A SURVEY OF EXPERTS

The Four Percent Solution

What are the chances that a significant minority in the U.S. Congress, feeling the pain their constituents are experiencing from higher interest rates and economic slowdown, some time in 2023 urges the Federal Reserve to raise its inflation target from 2 to 4 percent?

How would such a request be received by the Fed leadership? Welcomed relief? Or a message that time is running out and the Fed needs to be even more preemptive in its tightening?

More than a dozen expert analysts rate the chances on a scale of one to ten.

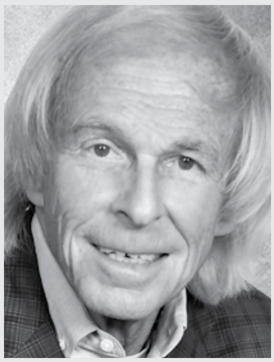
On a scale of one to ten, a three.

EDWIN M. TRUMAN

Senior Fellow, Mossavar-Rahmani Center for Business and Government, Harvard Kennedy School, former Assistant Secretary for International Affairs, U.S. Treasury, and former Director, International Finance, Federal Reserve Board

How likely: three.

The Fed leadership would have to listen to such a request and prepare a thoughtful response, but I suspect they would reject the idea for now. First, it is necessary to get the inflation rate into that range before moving the goalposts. Second, it is not wise to move the goalposts. Third, we are not likely to be in that range in 2023. Fourth, we will address in our upcoming review.



The odds are high, on a scale of one to ten perhaps eight, that the public and U.S. Congress will pressure the Fed to raise its price inflation target.

ALLEN SINAI

Chief Economist/Strategist and President, Decision Economics, Inc.

Price inflation in the United States, although it has peaked and is diminishing, likely will remain entrenched high over the next year or two, in a 4–6 percent range, then perhaps lower thereafter but far above the Federal Reserve's price stability target of 2 percent.

The Fed, almost messianic and religious in its zeal, is determined to achieve the 2 percent inflation target in order to all by itself reach "price stability." This is seemingly regardless of the potential recessionary effects of their actions and very likely rising unemployment.

Continued next page

Sinai, *continued*

But it is extremely difficult to see anywhere near achievement of that target within any reasonable time horizon.

Historically, once the "Inflation Genie Is Out of the Bottle" and the inflation dynamics of the inflationary process are well in train—regardless of the initial inflation impulses whether energy, demand-pull, supply-side, or from external shocks—sticky high and entrenched inflation is the result.

Rising interest rates alone, induced or central bank-driven, historically have not and cannot alone bring down inflation, especially the case in this episode, which is demand-side and supply-side, similar to the 1960s, 1970s, 1980s, and 2000s without financial disarray, credit crunches, potentially a financial crisis, and unacceptably high unemployment.

As this becomes increasingly evident, the odds are high, on a scale of one to ten perhaps eight, that the public and U.S. Congress will pressure the Fed to raise its price inflation target or at least modify its targeting approach.

Given its current policy stance and price stability objective, any potential hike in the inflation target likely will be rejected by the Fed.

As an institution, the U.S. central bank typically is slow to change, only doing so after extensive damage is done and the need to alter its approach becomes clear and obvious.

The coming future looks unlikely to differ from the past. The U.S. central bank thus should change its inflation target and approach preemptively.

There is nothing magical about what is a central bank myth, 2 percent inflation as "price stability." Under Chair Alan Greenspan, price stability was defined as not too much acceleration nor too much deceleration of inflation—a qualitative, rather than numerical, target, which left room for the normal variations in a dynamic economy of price inflation around a basic trend.

Lots of alternatives to the current inflation targeting approach and target exist that would be associated with a different pattern for interest rates and for reducing the Fed's balance sheet—all with economic, inflation, and unemployment consequences.

Rather than pick another price inflation target in response to mounting criticism and concern, a staged targeting approach likely would result in a tapering of interest rate increases and prevention of destructive financial disarray and credit restraint, historically a prelude to recessions that didn't have to happen.

Targeting a graduated approach of reductions toward 2 percent is one way. For example, this year 4 percent on price inflation for the consumption deflator, then 3 percent end-2023 and 2024, and 2 percent thereafter—thus accounting for, and allowing, the long lags of inflation behind changes in monetary policy to unfold without undue damage to the economy and unemployment.

Choosing the paths of interest rates and sales of securities from the Fed's balance sheet to achieve a graduated and staged decline of inflation would be less punitive to the economy, jobs, and unemployment than strictly adhering to a 2 percent inflation target, and reduce unnecessary volatility in financial markets that is part of the current approach.

Zero.

