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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Key Lessons from Recent Years

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

Key Lessons from the Financial Crisis

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%

Should the Long-Run Inflation Target be Raised to Above 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 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

Should Monetary Policy Ever Try to Overshoot the Inflation Target?

- 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.

Should Monetary Policy Ever Try to Overshoot the Inflation Target?

- 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).

Should Monetary Policy Ever Try to Overshoot the Inflation Target?

- 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.

Should Monetary Policy Ever Try to Overshoot the Inflation Target?

- 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%