

Inflation Targeting

The Future of U.S. Monetary Policy?

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Turnover at the Federal Reserve

- **Alan Greenspan** leaving Jan.31
 - Where do we stand? Are we on the right track?
- **Ben Bernanke** – presumed successor
 - **Has long supported Inflation Targeting**
 - Controversial: Resistance from Greenspan & others
 - What is this about? Does it make sense?
 - Debate provides insights about monetary policy.
 - Clues about Bernanke's thinking.



What is Inflation Targeting?

- Not an easy question:
 - Many variations on the theme.
 - The extremes:
- Hard version: Fed should care only about inflation
 - Set fixed target value - put policy on autopilot.
 - Not seriously pursued - target for opposition.
- Soft version: Inflation as one target among many
 - Nothing new: Central bankers always promise low inflation.



Most likely: Target with exceptions

- Real issues in the debate:
 - What's the horizon? Short vs. long term targets.
 - How precise? Point target vs. a target range.
 - What conditions justify deviations? For how long?
- Roadmap to Bernanke's views:
 - Book: "Inflation Targeting: Lessons from the International Experience" (1999)
[coauthored with T. Laubach, F. Mishkin, A. Posen]



Outline

1. **Understanding the Inflation Problem**
 - What monetary policy can and cannot accomplish.
 - Why credibility matters.
 - Why central banks are set up as independent entities.
2. **Inflation targeting: How it's supposed to work.**
 - Specifics of Bernanke's (1999) proposal.
3. **A bit of critique:**
 - Is Bernanke's approach "hard" enough to be credible?
 - Is it sufficiently protective of Federal Reserve independence?



What can the Fed do?

Three issues:

- I. Inflation
- II. Interest rates.
- III. The Real Economy



I. Money and Inflation

- Easy: Fed CAN control inflation – No dispute
 - Growing money supply => Rising prices
 - Milton Friedman: “Inflation is always and everywhere a monetary phenomenon”
- Caveats
 1. Control is not perfect in the short run
 - Disturbances: Oil shocks, structural changes, etc
 2. Responding to disturbances: How strongly?
 3. Stabilizing inflation vs. stabilizing prices?



II. Money and Interest Rates

- Easy part: Controlling the Fed Funds rate
 - Very short term: Overnight rate on loans between banks
 - Controlled through open market operations => Bank liquidity
 - Fed funds rate used as operating instrument to control money growth & inflation
- Challenge for the Fed: Influencing longer-term rates
 - They depend on expectations about the future:
$$\text{Interest rates} = \text{Real interest rate} + \text{Expected Inflation}$$
 - Important for the economic impact of Fed policy
[For mortgage rates, exchange rates, equities, etc]
 - The challenge is to manage expectations
 - Credibility is crucial.



III. Money and the Real Economy

- Unexpected inflation tends to increase aggregate demand
[Assuming prices adjust slowly to increased demand – a controversial issue]
 - More jobs. Less unemployment.
 - Redistribution from lender to borrowers
 - Gains for home owners, corporations, governments.
 - Losses for fixed-income investors/savers.
 - In reverse: Sudden monetary contraction => Recession
 - Effects are short term – evaporate when inflation is expected.
Nonetheless:
- Strong temptation to let inflation run ahead of expectations.
 - Public has good reason to disbelieve promises of low inflation!
Potential for a vicious cycle of rising inflation & inflationary expectations.



What keeps inflationary expectations down?

- **Leading answer: Central Bank Independence**
 - Provides protection from political pressure.
 - Framework to establish credibility for low inflation.
 - But raises new questions
- 1. **How should central banks respond to disturbances?**
 - Important issue. Example: Oil shock – rising inflation.
 - Option 1: Higher interest rates to fight inflation
=> Real contraction, perhaps recession.
 - Option 2: Do nothing or reduce rates to prevent a contraction
=> Increase in inflation – unclear for how long.
 - Concern: **Variable inflation is useful, but hurts credibility.**
- 2. **Who decides what inflation rate is low enough?**
 - **Is the central bank accountable to anyone?**



Turning to current U.S. policy:

How is the Fed maintaining credibility?

