

Is It Time to Reconsider Inflation Targeting?

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Reconsidering IT

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 - but should this be reconsidered in the light of subsequent events?
- Some have argued that CBs were unprepared for the challenges of the past decade because their focus on inflation control amounted to “preparing for the last war”
 - have the arguments advanced in favor of IT before the crisis actually been proven invalid?
 - or does our conception of a desirable IT regime at least need significant revision?

Reconsidering IT

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- Differ in degree to which it is appropriate to publicize them, to how wide an audience and how far in advance

IT as a Statement of Goals

- A defining feature of IT: explicit statement of a quantitative target for (some measure of) inflation, to be maintained over the medium term
- has this proven unnecessary, or even harmful, in the context of recent challenges?

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 - a severe financial crisis — yet no **sharp decline in inflation expectations**, worsening the constraint implied by lower bound on nominal interest rates, as in Great Depression
 - considerable volatility in oil prices — yet no **wage-price spirals** set off, requiring monetary policy to be tightened, as in 1970s

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- Possible alternatives to an **inflation target**:
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- Rules that stabilize the latter quantities have desirable features, in some models
 - but this is more an observation about desirable **target criteria** [level 2 description] than about what the stated **goals** of policy should be

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 - doesn't encourage misunderstanding of what monetary policy can achieve
 - relatively direct connection to welfare-relevant distortions

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 - or that it should have explicit **priority** over other goals?
- Broad agreement before the crisis that stability of **aggregate activity and/or employment** should also be an explicit goal, and that it should be possible to trade some increased variability of inflation around long-run target for (sufficient) reduction of output/employment variability
 - **“flexible inflation targeting”**

IT as a Statement of Goals

- Nonetheless, inflation target has a special status:
 - explicit quantitative target for inflation, no similar numerical target for variables like unemployment rate
 - FOMC “Statement on Longer-Run Goals”: “maximum level of employment” also a goal, but “not ... appropriate to specify a fixed goal for employment,” as Committee assessments “necessarily uncertain and subject to revision”

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- Crisis has pointed to importance of **financial stability** as an additional goal
- But this is possible within a framework that could still be considered “flexible IT”

— inflation target should still retain its special status

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 - offers too little scope for other stabilization objectives

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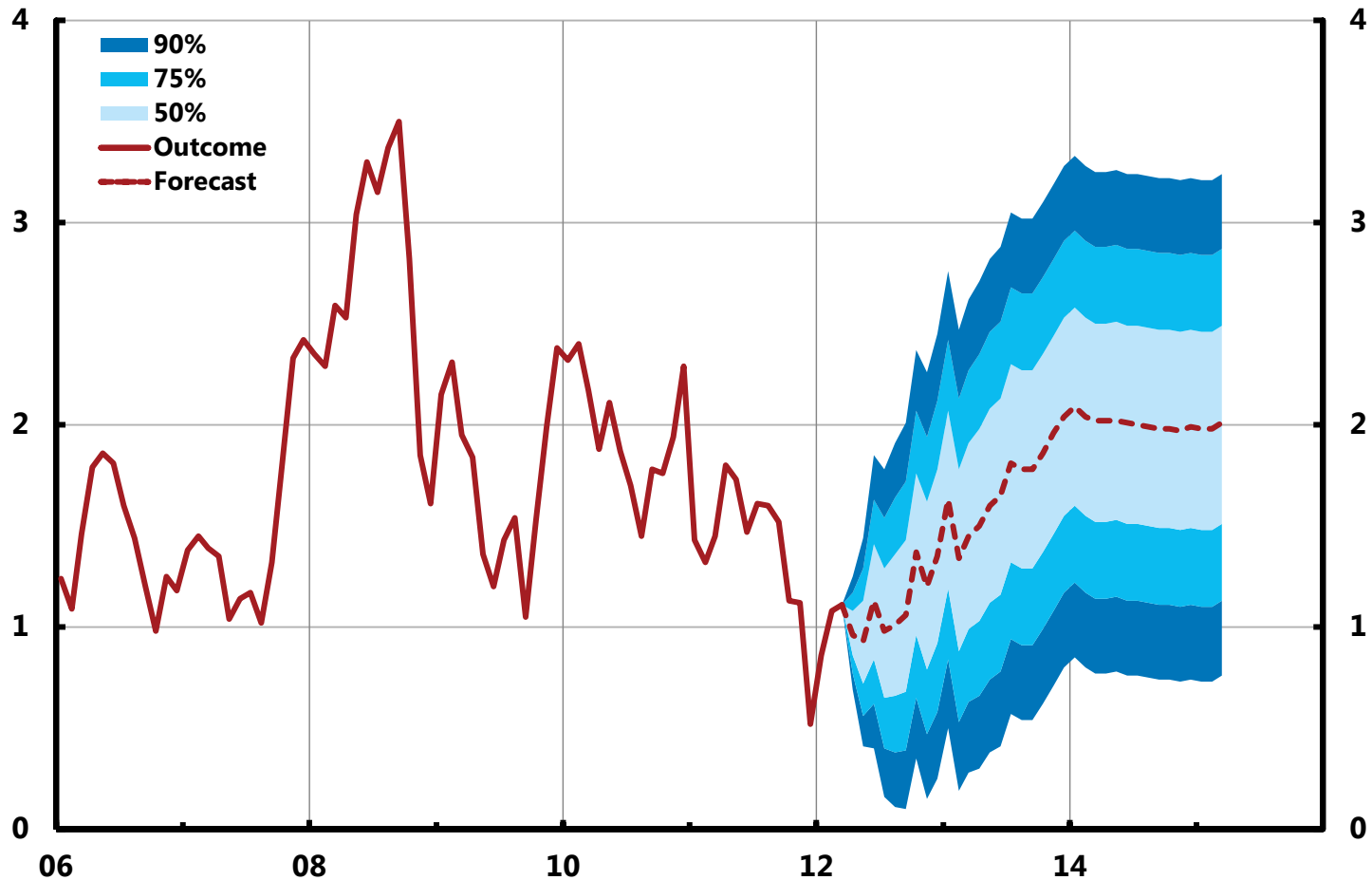
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- Two possible interpretations:
 - ② policy decision should follow from requirement that inflation be **projected to return to target** within projection horizon
 - doesn't seem in practice to constrain policy decision very much
 - nor does it seem an effective way of ensuring that policy will actually **achieve** the target (at least in the medium run)

