BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

FOMC SECRETARIAT

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To: Federal Open Market Committee

From: Vincent Reinhart

Via: Subcommittee on Communications

Subject: Discussion at the Upcoming FOMC Meeting

The schedule for the second day of the upcoming two-day FOMC meeting includes time for a discussion of steps the Federal Reserve might consider to determine and communicate a numerical specification of its long-run price stability objective. The Subcommittee on Communications decided to begin with consideration of this item based on the interest expressed in this topic during FOMC meetings and the conversations its members had with meeting participants. But this will be only an initial step: At subsequent meetings, the FOMC will also consider the central tendency forecast and the monetary policy report; the statement—including contents and ownership; the minutes; and the details associated with selection of a numerical price stability objective (if the Committee decides to go in that direction at this meeting). Many of these items are related and may ultimately be best decided as a package. One consequence of this observation is that if any decisions are made at the October meeting or subsequent meetings, they might be considered as only preliminary, tentative, and subject to revision and reconsideration as other elements are discussed and as the Committee considers the implications of the entire set of changes taken together.

As for the October meeting, the attached decision tree could be used as a device to help organize the discussion of the long-run price objective by suggesting several key questions that could be addressed in the opening go-round. That those questions are organized in a flow chart does not imply that the Committee's decisions have to be made in a rigid sequence. Rather, each limb of the schematic spells out the collection of determinations—including the technical matters in the bottom row—that would have to be made to arrive at the choice of a specific way of communicating the Committee's long-run objective.

The limbs of the decision tree are not all mutually exclusive routes. The Committee may decide to pursue more than one route to communicating the long-run price objective at the same time, either because the alternative methods are viewed as reinforcing each other or because multiple approaches may ensure some measure of progress even if an unexpected obstacle were to emerge in the pursuit of one of them. For instance, the Committee might see some merit in providing a numerical specification of its price stability objective in an annual vote while routinely publishing a central tendency forecast that spans a longer period than under current practice; the central tendency forecast might be seen as providing reassurance to the public that the Committee has a plan to reach its inflation objective as well as a useful fallback position if political objections to a formal numerical specification emerge.

The discussion below splits the questions into two groups. The first are relatively high level and consider general properties of quantifying the price stability objective. The second are more technical in nature and are specific to individual proposals. At this early stage, the Committee may want to focus on those technical details only to the extent that they make a material difference in the attractiveness of a specific proposal.

Three Fundamental Questions

The decision tree is laid out to focus attention on three issues (which are highlighted in yellow) related to the specification of the long-run objective of price stability.

1. Is an explicit numerical specification of price stability helpful? Participants might want to speak initially to their own assessments of the costs and benefits of the quantification of the price stability objective. In particular, it would be helpful to indicate the potential changes at the margin relative to the status quo produced by more specificity.
2. How will the FOMC choose an inflation objective? As a governance issue, the Committee could view the quantification of price stability as a decision to be arrived at jointly, analogous to the annual selection of ranges for the monetary aggregates from the 1970s to the 1990s or to the passage of a standing resolution that remains binding until superseded. Alternatively, members may take it as their individual responsibilities to interpret the instructions from the Congress against the backdrop of their own beliefs about the functioning of the economy and the public's welfare. To force a common view on the appropriate long-run goal, in this interpretation, could unduly constrain the gains to be had from the Committee's diversity. The central tendency forecast might be seen as a potentially useful means to

convey a consensus view on the price stability goal. This could be accomplished implicitly by extending the horizon of the forecast sufficiently so that the out-years of the projection reveal more about policy intentions and less about initial conditions. As currently structured, though, the central tendency forecast also includes participants' views on real GDP growth and the unemployment rate. As a consequence, lengthening the forecast horizon would also convey information about the Committee's views on the rate of growth of potential output and the natural rate of unemployment. A more explicit signal about the Committee's ultimate objective might be sent by surveying participants about their working definition of price stability. Such an approach would allow the Committee to be less specific about the other attributes of the longer-run structure of the economy as well as about the anticipated contours of inflation—a different that might or might not be seen as an advantage.

3. <u>Will the quantification of the long-run objective serve as a new influence on policy setting</u>? Some participants may view the quantification of price stability as merely better explaining existing Committee practice. That is, there is no reason to change from the way policy has been conducted in the past, but there may be potential benefits of increasing transparency about the Committee's long-run inflation objective and of preventing backsliding by future Committees. For other FOMC participants, quantifying the long-run objective for price stability may be seen as a means of making more pervasive changes in Committee practices. If that is the case, it would be important to convey some sense at the meeting of how the policy process

and outcomes may change as a result and the benefits and costs that are expected to accrue.

Other Questions

There are limits to how general the discussion at the upcoming meeting can remain and still be productive. Technical details (as sketched out in the blue boxes) might enhance the allure or dim the luster of some proposals. It would be helpful if participants identified instances where decisions in the blue boxes might materially affect a decision. For instance, the choice of the period over which price stability is defined could have significant consequences for the conduct of policy. Presumably, a shorter time frame would imply a tighter constraint on policy choice than would a longer one. Other technical details, such as the choice of price index and whether it is measured by its headline or core component, might better be deferred at this stage.

Issues related to the specification of price stability