INFLATION TARGETING AFTER THE CRISIS

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IT is still a sound framework for monetary policy.

But the practice of IT should be amended:

- Policymakers should have an explicit employment mandate.

- The level of the inflation target should be at least 4%.

- Central bank independence should not be excessive.

[continued]
• Policy should seek financial stability and orderly capital flows.

• Policymakers should use multiple instruments. (Which instruments are best??)

• IT is better than nominal GDP targeting.
IT Is a Sound Framework

- Monetary policy should ensure that inflation is a stationary process; thus the inflation rate should have some long-run mean.

- Policymakers should agree on this long-run inflation rate and announce it to the public.
An Explicit Employment Objective

- Dual mandate in U.S.

- Stabilizing inflation does NOT guarantee acceptable behavior of unemployment, even in the long run. Demand shocks can raise unemployment permanently unless policy responds. ("Hysteresis"; Ball, 2009)
Unemployment Rate - Colombia

Disinflation Begins

Year

Unemployment Rate - Korea

Financial Crisis
Unemployment Rate—United States

Disinflation Begins

Financial Crisis
Many IT central banks have implicit employment objectives.

But some take a single mandate literally.

Jean-Claude Trichet, September 2011:

“We have delivered price stability over the first twelve years of the euro -- impeccably! Impeccably! I would very much like to hear congratulations...”
Central Banks Should Not Be Too Independent

- In a democracy, it should be OK for elected leaders to comment on monetary policy.

- In particular, central bankers can become overly close to the financial sector and/or overly concerned about inflation. Political leaders can remind central bankers of the importance of employment.
What Level of Inflation?

- Targets in advanced economies are approximately 2% (Federal Reserve, ECB, Bank of England, Bank of Canada....)

- This is too low. Recessions push interest rates to the zero bound, preventing sufficient monetary stimulus. Japan, 1997; U.S., 2008.

- Ball (2013): If U.S. had 2% target since 1960, interest rates would have hit zero in many recessions.
Table 1: Recessions and Interest Rates

<table>
<thead>
<tr>
<th>Recession</th>
<th>Inflation Rate at Start</th>
<th>Maximum Unemployment Rate</th>
<th>Minimum Federal Funds Rate</th>
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<tr>
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<td>Nominal</td>
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<td>Real</td>
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<td>1960:4 - 1961:2</td>
<td>2.00</td>
<td>7.10 (1961:05)</td>
<td>1.17 (1961:07)</td>
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<td>-0.14 (1961:07)</td>
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<td>-2.31 (1971:02)</td>
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<td>1973:11 - 1975:3</td>
<td>4.73</td>
<td>9.00 (1975:05)</td>
<td>4.61 (1977:01)</td>
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<td>-5.80 (1975:03)</td>
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<td>-4.13 (1980:06)</td>
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<td>1.71 (1986:09)</td>
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<td>-0.55 (1993:02)</td>
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<td>2001:3 - 2001:11</td>
<td>2.61</td>
<td>6.30 (2003:06)</td>
<td>0.98 (2003:12)</td>
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<td>-0.96 (2001:12)</td>
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<td>-2.19 (2012:01)</td>
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Countries with 2% targets should raise them to 4%.

- This would greatly reduce the zero-bound problem.

- No evidence that 4% inflation has significant costs.

Krugman (1997):

One of the dirty little secrets of economic analysis is that even though inflation is universally regarded as a terrible scourge, efforts to measure its costs come up with embarrassingly small numbers.

- Paul Volcker reduced U.S. inflation to 4% in 1980s. This was the “conquest” of inflation.
Why not 4% inflation?

Bernanke (2010, Jackson Hole):

“Inflation would be higher and probably more volatile under such a policy.... Inflation expectations would also likely become significantly less stable.”

Bernanke (2010, Congressional testimony):

“The Federal Reserve, over a long period of time, has established a great deal of credibility in terms of keeping inflation low, around 2%.... If we were to go to 4% and say we’re going to 4%, we would risk a lot of that hard-won credibility, because folks would say, well, if we go to 4%, why not go to 6%? It’d be very difficult to tie down expectations at 4%.”

[continued]
Mishkin (2011):

“If it were no more difficult to stabilize inflation at a 4% level than at a 2% level, then the case for raising the inflation target to 4% would be much stronger. However, the history of the inflation process suggests that this is not the case... [With 4% inflation] the public is likely to believe that price stability is no longer a credible goal of the central bank and then the question arises, ‘if a 4% level of inflation is OK, then why not 6%, or 8%, and so on.’ We have seen that when inflation rises above the 3% level, it tends to keep on rising.

- Call this the addictive theory of inflation. The rationale is not clear. Why not announce the optimal policy and carry it out?

- In the past, expected inflation has followed actual inflation with a lag. Overshooting of expectations seems unlikely.
Another view (Woodford): A price-level target addresses the zero-bound problem, so not necessary to raise average inflation.

- This policy depends on unrealistic manipulation of short-run inflation expectations.
For countries with targets above 4%:

- Reducing the target should not be a priority, given the costs of disinflation.

- Similarly, if inflation is near the top of a target band, pushing it down to the middle should not be a priority.
Financial Stability and Capital Flows

The dogma of IT holds that policy should not respond directly to asset prices or developments in the financial system.

- The 2008 crisis shows that we should modify this view.

Even before the crisis, it was obvious that shifts in capital flows are harmful to emerging economies.

- Effects on exchange rates -> competitiveness in tradeables sector
- Risk of sudden stops
- So policymakers should make some effort to manage capital flows
New Policy Instruments

- With multiple objectives, policymakers need multiple instruments—not only a short-term interest rate.

- Which instruments are best? Taxes on capital inflows? Macro-prudential policies? We do not know.
One approach: Central Bank of Turkey

(an interpretation)

Three instruments help policymakers hit three targets:

- One-week repo rate → aggregate demand → output and inflation
- Interest rate corridor → capital flows → exchange rate
- Reserve requirements → credit growth

Research departments at central banks should try to figure out the optimal set of policy instruments.
Nominal GDP Targeting

Various practical problems:

- Difficult to explain to public

- Inflation level must move in opposite direction from trend output growth

- If the target is the level of nominal GDP, requires overshooting of long-run inflation, which may be destabilizing (Ball, 1999)

So inflation targeting, if made sufficiently flexible, is preferable.