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:
    [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:
    - Interest rates = Real interest rate + 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]
  - 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 flight 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.