Figure 4. CPIF with uncertainty bands

Annual percentage change

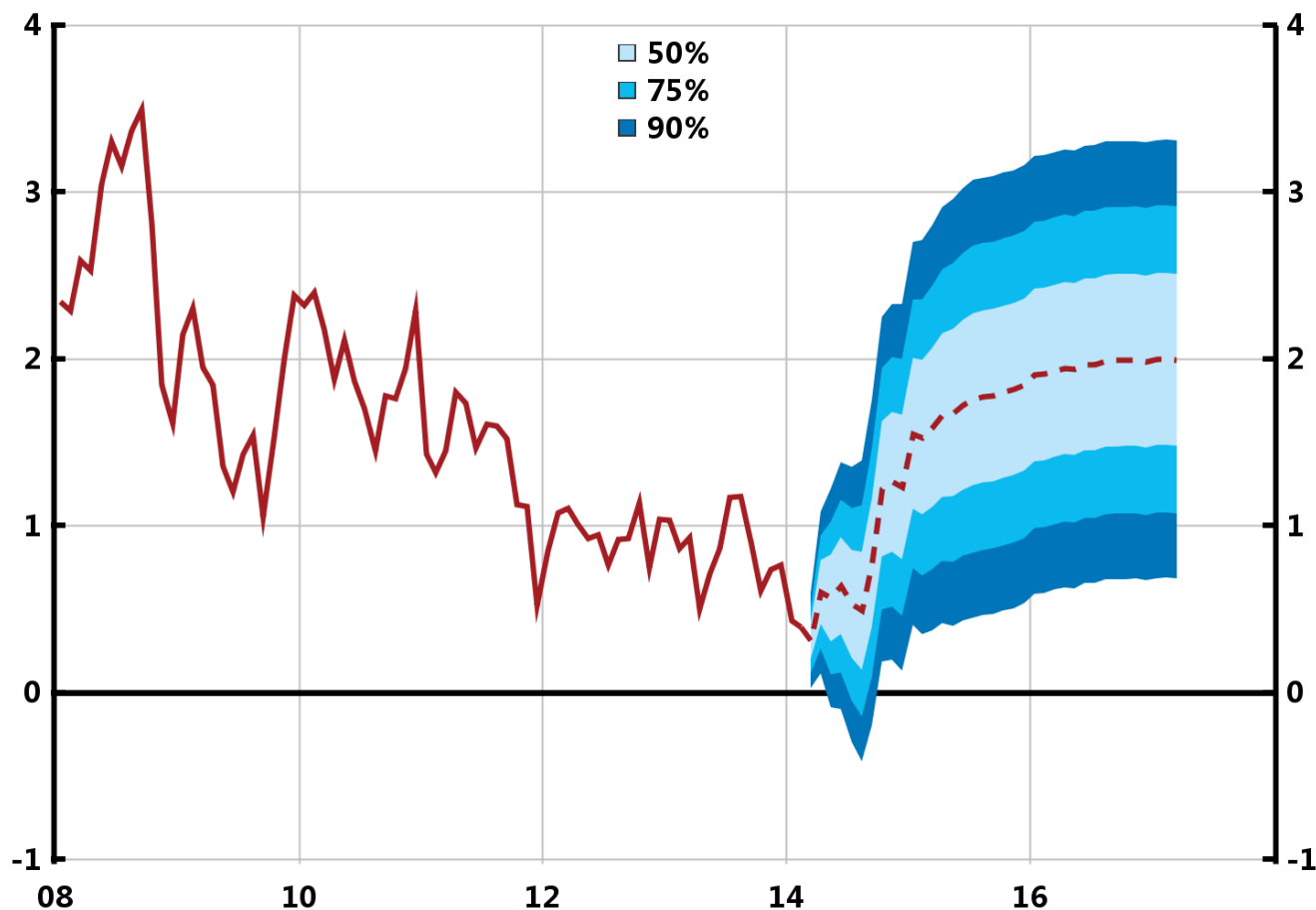


Note. The uncertainty bands are based on the Riksbank's historical forecasting