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Prices or jobs?

Could the Federal Reserve lower unemployment by revamping its goals?

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THE Federal Reserve has scored highly for creativity over the course of the economic crisis. It has already, in effect, lowered short-term interest rates to zero, and carried out two rounds of quantitative easing (QE), the purchase of government bonds with newly printed money. On August 9th it surprised the market by saying it expected to hold its short-term interest rate where it is until mid-2013. By removing any expectations of monetary tightening before then, the announcement delivered a powerful downward jolt to bond yields. The Fed also disclosed it had discussed other policy options and was “prepared to employ these tools as appropriate”. That has fuelled speculation that the Fed will play yet another card when its policy-setting committee gathers for an extended meeting on September 20th-21st.

Many have focused on whether the Fed will embark on another round of quantitative easing, or QE3. That looks unlikely. QE2 was followed by surging commodity prices and vociferous condemnation at home and abroad, extinguishing much of the Fed’s enthusiasm for an encore. The Fed could accomplish something similar by reshuffling the composition of the \$2.6 trillion in Treasury and mortgage bonds it already owns. By selling short-term bonds, whose yields would stay close to zero thanks to the Fed’s rate commitment, it could boost holdings of longer-term issues, pushing their yields down further. This has been dubbed “sterilised” QE or “Operation Twist”, after a 1960s programme in which the Treasury and the Fed tried to “twist” the yield curve by altering the pattern of Treasury-bond issuance. Anticipation of something along those lines helps explain why ten-year Treasury bonds now yield around 2%, the lowest in 50 years.

There are other options, too. The Fed could lower the interest rate it pays banks for excess reserves left on deposit with the central bank, from 0.25% currently. It could also announce targets for longer-term rates, such as those on two- or three-year bonds. But if the Fed wants to surprise the markets again, a more radical idea would be to fiddle with its own mandate.

Mission half-accomplished

By law the Fed is supposed to pursue both low inflation and low unemployment. You would not know it from the recent record. Since the start of America’s recession in late 2007 both overall and core inflation (a measure which excludes energy and food costs) have fluctuated wildly but averaged around or below 2%, the Fed’s preferred range (see left-hand chart). Unemployment, on the other



hand, has been stuck at around 9% since the start of the year. Fed policymakers reckon America’s “natural” unemployment rate—that is, the lowest compatible with stable inflation—is at or below 6% (see right-hand chart). If inflation were running three percentage points above target “any central banker worth their salt would be...acting as if their hair was on fire,” observed Charles Evans, president of the Federal Reserve Bank of Chicago, in a speech on September 7th. “We should be similarly energised” about unemployment.

Although the Fed is bound to pursue stable prices and full employment, it has wide latitude in how it defines those goals. It could, for example, announce it is targeting inflation, perhaps just temporarily, of 4% instead of 2%. If people’s expectations of inflation rose (which is by no means

assured), then real interest rates would fall, boosting demand. Ben Bernanke, the Fed chairman, has flatly rejected this option, however. It would, he says, ruin the credibility the Fed has invested in low inflation, and undermine the ability of firms and people to plan.

An alternative would be to switch to targeting the growth of nominal gross domestic product. If the target were 5%, say, inflation of 3% would not interfere with monetary stimulus so long as real GDP was growing by less than 2%. The Fed toyed with nominal GDP in the past when it was searching for something more stable to target than the money supply. But a regime of this sort has several drawbacks: since the trend in real GDP varies, inflation would, too, presenting similar problems to a higher inflation target. It would also be harder to explain to the public.

The Fed may be able to justify a more forceful attack on unemployment by tweaking, rather than replacing, its current framework. Although a 2% rate may be the Fed's de facto inflation target, the central bank operates (and markets react) as if 2% were a ceiling rather than the midpoint of an acceptable range. Mr Evans noted the problem with this in his speech: "To average 2%, inflation could be above 2% in some periods and below 2% in others. If a 2% goal was meant to be a cap on inflation, then policy would result in inflation averaging below 2% over time." A related problem is that the consequences of overshooting or undershooting the 2% target are not symmetrical. The Fed should arguably accept a higher risk of overshooting than undershooting inflation since it has far more experience with, and more tested tools for, curing inflationary pressures than deflationary ones.

One way around this problem would be for the Fed explicitly to state its tolerance of inflation above 2%. Mr Evans proposes, for example, committing to easy monetary policy until unemployment is 7.5% or lower, so long as inflation is not above 3%. This still presents problems. The Fed may insist it has not changed its commitment to low inflation but the public may not believe it. And it would require the Fed to have a lot of confidence in its estimate of the natural unemployment rate, a notoriously slippery thing to measure. Laurence Meyer, a former Fed governor now with Macroeconomic Advisers, a consultancy, suggests a different approach: the Fed would explicitly set a 2% medium-term inflation target and a 1.5% to 2.5% short-term range for core inflation. The advantage of both proposals would be to dissuade markets from pricing in higher interest rates even if inflation topped 2%.

Such changes would represent a big shift in how the Fed operates. Less clear is how helpful they would be. The Fed's mandate already provides the justification it needs for steps like QE3. That it has not taken them reflects scepticism that driving long-term interest rates even lower would be worth the criticism.

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