JAMES K. GALBRAITH

Lloyd M. Bentsen, Jr., Chair in Government/Business Relations, LBJ School of Public Affairs, University of Texas at Austin, and drafter of the monetary policy provisions of the original version of the Humphrey-Hawkins Full Employment and Balanced Growth Act

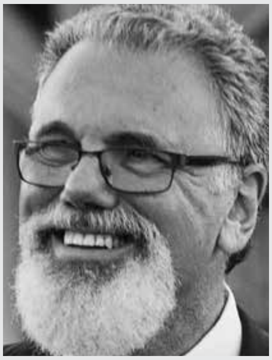
The Federal Reserve is a creature of Congress and subject to the full employment mandate of the Humphrey-Hawkins Act. It is also required to account to Congress for the conduct—or misconduct—of monetary policy and has done so since 1975. Members of Congress are within their rights to exercise oversight and to specify objections to Chair Jay Powell's neo-Volcker policies—if those policies continue, now that inflation is visibly slacking off. But on a scale of one to ten, the chance that a "significant" group in Congress would couch an appeal in the politically catastrophic jargon of a higher inflation target is … well, it's zero, or if possible even less.

A two.

MICHAEL J. BOSKIN
Tully M. Friedman Professor of Economics and Wohlford Family Hoover Institution Senior Fellow, and former Chairman, President's Council of Economic Advisers

I'd give this a two. There likely will be a few demanding the Fed raise its inflation target, some ignorant, some reckless, some seeking media attention.

You never know what nervous elected officials will do, but 4 percent will still seem quite high to most voters, who got used to 2 percent or less for decades. In fact, nobody under sixty had seen high inflation in their working lives until the recent inflation surge. And recall, when President Richard Nixon imposed wage and price controls when inflation rose to 4 percent, the results were disastrous. The eventual toll on the economy—to output and employment—would be much worse if the Fed did raise its inflation target to 4 percent, in part because even fairly predictable inflation of 4 percent will create much worse distortions in the economy and in part because it would be far more difficult to keep it there in a stable predictable mode.



They'd be better off asking for a "pause."

EV EHRLICH
President, ESC Company

There are still enough centrists among the Democrats on Capitol Hill—and in the White House—to avoid a "significant majority" from putting demands on the Fed, and the Fed would surely ignore such a demand were it to occur. That's particularly true after an election that made clear the centrists are keeping the Democrats afloat.

Most (not all!) of the current inflation is due to exogeneities—Ukraine, Chinese Covid policies, supply-chain issues, Saudi political considerations, and the like. Fitting aggregate demand into that truncated available aggregate supply is a tough row to hoe. But a "4 Percent Solution" would be widely viewed as a surrender and would lead inflationary expectations to skyrocket. If the Elizabeth Warrens need to make a demand, they'd be better off asking for a "pause" in rate increases to get a better sense of the effects of policy to date, and to build support for such a strategy among economists. To talk to central bankers, you need to sound like them, not like aggrieved claimants.

Inflation is clearly slowing.

DEAN BAKER
Senior Economist, Center for Economic and Policy Research

I would put it at two. Inflation is clearly slowing, so I expect the Fed will soon be done with its hikes. It may start cutting not long into 2023. But the biggest reason I don't see an ask for a higher target is that it is way too technical to have political appeal. If they are writing a letter to the Fed, they want credit for something their constituents would understand. That means the letter would be asking for lower interest rates, not a higher Fed inflation target.

It's 100 percent likely that a minority will be pushing back. The odds are much lower that the opposition will coalesce around any particular number.

ROBERT E. LITAN
Non-Resident Senior Fellow and former Economic Studies Director, Brookings Institution

It's 100 percent likely that a minority will be pushing back on the Fed to ease up on monetary tightening, though the odds are much lower (less than 50 percent) that the opposition will coalesce around any particular inflation number.

While economists and those who read this magazine are into the debate about inflation targeting, and what number to pick, this is not how politicians think. Rather, as unemployment inevitably rises, the political voices saying "stop" or "slow down" simply will get louder and louder. How loud will depend on how fast the inflation rate comes down, a prospect that models built on historical data are not well-suited to predict in this different sort of "supply shock" world—and the shocks themselves, whether from the war in Ukraine, more angst about, or even military action by China to take Taiwan, or a renewed bout of Covid, may still keep coming.

As to whether the Fed (Chair Powell) accedes to a higher inflation target at some point, that all depends on how much pain the current anti-inflation monetary campaign inflicts. My guess is that if the Fed could get inflation down to 2 percent with unemployment no higher than 6 percent, it would stick to its guns. Unemployment much higher than that for any sustained period with inflation still stuck at our near-4 percent would change the Fed's calculus, in my guestimate, pushing it to implicitly settle for a 3 percent inflation target rather than 4 percent.

The Fed leadership will not change its target rate of inflation.

