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Did the Federal Reserve Anchor Inflation Expectations Too Low?

By Brent Bundick and A. Lee Smith

In 2012, the Federal Reserve adopted a 2 percent target for inflation to firmly anchor longer-term inflation expectations. Since then, inflation has averaged about 1.4 percent. Modern theories suggest that inflation should eventually gravitate toward measures of longer-run inflation expectations. The tendency for inflation to reside below the Federal Reserve's 2 percent inflation target over much of the past decade raises questions of whether longer-run inflation expectations are anchored—and, if so, whether they are anchored below 2 percent.

Brent Bundick and A. Lee Smith argue that the Federal Reserve's communication of a numerical objective for inflation better anchored longer-term inflation expectations; however, Federal Open Market Committee (FOMC) projections for longer-run inflation from 2009–11 may have anchored them below 2 percent. The authors present evidence that the 2009 addition of longer-run inflation to the FOMC's Summary of Economic Projections (SEP), together with the eventual adoption of a longer-run 2 percent inflation objective in 2012, made investors' inflation expectations more stable. At the same time, SEP projections for longer-run inflation from 2009 to 2011 generally resided below 2 percent, which may have led inflation expectations to anchor below 2 percent.

How You Say It Matters: Text Analysis of FOMC Statements Using Natural Language Processing

By Taeyoung Doh, Sungil Kim, and Shu-Kuei Yang

The Federal Reserve has increasingly used public statements to shape expectations about future policy actions. After the Great Recession, when the nominal short-term interest rate reached its effective lower bound, the Federal Open Market Committee turned toward explicit forward guidance about the future path of the policy rate as well as the amount and composition of large-scale asset purchases in their post-meeting statements. Although these statements sometimes included quantitative information, they also included more nuanced, qualitative descriptions of economic conditions. However, measuring the effects of these qualitative communications is not straightforward.

Taeyoung Doh, Sungil Kim, and Shu-Kuei Yang use a natural language processing tool to provide a new measure of how changes in qualitative descriptions of the economy in post-meeting statements affect bond prices. They find that qualitative descriptions of economic conditions and

the balance of risk can have as much of an effect on bond prices as quantitative information about the target policy rate. In some cases, the tone of the Committee's statement can affect financial market conditions even if no policy action is taken. Their new measure is generally correlated with alternative measures in prior research based solely on bond price data, and particularly well correlated with medium-term policy expectations.

The Evolving Link between Oil Prices and U.S. Consumer Spending

By Nida Çakır Melek and Robert J. Vigfusson

Oil prices have fluctuated widely since the 1970s. Historically, consumers have tended to increase spending on non-oil goods and services when oil prices decline and cut back on such spending when oil prices rise. However, this relationship may have changed more recently. The U.S. oil sector has increased in importance in the last decade, and consequently the United States has become less reliant on oil imports. Moreover, gasoline expenditures have fallen as a share of households' budgets. As a result, price swings may no longer have the same effect on U.S. consumption.

Nida Çakır Melek and Robert J. Vigfusson look at two channels through which oil price changes affect consumption—the discretionary income channel and the oil producer channel—and provide evidence that the effect of oil price changes on consumption has become more muted. Their analysis suggests changes in oil prices are less likely to yield major changes in consumption, even among lower-income households.

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