Daiwa's View

What is average inflation targeting? Purpose, format, and market implications

- Depending on the format and implementation, could be a powerful easing scheme

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On 5 August, former Fed Chair Janet Yellen said that the Fed would complete the strategic review of its monetary policy framework by September and could implement average inflation targeting (AIT). She said that the Fed would proactively prefer a slight overshoot of 2% under an average inflation targeting regime, noting that this announcement would give the Fed's commitment to keep interest rates low for an extended period more credibility with the market, and likely stimulate economic activity and boost inflation.

◆ **Former Fed Chair Janet Yellen** (5 Aug 2020)
・Instead of saying that it (Fed) is always aiming for 2% inflation, regardless of how inflation has actually behaved and evolved in the past, I anticipate that it will indicate a desire for inflation to average roughly 2% over time." Such an announcement would provide the market confidence in the Fed's commitment to keep rates low for a long time and would spur activity and push up inflation. ...The Fed would consider it positively desirable to overshoot 2% somewhat. …The Fed may well do more in coming months as reopening proceeds and its outlook for inflation, jobs and growth becomes somewhat clearer.

◆ **Motivation behind the monetary policy framework review**

As we noted in our previous report, the Fed will announce the results of its policy review at the September FOMC meeting, which the consensus believes will entail shifting to a makeup strategy using a soft average inflation target. The original motivation behind the Fed's policy review, as indicated by former Fed Chair Janet Yellen in a speech at Jackson Hole in 2016, is that the global decline in neutral interest rates makes it more likely that policy rates will hit the effective lower bound during recessions, thereby limiting the tools available for monetary easing. The flattening of the Phillips curve has brought with it concerns that long-term inflation expectations will destabilize and decline.

Particularly when rates are at their effective lower bound, if actual inflation and inflation expectations remain below the 2% target, there is a risk that this will change the expectations of the market (households and businesses) and fix them below 2% (Japanization). If inflation expectations decline, actual inflation will decline even more, depressing economic activity in a downward spiral (bad equilibrium). This was eloquently expressed in the following comments by New York Fed President John Williams.

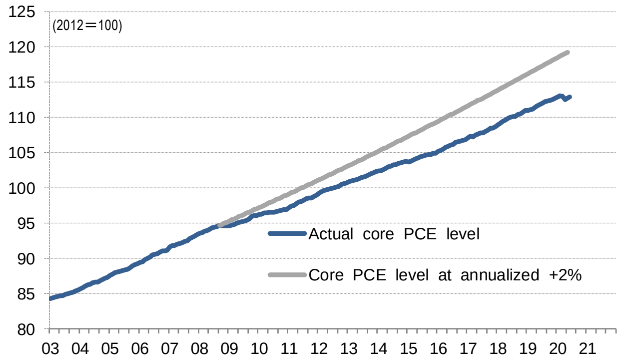
◆ **New York Fed President John Williams** (30 Nov 2018)
・Say that 80 percent of the time, the lower bound on interest rates does not constrain policy and the central bank aims for a 2 percent target inflation rate. During these "good" times, an inflation-targeting central bank aims to keep inflation near 2 percent. But, 20 percent of the time, the economy falls into a recession that's severe enough that the lower bound constrains policy. Assume that during these periods, inflation averages only 1 percent. So, 80 percent of the time inflation averages 2 percent and 20 percent of the time inflation averages 1 percent. The resulting average rate of inflation is about 1.8 percent. As a consequence, inflation expectations are likely to become anchored at the long-run average of 1.8 percent, below the desired 2 percent target.

◆ **Average inflation targeting as a "makeup strategy"**
As is the case here, the 2% inflation target currently used by the Fed consistently targets 2% irrespective of the previous inflation trend (former Fed Chair Janet Yellen). In other words, because it is a "let bygones be bygones" strategy, the previous inflation trend has no impact on current policy decisions.

In contrast, average inflation targeting is considered a "makeup" strategy. Under this framework monetary policy aims to make up in the future any past deviations in inflation from the 2% target.

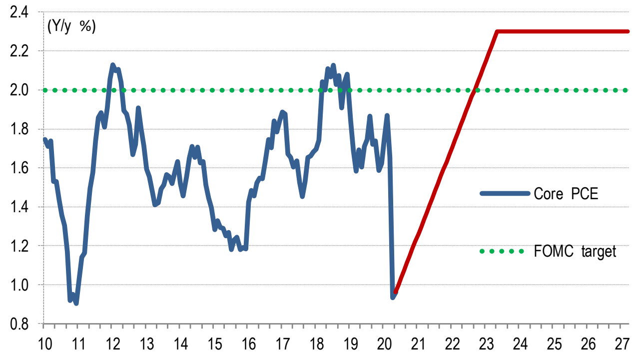
A makeup strategy can take many forms, including price level targeting, temporary price level targeting, and nominal income targeting, but the Fed is currently leaning toward average inflation targeting because it is not far from current policy and therefore easier to communicate. In fact, Fed Governor Lael Brainard has expressly supported this in several speeches she has given previously. More recently, San Francisco Fed Bank staff published an Economic Letter[1] arguing that average inflation targeting is "a monetary policy framework that is well suited for the current environment."