errors. The CPIF is the CPI with a fixed mortgage rate.

Sources: Statistics Sweden and the Riksbank

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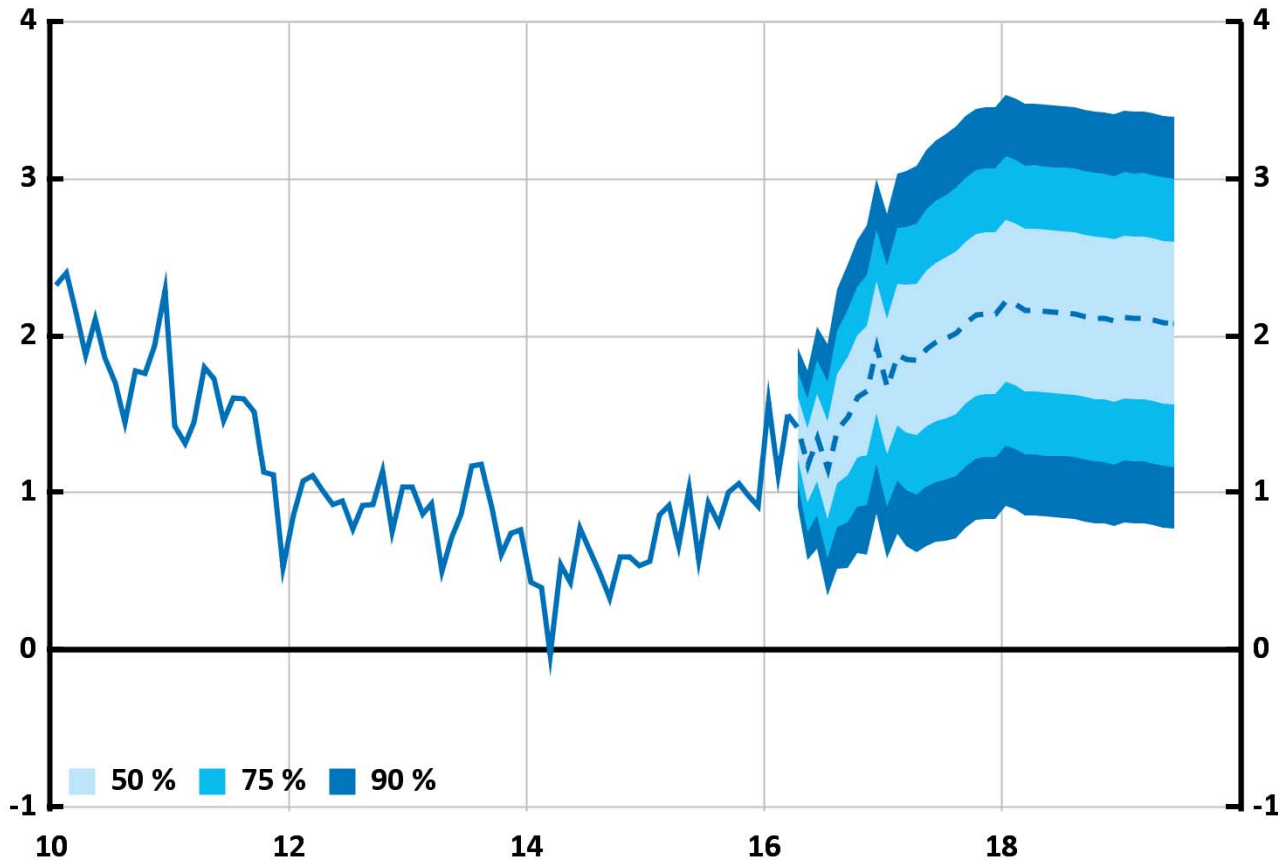


