POLICY SPOTLIGHT

Average Inflation Targeting and the Benefits of Offsetting Periods of High or Low Inflation

SCOTT SUMNER | DECEMBER 2021

In 2020, the Federal Reserve (Fed) adopted a new approach to monetary policy called flexible average inflation targeting (FAIT). Under this policy, the Fed commits to maintaining an average inflation rate of 2 percent, as measured in the Personal Consumption Expenditures (PCE) price index, over an extended period. (The news media's focus on the alternative Consumer Price Index can occasionally create the false impression that inflation is running above the Fed's 2 percent PCE target.)

However, the Fed's congressional mandate includes maintaining not only price stability but also high employment. Fed officials believe this dual mandate can best be achieved with a slightly positive average rate of inflation. Indeed, there is now widespread belief that 2009–2016's unusually low inflation rate (which averaged well below 2 percent) slowed recovery from the Great Recession of 2008–2009.

HOW AVERAGE INFLATION TARGETING CAN HELP ECONOMIC RECOVERIES

If the Fed had pursued FAIT after the Great Recession, it would have been able to make up for the close-to-zero inflation of 2009 with inflation slightly above 2 percent in 2010 and later. This strategy would have allowed the Fed to pursue a more expansionary monetary policy, which would have led to a more rapid reduction in the unemployment rate.

During the COVID-19 recession, the inflation rate fell below 2 percent. In accordance with FAIT, however, the Fed committed to bringing the price level back up to the previous trend line, which meant pursuing inflation greater than 2 percent in future years to offset 2020's low inflation. A highly expansionary policy was adopted, and this time the unemployment rate fell rapidly, unlike during the recovery from the Great Recession, when unemployment declined slowly.

SO IS INFLATION A GOOD THING?

The public is often confused by the fact that the Fed sometimes tries to raise inflation to achieve an average rate of 2 percent. The Fed does not believe that inflation itself is good. Rather, the 2 percent average inflation target makes it easier for the Fed to achieve the other part of its dual mandate, high employment.

Going forward, the Fed's challenge is to bring inflation back down to roughly 2 percent to ensure that inflation during the 2020s does not overshoot the Fed's long-run 2 percent target.

FURTHER READING

Scott Sumner, “New Fed Approach Takes Inflation Targeting More Seriously,” *The Hill*, September 17, 2020.

David Beckworth, “A New Way to Manage Inflation,” *The Bridge*, August 27, 2020.

Joseph G. Haubrich and Sara Millington, “PCE and CPI Inflation: What’s the Difference?,” Federal Reserve Bank of Cleveland, April 17, 2014.

Scott Sumner, “The Princeton School and the Zero Lower Bound” (Mercatus Working Paper, Mercatus Center at George Mason University, Arlington, VA, October 2021).

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