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Ending the Fed's Inflation Fixation

The focus is misplaced—and because it delays an overdue interest-rate rise, it is also dangerous.

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The primary role of the Federal Reserve and other central banks should be to prevent high rates of inflation. The double-digit inflation rates of the late 1970s and early '80s were a destructive and frightening experience that could have been avoided by better monetary policy in the previous decade. Fortunately, the Fed's tighter monetary policy under Paul Volcker brought the inflation rate down and set the stage for a strong economic recovery during the Reagan years.

The Federal Reserve has two congressionally mandated policy goals: "full employment" and "price stability." The current unemployment rate of 5% means that the economy is essentially at full employment, very close to the 4.8% unemployment rate that the members of the Fed's Open Market Committee say is the lowest sustainable rate of unemployment.

For price stability, the Fed since 2012 has interpreted its mandate as a long-term inflation rate of 2%. Although it has achieved full employment, the Fed continues to maintain excessively low interest rates in order to move toward its inflation target. This has created substantial risks that could lead to another financial crisis and economic downturn.

The Fed did raise the federal-funds rate by 0.25 percentage points in December, but interest rates remain excessively low and are still driving investors and lenders to take unsound risks to reach for yield, leading to a serious mispricing of assets. The S&P 500 price-earnings ratio is more than 50% above its historic average. Commercial real estate is priced as if low bond yields will last forever. Banks and other lenders are lending to lower quality borrowers and making loans with fewer conditions.

When interest rates return to normal there will be substantial losses to investors, lenders and borrowers. The adverse impact on the overall economy could be very serious.

A fundamental problem with an explicit inflation target is the difficulty of knowing if it has been hit. The index of consumer prices that the Fed targets should in principle measure how much more it costs to buy goods and services that create the same value for consumers as the goods and services that they bought the year before. Estimating that cost would be an easy task for the national income statisticians if consumers bought the same things year after year. But the things that we buy are continually evolving, with improvements in quality and with the introduction of new goods and services. These changes imply that our dollars buy goods and services with greater value year after year.

Adjusting the price index for these changes is an impossibly difficult task. The methods used by the Bureau of Labor Statistics fail to capture the extent of quality improvements and don't even try to capture the value created by new goods and services.

The true value of the national income is therefore rising faster than the official estimates of real gross domestic product and real incomes imply. For the same reason, the official measure of inflation overstates the increase in the true cost of the goods and services that consumers buy. If the official measure of inflation were 1%, the true cost of buying goods and services that create the same value to consumers may have actually declined. The true rate of inflation could be minus 1% or minus 3% or minus 5%. There is simply no way to know.

With a margin of error that large, it makes no sense to focus monetary policy on trying to hit a precise inflation target. The problem that consumers care about and that should be the subject of Fed policy is avoiding a return to the rapidly rising inflation that took measured inflation from less than 2% in 1965 to 5% in 1970 and to more than 12% in 1980.

Although we cannot know the true rate of inflation at any time, we can see if the measured inflation rate starts rising rapidly. If that happens, it would be a sign that true inflation is also rising because of excess demand in product and labor markets. That would be an indication that the Fed should be tightening monetary policy.

The situation today in which the official inflation rate is close to zero implies that the true inflation rate is now less than zero. Fortunately this doesn't create the kind of deflation problem that would occur if households' money incomes were falling. If that occurred, households would cut back on spending, leading to declines in overall demand and a possible downward spiral in prices and economic activity.

Not only are nominal wages and incomes not falling in the U.S. now, they are rising at about 2% a year. The negative true inflation rate means that true real incomes are rising more rapidly than the official statistics imply.

The Federal Reserve should now eliminate the explicit inflation target policy that it adopted less than five years ago. The Fed should instead emphasize its commitment to avoiding both high inflation and declining nominal wages. That would permit it to raise interest rates more rapidly today and to pursue a sounder monetary policy in the years ahead.

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