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Figure 1.4. CPIF with uncertainty bands

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 - what one looks for in the projections implied by intended policy, to judge that policy is appropriate
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- This is needed for two reasons:
 - in order to allow policy decisions to be made in a way that is transparent and allows accountability
 - in order to explain how the succession of short-run policy decisions should add up to a pattern of conduct that, over the medium run, should conform to the declared medium-run target

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 - but it cannot be a criterion that involves **only real variables** (e.g., some property of the GDP projection), either

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- One possibility: check that projected path of **nominal GDP** conforms to a target path
 - target path should have steady growth at a rate equal to 2 percent plus estimated long-run growth rate of potential output
 - so that achieving that path for NGDP should imply 2 percent inflation over medium to long run
 - should require projections to conform to target path sooner than only in final year of projection
 - so stronger connection between near-term policy intentions and the target criterion

What Target Criterion?

- A criterion that would reflect **both** Bank's commitment to achieving 2 percent inflation rate over medium to long run **and** fact that a trade-off is allowed between inflation and output growth in the short run
 - and would explain clearly how that trade-off is made, rather than allowing it to be purely discretionary

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- Criterion is **forward-looking**, and formulated in terms of **projected outcome** of policy, rather than an explicit rule for the policy decision itself [of the kind proposed by the US Congress to bind FOMC decisions]
 - hence would allow pre-emptive policy response to financial disturbance [situation in late 2007, early 2008], without requiring effects on inflation and/or real GDP to already be visible

What Target Criterion?

- If formulated in terms of a **level path** for NGDP [as opposed to pure concern with growth rate looking forward], would also automatically imply loosening of anticipated future policy in a period where **effective lower bound** on interest rates constrains current policy
 - simple version of the “output-gap-adjusted price-level target” shown to be optimal in the model of Eggertsson and Woodford (2003)

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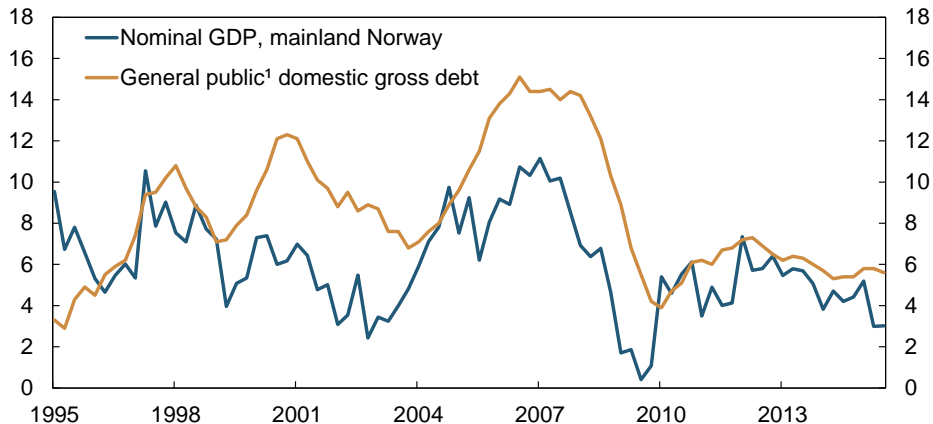
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 - at least as subsidiary criteria that might qualify the conclusion drawn from the primary criterion, on some occasions?
- Perhaps — but maintaining a stable path for NGDP might already be a criterion that would lead to tightening of policy during credit booms, even without any explicit reference to credit variables in the target criterion

Nominal GDP and credit

Four-quarter change. Percent



1) Households, non-financial enterprises and municipalities

Source: Statistics Norway

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- Disadvantages of “minimize the loss function” as a decision criterion:
 - decision process lacks **intertemporal consistency** ⇒ NOT a procedure that should actually minimize the loss function, and undermines credibility of CB communication
 - makes decision process opaque, completely **model-dependent** ⇒ reduces accountability, vulnerable to errors in model specification

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 - commitment to an **explicit quantitative target** for (medium-run) inflation
 - making this the **unique** variable for which there is such an explicit quantitative goal
- Flexible inflation targeting allows however for additional stabilization goals (for the sake of which temporary departures from the medium-run target may be allowed)

— and to these it may be appropriate to add minimizing risk of **financial instability**

Summary

- The inflation target itself does not provide a sufficient criterion for policy decisions
 - possible role for **target criterion** based on **nominal GDP** projection