Price Stability and The Fed's Inflation Goal

There are many things that the Federal Reserve (Fed) is doing these days to cause concern. A chief concern of late has been the Fed's objective with regard to the inflation rate in this country.

What got me thinking about this matter more is the latest financial reporting related to the Fed and inflation. Take, for example, what Hilsenrath and Sparshott recently reported in the Wall Street Journal (May 22, 2015): "Fed officials don't want inflation too high, because it eats away at consumer purchasing power. But they also don't want it too low, because that signals broader weakness in demand in the economy for consumer goods. The Fed's goal is 2 percent inflation and their preferred measure of it, the Commerce Department's personal consumption expenditures price index, has been running below that goal for nearly three years."

I can fully understand not wanting the inflation rate to be too high. High inflation rates have been seen to be detrimental to our economic functioning. But the above characterization makes the subtle but important point that the Fed is disturbed that the inflation rate is too low these days. In other words, while prices are rising in this country, they are not rising fast enough for the Fed to be happy. All I can say is, as my students state when they want to express disgust: "Really?"

In the Fed's thinking an annual rate of inflation of 2 percent is preferable to a 0 percent inflation. I know I travel in very limited circles, but I have not met any fellow consumers, business owners, bankers, doctors, students, or even university administrators that share such a similar concern. Rather, I have heard many folks speaking quite happily about lower prices at the gas pump. Moreover, I suspect that the strong dollar in international foreign exchange markets has kept the price of foreign made goods from rising rapidly, but I have again heard no objection to this. Indeed, prices that don't rise on average seems to be a good thing, and nothing to fear or be disturbed by it.

So, the news I can share with you is that if you are happy that prices have not been rising much of late, then don't expect this joy to last much longer. The Fed is not happy and they will do what they can to change things.

Now, as a financial economist, I don't see why this 2 percent inflation goal is better than zero inflation! Zero inflation coincides with the notion of "price stability", in my thinking. The Fed seems to also support "price stability", but not using my definition. Rather, they have co-opted the definition of price stability to mean a 2 percent inflation rate. They seem to have done this without objection or even question. This doesn't make sense.

I can see part of the public reasoning, wrongly, that 2% is close to 0 percent, and therefore not be concerned about this goal. Such reasoning is wrong, however, because it ignores the impact of compounding. And if the 2 percent inflation rate is a goal to be achieved over an extended period of time, then the power of compounding is of great import. As an illustration of this principle, if you use your calculator to raise 1.02 to the power 35, you see that prices will approximately double in 35 years' time, if the Fed hits its 2 percent goal each year. In other words, if you are 35 years old today you see prices twice as high as today when you retire in 35 years' time. You better plan on having twice the amount of income then to live on. This is why I disagree with the suggestion that this is anything close to "price stability".

Now, if you are like me, you start to wonder as to the Fed's thinking in establishing this 2 percent inflation goal, as opposed to a 0 percent inflation goal. To the Fed's credit, they seem to have anticipated such a question and have posted on the Board of Governors website a brief statement, "Why does the Federal Reserve aim for 2 percent inflation over time?" http://www.federalreserve.gov/faqs/economy_14400.htm In this statement the Fed states that inflation above 2 percent is to be avoided because this would be harmful to the economy, a claim that most would seem to accept. The statement goes on to explain why a rate of inflation below 2 percent is not desirable: "a lower inflation rate would be associated with an elevated probability of falling into deflation … -a phenomenon associated with very weak economic conditions." The argument here is that if people come to expect lower prices in the future they will postpone consumption and make the economy weaker.

Putting the pieces together then, the Fed wants to avoid prices falling in our economy so much that they are aiming at doubling the price level in one's work life. That is, the risk of prices falling is so troublesome that the goal of price stability should be thrown out the window. I don't know about you, but this strikes me as the wrong reason to establish a long-term goal, when the Fed already has a goal of avoiding very weak economic conditions, as well.

In the meantime, when you see prices for stuff you buy start to rise again more rapidly, don't be surprised: The Fed has told you that is what they want. And if you are going to retire in 35 years, plan to have twice the income you think you would need today. With this long-term stated inflation rate goal in mind, the current Fed zero interest rate policy (ZIRP) appears very outdated, and in need of change. The Fed's current policy and long-term goal are doubly penalizing savers and retirees.

Scott E. Hein

Robert C. Brown Chair in Finance and Faculty Director, Texas Tech School of Banking, Rawls College of Business, Texas Tech University, Lubbock, TX