Rethinking the Inflation Target

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Brookings Conference
“Should the Fed Stick with the 2% Inflation Target or Rethink it?
Washington, D.C., January 8, 2018
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1. *The zero-lower-bound (ZLB) constraint on policy interest rates binds more often than expected.*

   • Three reasons:
     • Economy is non-linear (“over the cliff”).
     • Shocks from financial disruptions can be huge.
     • Natural rate of interest has fallen
2. Once ZLB constraint occurs, it is much harder to stimulate the economy and raise inflation.

- Nonconventional tools less effective than hoped.
- Key dilemma for central banks in advance countries is that despite heroic measures, inflation remains below 2%
Prominent economists (e.g., Blanchard) suggest target should be raised to something like 4%.

Pros:
- With higher target, ZLB less likely to occur.
- With higher target, conventional monetary policy of lowering policy rate can ease more because higher expected inflation allows lower real rate.
Should the Long-Run Inflation Target be Raised to Above 2%?

• Cons:
  • More difficult to stabilize inflation at 4% than 2%.
    • 4% not consistent with Greenspan definition of price stability where inflation is not a big factor in economic decisions.
  • Once inflation rises above Greenspan definition at 4%, then why not 6%, or 8% and so on.
  • Exactly what happened in U.S. starting in 60s: View that 4-5% inflation could be tolerated to achieve lower unemployment, with outcome of Great Inflation and high cost to getting inflation back down.
  • One of great successes of central banks over last 20 years is anchoring of inflation expectations around 2%: Raising target to 4% would jeopardize hard-won success of establishing a strong nominal anchor.
Should the Long-Run Inflation Target be Raised to Above 2%?

- Additional Cons:
  - Although raising target might have short-run benefits, it produces distortions in long run.
  - These costs may be small for any given year, but they add up over time.
Should the Long-Run Inflation Target be Raised to Above 2%?

- Bottom line:
  
  Costs of raising inflation target to 4% outweigh the benefits.

Answer to question above?
  
  NO
Inflation targeting as practiced is not history-dependent: treats bygones as bygones, so past undershoots do not affect policy.

Woodford (2003) provides compelling theoretical argument for history-dependent target in which if the target has been undershot in recent past, the monetary policy should strive to overshoot in near future.
Price-level target is one form of history-dependent policy and it produces less output variance.

Negative demand shock results in price level falling below target path, say 2% growth, requires raising price level back to path, so inflation rises above 2% temporarily.

Expected inflation rises above 2%, lowering real interest rate, thereby stimulating economic activity.

History-dependent price-level target is automatic stabilizer: negative shock leads to stabilizing expectations.

Even more effective when ZLB is binding (Eggertsson and Woodford, 2003).
Another similar history-dependent policy is nominal GDP target.

- Eggertsson and Woodford argue for target criterion of output-adjusted price level.

- Because “output-adjusted price level target” hard for public and markets to understand, Woodford (2012) argues for a simpler criterion of nominal GDP path which grows at the inflation target plus the growth rate of potential GDP.
Should Monetary Policy Ever Try to Overshoot the Inflation Target?

- Formidable challenges to price-level and nominal GDP targets:
  - Hard to explain aiming for a target that is rising over time: targeting a level of inflation easier to explain.
  - When inflation temporarily rises above 2%, may be hard to explain that commitment is to long-run 2% target.
  - Nominal GDP target has additional problem because it requires that central bank takes a stance on number for potential GDP, which is highly uncertain and can lead to policy mistakes circa Fed in 1970s.
  - Explains why have not been adopted.
Should Monetary Policy Ever Try to Overshoot the Inflation Target?

• Another way to skin the cat and adopt a history-dependent policy that can be explained to public and markets.
  • 2% target should be for an average over a particular period, say 5-years, or over the business cycle, or since the ZLB started (Bernanke), rather than for a particular date such as 2-years ahead.
  • If inflation had been running at 1.5% for a several years, then monetary policy would aim for 2.5% for several years.

  Would be particularly effective with ZLB because it would raise inflation expectations temporarily, lowering real interest rate.

• Additional benefit: encourages more expansionary policy in face of negative demand shocks.
Should Monetary Policy Ever Try to Overshoot the Inflation Target?

• This history-dependent policy has been implemented by the Reserve Bank of Australia, with 2-3% target “on average over the business cycle”.

• Economic performance in Australia has been excellent:
  • Average inflation since 1995 is 2.7%--very close to 2.5% midpoint of target range--and no recession in 25 years.

• Curdia (2016) provided evidence that such a policy, which would have implied a temporary overshooting of 2% target to 2.5%, would have produced better outcomes in U.S.
Bottom line:

Fed and other central banks should commit to achieve an *average* inflation rate of 2% over a fixed period say 5 years or since ZLB occurred, and if there have been undershoots, this implies having a target inflation rate above 2% for several years.

However central bank should be very clear that it is continuing its commitment to long-run target of 2%