Trust Alan Greenspan!

- The all-purpose answer: Greenspan knows best.
- General approach:
 - All decisions left to the Fed leadership – complete discretion.
 - No accountability – instead a personality cult around Fed chairs.
 - Uncertainty when there is a change in leadership.
- **U.S. Monetary Policy is in worse shape than it may appear**
 - Greenspan made no effort to institutionalize his personal credibility
 - Fed compares unfavorably to foreign central banks
 - In short: **Let's hope that Ben Bernanke is a genius, too.**



Main Arguments

For Inflation Targeting

1. Provides clarity about the Fed objective
 - Numerical answer to how low is 'low' inflation.
 - Less emphasis on Fed personalities.
2. Helps stabilize inflation expectations
 - Important because short run fluctuations are unavoidable. Target anchors expectations
 - Does not preclude stabilization policy – facilitates it.
3. Provides political accountability
 - **Operational Independence** allows political debate about the target. Fed independence regarding implementation.



Common arguments

Against Inflation Targeting

1. A target would constrain Fed Policy
 - But lack of commitment is damaging.
Kydland & Prescott's Nobel-winning argument.
2. Price stability cannot be quantified
 - Inflation is measured with errors, upward-biased.
[Due to new products, substitutions, shifts in product quality, etc]
 - Consensus: Inflation target should be positive, 1-2% range.
3. By law, Fed must pursue "maximum employment"
 - Inflation target would lead to the neglect of other goals.
 - Defense: Low & stable inflation supports long run growth.
 - Merits discussion: Verdict depends on the specifics.



Specific Proposal: Nine points

[From Bernanke et al. (1999)] (6 technical; 3 institutional)

1. Fixed long-run inflation target; above the measurement bias
 - Example: 1% bias in measured inflation + 1% inflation = 2%
2. Short-run inflation targets; reviewed once a year
 - May respond to disturbances. Gradual return to long-run target.
3. Target horizon 1-2 years ahead when introduced.
 - Allows public to learn about it and adjust expectations.
4. Point target - not a target range
 - With some tolerance around it. Avoids focus on specific bounds.
5. Symmetric response: Expansionary policy if inflation is too low.
6. Target the Core CPI: Consumer Price Index ex. food & energy.
 - Avoids policy responses that might destabilize the real economy.



Institutional Points

[From Bernanke et al. (1999)]

7. Inflation targets set by 'The Government'
 - Commission with Fed as active participant
8. Accountability: Fed chair to testify in Congress
 - New Zealand model: Dismissal if target is missed
9. Reporting to the public in a transparent manner
 - British Example: quarterly "Inflation Report"



Critique

- Is the Bernanke proposal too soft?
 - A multiplicity of excuses for missing targets
 - Variable short run targets. Core CPI instead of all-items CPI.
 - Variations around the target point.
 - Core CPI with some tolerance should suffice for flexibility.
 - Pledge of continuity with Greenspan era is ominous.

- Would the Bernanke proposal disarm the Fed?
 - Target-setting commission invites political interference.
 - Why not announce a target and build credibility?
 - If public reporting is effective politicians won't interfere.



Conclude

- Is U.S. Monetary Policy in good shape?
 - Good track record since 1980.
 - Too dependent on Fed leadership's judgment.
 - Challenges ahead: CPI 3.4%, Core CPI 2.2% (Dec.05)
- Is Inflation Targeting an improvement? Yes.
 - Will it be adopted?
- What have we learned about the new Fed chair?
 - Thoughtful economist. Not a politician.

Copies of this presentation are available at
<http://www.econ.ucsb.edu/~bohn/papers/inflationtargeting.pdf>