Price Level Targeting



Source: US Department of Commerce; compiled by Daiwa Securities.

Average Inflation Targeting



Source: US Department of Commerce; compiled by Daiwa Securities.

◆ **What is average inflation targeting?**
Average inflation targeting is generally understood to aim for a long-term average inflation rate of about 2% (Fed Chair Janet Yellen). In other words, it will make up for when the inflation rate falls below 2% during a recession by targeting an inflation rate above 2% (overshoot) during the economic expansion. Consequently, monetary policy seeks to have periods when inflation is below 2% offset by periods when it is above 2%, over time achieving average inflation of 2%.

There are many different ways to do this, however, depending on the length of time over which the average is calculated (3yrs, 5yrs or 10yrs?) and how high the inflation overshoot during expansion is set (2.25% or 2.5%?). The San Francisco Fed staff report gave two examples of approaches to average inflation targeting: averaging over a fixed time window and averaging over the business cycle.

◆ **Average inflation targeting formats**
Under the former approach, a 2% target is set for the moving average of current and past inflation over a specific time period. The San Francisco Fed staff report referenced research showing that a 2-year period is effective. In that case, policy would be set so as to achieve, under whatever circumstances, a 2% average over the next two years. This is a quite strict approach.

Under the latter approach, policy targets an inflation rate averaging 2% over the entire business cycle. Because inflation is likely to fall below target during a deep recession, the Fed aims to overshoot the 2% target during the expansion so that inflation averages the target throughout the business cycle. This approach is more flexible than the first one described.

[1] Renuka Diwan, Sylvain Leduc, and Thomas M. Mertens (2020) "Average-Inflation Targeting and the Effective Lower Bound."

We noted in the introduction that the consensus is that there will be a transition to a soft average inflation target, meaning the Fed is more likely to adopt the second, more flexible approach. For example, in a speech she gave in February, Fed Governor Lael Brainard said the following. "Following several years when inflation has remained in the range of 1-1/2 to 2%," as occurred over the past decade, the Fed "could target inflation outcomes in a range of 2 to 2.5% for a period to achieve inflation outcomes of 2%, on average, overall." Noting that this approach is flexible because it does not use an automatic inflation averaging rule, she supported "flexible average inflation targeting."

◆ **Governor Lael Brainard** (21 Feb 2020)

・While formal average-inflation-targeting rules have some attractive properties in theory, they could be difficult to communicate and implement in practice due to time-inconsistency problems as well as uncertainty about underlying economic parameters. I prefer flexible inflation averaging that would aim to achieve inflation outcomes that average 2 percent over time.

・Flexible inflation averaging would imply supporting inflation a bit above 2 percent for some time to compensate for the inflation shortfall over previous years and anchor inflation expectations at 2 percent. Flexible inflation averaging would bring some of the benefits of a formal average-inflation-targeting rule, but it could be more robust and simpler to communicate and implement. Following several years when inflation has remained in the range of 1-1/2 to 2 percent, the Committee could target inflation outcomes in a range of 2 to 2-1/2 percent for a period to achieve inflation outcomes of 2 percent, on average, overall.

The level of inflation overshoot would be between 2% and 2.5%, and 2.5% would likely be the maximum. Dallas Fed president Robert Kaplan recently remarked "I would be willing to see inflation run moderately above 2% in the aftermath of periods where we've been running persistently below," noting that he would be "comfortable with inflation of 2.25% or 2.375%." Under a soft average inflation targeting strategy, exact numbers will probably not be specified.

◆ **Chicago Fed President Charles Evans** (3 Aug 2020)

・Won't need to raise rates unless inflation heads to 2.5%

◆ Problems and risks with average inflation targeting

Of course, a strict average inflation target automatically applied to specific time frames and inflation rates would theoretically have significant policy affects, but the trade-off is that it would make policy less discretionary. This is the reason why the Fed is leaning toward adopting a flexible (soft) approach rather than a strict approach.

Because average inflation targeting and other makeup strategies provide easing over a longer time frame than do conventional inflation targeting strategies, there is an increased risk of financial instability (financial imbalances and/or bubbles). It is also possible to add a mechanism, such as a crisis management clause, that allows for adjustments to the policy plan if the Fed has serious concerns about the risk of financial instability.

