the labour market into account when determining the speed of adjustment back to the target.

It has limited practical experience; strong academic merits

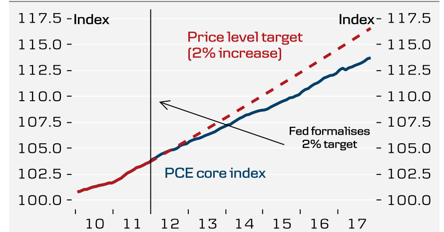
There is limited practical experience with price level targeting among central banks. Sweden is so far the only central bank that has tried it in practice, but that was in the 1930s. Bank of Canada conducted extensive research into the possibility of a switch to price level targeting, when its inflation target was up for evaluation in 2011.

Price level targeting has strong theoretical merits, though. Besides the recent floating of the idea by Ben Bernanke, other prominent economists such as Michael Woodford and Paul Krugman have advocated the idea. They find it particular convenient when facing the zero lower bound, which makes it even more compelling in the present low rate environment. It would further help make forward guidance more concrete with reference to the level target.

Operational hurdles for the Federal Reserve

A move from targeting inflation to targeting the price level does bring up some operational hurdles for the Federal Reserve. It has put a lot of faith in the predictive power of unemployment over future inflation – the so-called Phillips curve model of inflation. It has also committed to a steady mechanic reduction of the balance sheet over the coming years. Introducing a price level target would essentially be admitting that it has been wrong the past couple of years. It may also not be consistent with the current normalisation strategy.

Chart 2. PCE core index is 2.4% lower than what it should have been if core inflation had been 2% on average



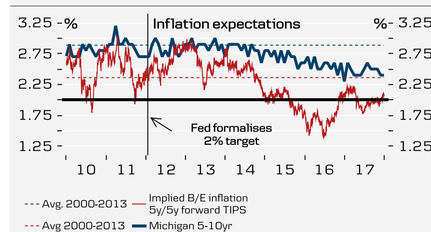
Source: BEA, Federal Reserve, Macrobond Financial

Federal Reserve may lack sufficient credibility

The long record of below target inflation has started to impact longer-term inflation expectations. Chart 3 shows that both market-based and survey-based measures of inflation expectations have declined from stable average levels in the past couple of years. Further evidence of this is the persistently low wage growth around 2.5%, which Federal Reserve members like Brainard, Evans and Kashkari have attributed to low inflation expectations.

Neel Kashkari, President of the Minneapolis Fed and one of the most dovish members of the FOMC, has *tweeted* that he thinks a price level target is an interesting theoretical concept but it lacks credibility given that the Fed has not been able to hit 2% already. The Federal Reserve may thus face a tough task of regaining credibility in the public if it wants to successfully change its price stability target.

Chart. 3 Inflation expectations still significantly below historical average



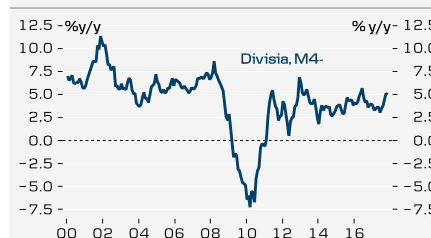
Source: Michigan, Bloomberg, Federal Reserve, Macrobond Financial

Price level targeting may not be in line with balance sheet normalisation

Chart 4 reveals that broad money supply growth has been relatively low in the US after the financial crisis. Since a price level target would imply the Federal Reserve to commit to hitting 2% inflation immediately, it would require it to deliver higher money supply growth. It is difficult to see how the Federal Reserve would succeed in this, while staying with the plan to reduce the balance sheet (see Chart 5).

In our view, introducing a price level target would require the Federal Reserve to backtrack on quantitative tightening. It may additionally have to expand its balance sheet further to hit its price level target. The Federal Reserve's own perception of the expansion of the balance sheet has been that it was temporary. A price level targeting strategy would mean a break with this idea. This may also be unpopular among (Republican) politicians, who opposed the idea of quantitative easing during (and after) the financial crisis.

Chart 4. Low broad money growth in the US



Source: Macrobond Financial

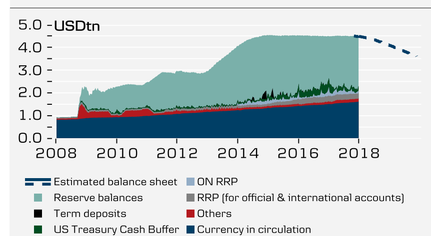
Market impact from introduction of price level targeting

While a move to price level targeting does not look imminent, the genie is out of the bottle. The possible addition of Marvin Goodfriend and Richard Clarida – both with a strong resume in modern monetary theory – to the Board of Governors could spark a debate within the Federal Reserve on this topic.

The experience from central banks introducing inflation targeting in the 1990s suggests that the circumstances for a change to price level targeting are present. Inflation targeting was a reaction to a period of *too high* inflation during the 1970s and 1980s. The recent period of *too low* inflation in the US and other places may persuade central banks to evaluate the current monetary policy framework.

At the current stage we put 15% probability that the Federal Reserve moves to a price level target in the coming years, while the start of 2019 would be the earliest time for a decision. In our view, this warrants a consideration of the potential market impact, but we stress that the effects below are not part of our base case scenario.

Chart 5. Balance sheet reduction has begun



Source: Macrobond Financial, Danske Bank calculations

Price level targeting would weigh negatively on the USD

In our view, the market has not priced the possibility of the Federal Reserve changing its target to a significant extent. The current pricing in the inflation market suggests that, if perceived credible by the market, an introduction of a price level target would push breakeven higher across the curve with the biggest impact on the 1-5Y segment. That should push nominal yields up correspondingly and real rates lower. That, in addition with a higher pace money supply growth would weigh negatively on the USD. The lower USD would further send USD-denominated commodity prices, including the oil price, higher.

Disclosures

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