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THE AMERICAS: Inflation target 'would prevent swing in rates'

 By Alan Beattie in Washington
 Financial Times; Nov 20, 2003

A British-style numerical inflation target would help the US Federal Reserve avoid the swings in long-term interest rates from which the US suffers, a study by Fed economists has concluded.

The study, a discussion paper that does not set Fed policy, found long-term interest rates reacted with surprising sensitivity to data releases and policy announcements.

The authors found movements in expected inflation in the long run seemed to be responsible for generating this volatility.

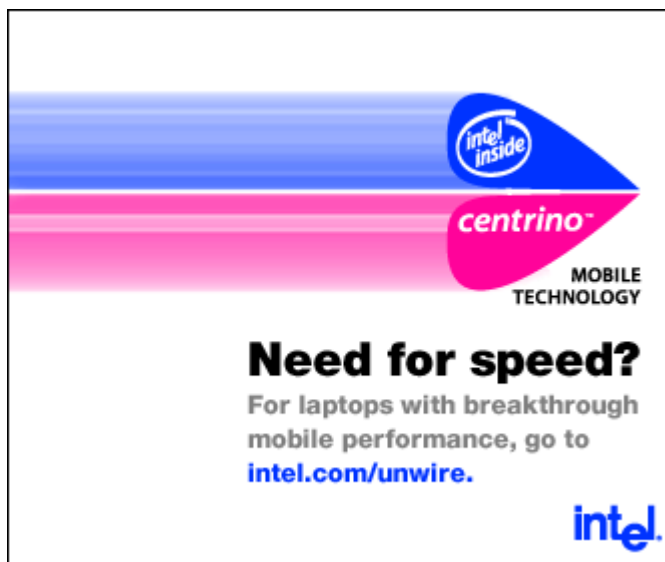
By contrast, the UK saw a marked fall in long-term rate volatility after adopting a formal 2.5 per cent inflation target when the Bank of England gained monetary policy independence in 1997.

The target helped anchor investors' inflation expectations at or around 2.5 per cent even when they were surprised by movements in data or short-term interest rates, the study found.

"The evidence presented from US financial markets suggests that forward rates are unanchored in part because the Federal Reserve does not have a commitment to a specific, known inflation target," the paper said.

"These findings lend support to the view that variation in the perceived long-run inflation target of the Federal Reserve accounts for some of the excess sensitivity of long-term rates."

The Fed has a dual mandate to achieve full employment and price stability but does not


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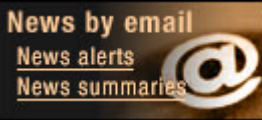


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have numerical targets for either.

Policymakers on the Fed's open market committee are divided about the need to set a formal target for inflation.

Alan Greenspan, the Federal Reserve chairman, has consistently opposed such a target, saying it limits the Fed's freedom of manoeuvre.

Several of his colleagues, notably Ben Bernanke, the former Princeton academic who joined the committee last year, have argued that it would help communication by clarifying the Fed's aims.

Alfred Broaddus, president of the Richmond Federal Reserve, said last week that a target would help in preventing inflation expectations from falling uncomfortably low in the current environment.

More and more central banks have begun adopting inflation targets, including emerging market countries such as Brazil, where it was often thought inflation was too volatile to be effectively targeted.

However, the experience of the European Central Bank, which changed the way its target was presented after complaints that it sowed confusion, has given inflation targeting a bad name in some quarters in the US. <http://www.federalreserve.gov/pubs/feds/>

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