MARTIN NEIL BAILY
Bernard L. Schwartz Chair in Economic Policy Development and Senior Fellow and Director of the Business and Public Policy Initiative, Brookings Institution

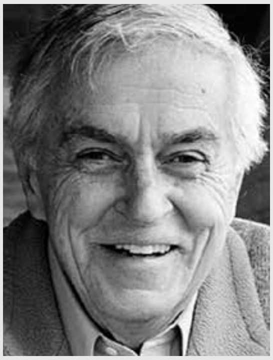
The Fed leadership will not change its target rate of inflation. To do so now would be seen as giving in to inflation, whereas the Fed is determined to maintain inflation expectations at around 2 percent. On the scale of one to ten, the chances of a significant minority in Congress urging the Fed to change its target is about two because most constituents today are complaining that inflation is too high. As the economy slows, more people will complain about the lack of jobs, but they do not have a tradeoff model in mind. They want plentiful jobs and low inflation and are very unlikely to urge their representatives to raise the inflation target. The inflation target is important but is an "inside the Beltway" issue for most voters.

Should the Fed raise the target? No. Certainly not at this time and probably not ever. The Fed can adjust policy in the event of a serious downturn without changing its target. After all, inflation was below the target often before the pandemic. The Fed does not have direct control over inflation, only over its policy levers. It can keep the 2 percent target and adjust policy to the needs of the economy.

A two.

STEVEN B. KAMIN
Senior Fellow, American Enterprise Institute, and former Director, International Finance, Federal Reserve Board of Governors

I attach a ranking of two to the likelihood that a significant minority of Congress will ask the Fed to raise their inflation target in response to the hardships associated with sustained high interest rates. To be sure, it is almost certain that Congressional representatives will urge the Fed to reverse their monetary tightening if and when the economy falls into recession. But with inflation likely to remain political anathema into the coming year, it is exceedingly doubtful that politicians will call for a higher inflation target. Nor would the Fed welcome such a call, as it would (rightly) fear that lifting the target would damage its credibility. Note that I assess the likelihood at two rather than its lowest value of one—in these topsy-turvy times, anything is possible!



A three.

RICHARD D. ERB
Former Deputy Managing Director, International Monetary Fund

Chance of a significant 4 percent inflation target minority in 2023: Three on a scale of one to ten..

But if "significant," the Fed will ask two questions. First, how strong is the minority's analytical base in financial markets and foreign central banks? And second, how strong is the minority's political base relative to low-inflation political forces?

If in 2023 the answer to both questions is "strong," the Fed would not change its 2 percent policy framework but would wisely, *de facto,* pursue a slower downward inflation adjustment.

A three.

GREGORY D. HESS
President and CEO, IES Abroad, and Member, Shadow Open Market Committee

I would give it a three! An increase in policy rates always brings controversy, and I have published research demonstrating that the number of U.S. congressional bills written that target the Federal Reserve system increases with misery—inflation plus unemployment. However, the Fed always circles the wagons when it fears interference and the urging will be counterproductive. Operationally, the Federal Open Market Committee will politely ignore or somehow fail to directly respond to any urging to change their numerical target for price stability from 2 percent to 4 percent and stick to a fast pace of tightening despite the fact that at least a couple of dovish FOMC members (currently wearing hawk's clothes) would likely prefer the target inflation rate to be north of 2 percent.

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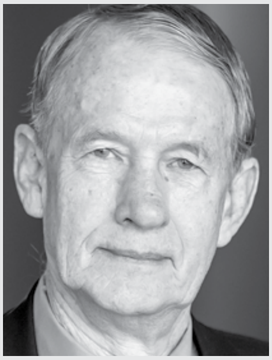
A five.

CHRISTOPHER WHALEN
Chairman, Whalen Global Advisors

Five. There are a number of members of Congress and organizations (the Peterson Institute for International Economics) criticizing the Fed's tightening and with good reason, but none have a real idea of what to ask for from the Federal Open Market Committee. Clearly 2 or 3 percent inflation is not in alignment with the mandate for price stability, thus the Fed may ignore such requests. Angst over Fed tightening may accelerate the process of eventually repealing the conflicted and impractical Humphrey-Hawkins law, which is the fundamental problem for monetary policy today. But for Humphrey-Hawkins, there would never have been "quantitative easing."



A six.

GARY CLYDE HUFBAUER
Nonresident Senior Fellow, Peterson Institute for International Economics

Given their fondness for Modern Monetary Theory, progressive Democrats will push to raise the inflation target to 4 percent. On a scale of one to ten, the reading could be six. But the Federal Reserve will not deviate from the 2 percent target. The target may be arbitrary, but the credibility cost of deviation would be huge. At most, Fed members may stretch out the time horizon to achieve 2 percent.

A two.

W. BOWMAN CUTTER
Senior Fellow and Director, Economic Policy Initiative, Roosevelt Institute

Chance: a two. I am sure that there are members of Congress who might want to do such a bizarre thing, but I cannot imagine that any substantial number would make a serious effort. If the unthinkable were to happen, the Fed institutionally would have to ignore the request and it would be correct to do so. I don't think the Fed would become more preemptive—its course is pretty tough already.