A NEW FRAMEWORK FOR TARGETING INFLATION: AIMING FOR A RANGE OF 2 TO 3.5 PERCENT

Overview

The Federal Reserve's dual mandate—maximum employment and price stability—has played a central role in economic policy discussion over the last decade. After both the slow recovery following the Great Recession, and the high inflation following the COVID-19 disruption and recovery, many are questioning the wisdom of the Fed's current 2 percent inflation target. In *A New Framework for Targeting Inflation*, Roosevelt Institute fellow Justin Bloesch argues that, instead, the Fed should establish an inflation range of 2 to 3.5 percent. Doing so would provide flexibility in monetary policy, create a better balance of full employment and price stability, and put the economy on a trajectory for sustainable growth.

Why the Fed's 2 Percent Target Is a Flawed Approach

In his brief, Bloesch identifies two main arguments against the current inflation target.

- **Excess unemployment:** A low inflation target generates risks of premature tightening in recoveries and can unnecessarily keep the economy below full employment. In the years following the Great Recession, the Fed, seeing the still-high unemployment rate of 5 percent but assuming the economy had reached "full employment," made an explicitly preemptive move to raise interest rates before inflation reached 2 percent. Yet, unemployment continued to dip with no measurable effect on overall inflation. In this case, the Fed acted too quickly, likely stalling the recovery and leading to years of unnecessarily high unemployment that created years of hardship for millions of families and dragged the economy well below potential.
- **Less accurate diagnoses and remedies for inflation:** The 2 percent inflation target often leads to a misdiagnosis and mistreatment of inflation, causing the Fed to overreact to changes in prices when the sources are uncertain. If inflation is the result of an overheating economy, it may make sense for the Fed to raise interest rates. However, when inflation is caused by sector-specific supply shortages—such as during the pandemic—raising interest rates to reach a 2 percent target could prove counterproductive, stifling investments that build the productive capacity of the economy.

A New Framework: An Inflation Range of 2 to 3.5 Percent

An inflation range is a framework that is realistic about how precisely changes in inflation can be engineered.

- **A range allows for maximum employment without preemptive tightening.** The risk of the Fed overshooting its target and tightening monetary conditions to the point of excess unemployment is much lower with an inflation range, which gives the Fed time and flexibility to assess underlying inflation—particularly during uncertain macroeconomic conditions—and adjust policy accordingly. A wider target can allow inflation to settle at a moderate level while maintaining high employment levels, minimizing the risk of overcorrecting and generating a recession.
- **A range responds to a wide range of unforeseen shocks and circumstances.** Compared to point inflation targets, an inflation range provides flexibility to respond to external events like global conflicts or environmental disasters with appropriate adjustments in monetary policy. With a range, Fed officials could more effectively account for the impact of such circumstances—such as COVID-19 or the Russian invasion of Ukraine—while maintaining a long-term trajectory.
- **A range provides more clarity and certainty in Fed action.** Over the last year, the uncertainty of how far the Fed will go to hit the 2 percent inflation target has generated fear of recession. This uncertainty has shifted economic activity and likely stunted growth. An inflation range could help individuals, companies, and analysts better predict Fed behavior and adjust their investment accordingly.