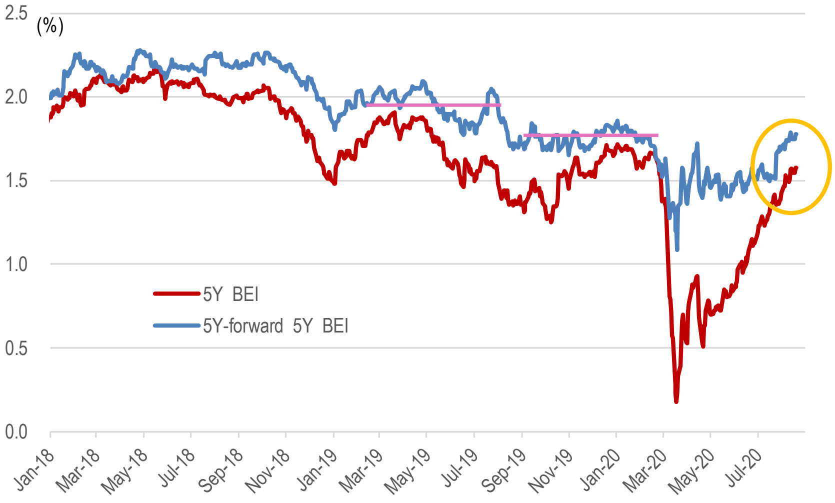
◆ Market implications

Even when adopting such a soft approach, once the policy framework itself is changed, the Fed's actions would be strongly bound by the strategic framework. In this sense, as described by the San Francisco Fed staff report, "the underlying mechanism [of average inflation targeting] is thus similar to forward guidance but can be applied more systematically because inflation overshooting is codified in the framework[2]." As a result, future inflation promises might be viewed as more credible." This change in framework should be able to provide a sustained tailwind for risk assets over a longer period of time.

It is no coincidence that immediately after release of the June FOMC minutes on 1 July revealed the suggestion that the strategic review would be completed within the near term, there was a slight upward shift in the inflation expectations implied by the 5-year forward 5-year rate that the Fed focuses on.

[2] The Fed plans to change its framework through revision of its Statement on Longer-Run Goals and Monetary Policy Strategy. One way it could do this is by adding the word "average" before inflation in this section of the text in that document: "The Committee reaffirms its judgment that inflation at the rate of 2 percent, as measured by the annual change in the price index for personal consumption expenditures, is most consistent over the longer run with the Federal Reserve's statutory mandate. The Committee would be concerned if inflation were running persistently above or below this objective."

US Inflation Expectations (5Y BEI, 5Y-forward 5Y BEI)



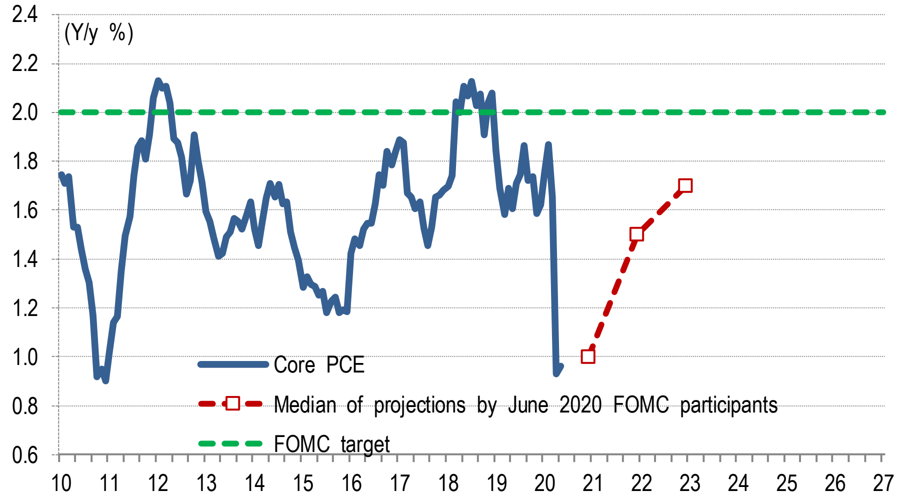
Source: Bloomberg; compiled by Daiwa Securities.

Meanwhile, as suggested by Fed Vice Chair Richard Clarida, who led the strategic review, when he said in [a speech](#) "our review is more likely to produce evolution, not a revolution," this latest change is unlikely to result in a regime change that sparks major discontinuous change in people's price perceptions (inflation expectations).

Under these conditions, even if the decline in inflation (that portion below 2%) since the pandemic began is made up, based on the Fed's estimate at its June FOMC meeting that inflation will average 1.4% over the three year period ending 2022, it would be necessary to makeup on average the 0.6% shortfall (2% -1.4%)[3]. This alone makes it clear that achieving an average of 2% will be challenging.

Of course, the Fed can ensure greater effectiveness by accompanying the change in framework with a change in action, such as by implementing forward guidance tied to the inflation target. However, the difficulty of hitting the target will be exposed with the shift to a soft average inflation target, and if the market recognizes this difficulty and it seeps in, that alone would probably have a major impact on various aspects of the financial environment.

Core PCE Deflator



Source: Fed, US Department of Commerce; compiled by Daiwa Securities.

[3] Here it uses the median outlook for the core PCE deflator. (1% (2020) + 1.5% (2021) + 1.7% (2022)) ÷ 3 = 1.4%. In this case, even if the core PCE deflator ran at 2.5% annualized over the three year period from 2023 to 2025, average inflation over the six years would be 1.95%. If annual inflation ran at 2.25% every year starting in 2023, it would require a 10-year period, ending 2029, for inflation to average 1.995%. If the new 2023 outlook to be announced at the September FOMC meeting is below 2%, it will be that much more difficult to achieve the average.

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[Standard & Poor's]

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February 2020

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