Discussion of "How Flexible Can Inflation Targeting Be and Still Work?"

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Prior to the current crisis, the monetary policy debate was centered on whether central banks should adopt an explicit inflation target or not. Many leading economists were in favor. One of the authors of this paper, for example, Adam Posen, who is now a member of the Monetary Policy Committee of the Bank of England, wrote a well-known book with the now Chairman of the Federal Reserve Ben Bernanke (together with Thomas Lauback and Friederick Mishkin). This book argued largely in favor of inflation targeting.

This paper nicely summarizes some of the pros and cons of inflation targeting. On the con side, the authors cite Benjamin Friedman as an early critic. Friedman expressed the concerns that the inflation-targeting framework would unduly constrain the policymaker in the face of a shock to focus only on inflation at the expense of unemployment. I think Friedman may have been onto something, a point I will get back to at the end of this comment.

The Bank of England has a formal inflation target, while the Federal Reserve does not. With that background, the authors ask an important and sensible question: When we look at the Bank of England and the Federal Reserve during the turbulence of the last few years, did the inflation-targeting framework impose any important limitations on the Bank of England, which the Federal Reserve did not face?

Broadly speaking, the authors argue that the answer is no. First off, they provide convincing evidence that in both countries long-term inflation expectations stayed stable throughout the crisis. The more novel finding is that there does not seem to be much difference across the two countries about the perceived speed of adjustment of inflation back to target in response to shocks. In other words, if one observes inflation above/below target in the United Kingdom, the speed at which people expect it to revert back to target is more or less the same as in the United States, according to the authors' findings. If anything, the authors claim, the Bank of England may be even a bit more "flexible" in the sense that people expect it will take a longer time for inflation in the United Kingdom to get back to target than in the United States. I see the main contribution of the paper as this finding—in particular, the innovative use of professional forecasts to illuminate it.

There are several ways of interpreting this finding. One is to say that the United Kingdom seems to have been able to put together an inflation-targeting framework without paying much cost in terms of flexibility, given that their reaction to deviation from target looks very similar to that of the United States. Another interpretation would be that the Federal Reserve seems to be behaving pretty much as an "inflation targeter" for all practical purposes. Everybody seems to think the "implicit" target of the Federal Reserve is 2.5, and this is relatively clear in the evidence the authors present. For what it is worth, my own reading is that the two central banks operated largely along the same principles. I think they can both, at least at a very broad level, be termed as flexible "inflation targeters."

To me the most interesting aspect of the experience of these two countries is seen in figures 6 and 7 on the one hand and 9 and 10 on the other. During the crisis period we see that the United States missed its "implicit inflation target" on the downside persistently since 2008. Meanwhile, the United Kingdom has been missing it persistently on the upside during that same period, i.e., inflation has been running above the official target of 2 percent. If we then look at the two-, four-, and six-quarter-ahead consensus forecasts, we see that in the United States professional forecasters predicted inflation to be persistently below the 2.5 percent target during this period, while in the United Kingdom the picture was more mixed. Sometimes inflation was forecasted to run below target and sometimes above it.

The reason this sparked my interest is that modern monetary theory suggests that when faced with a large shock that makes the zero bound binding, the optimal way to deal with it is to allow some overshooting of inflation. In particular, the optimal response is to commit to somewhat looser policy in the future so as to lower the real rate of interest today (see, e.g., Eggertsson and Woodford 2003). A casual look at figures 6 and 7 and 9 and 10 suggests that the United Kingdom avoided missing on its inflation target on the downside; moreover, short-run expected inflation did not run as persistently below the long-term target in the United Kingdom as in the United States. This would seem, at least on the surface, to suggest that real rates were lower during this period in the United Kingdom than in the United States. Two important questions this raises to me are: (i) Did this get the United Kingdom better outcomes as suggested by theory? (ii) If the answer to that is yes, the question is, did the more explicit inflation targeting help the United Kingdom get there? Those are two key questions that I have after having read this paper, and I suspect we will spend the next several years debating them. There are several moving parts to this story—different policy mix in both countries, different exposure to the financial sectors, and so on—so we will probably never have a complete answer.

Let me conclude with an additional observation that is only tangentially related to the paper's argument, but I think it matters for the greater debate about inflation targeting. It also relates to Benjamin Friedman's early skepticism of inflation targeting that the authors cite and I noted above. My understanding of the motivation for inflation targeting is that the point is to help central bankers to react to short-term shocks without "un-anchoring" medium- and long-term inflation expectations. The rationale for this is well summarized by the simple Lucas-style aggregate supply curve reported in the paper:

$$y = y + \beta(\pi - \pi^e) + \varepsilon.$$

So you want to react to bad shocks ε but without un-anchoring expectations π^e that enter *future* supply curves, as this would create worse trade-offs at that time.

This is a key lesson from the great inflation of the 1970s. What I want to point out is that today the situation is different in that if we move over to the aggregate demand side, we have a situation in which the economy calls for negative real interest rate, but the central bank cannot accommodate it due to the zero bound (this is a theme of a recent paper by Eggertsson and Giannoni 2011). In this case, as the literature on the zero bound has emphasized (see, e.g., Eggertsson and Woodford 2003), what is called for is a reduction in the real interest rate, which can be achieved, for example, by an increase in medium-term inflation expectations. In this respect, the goal of policy should be exactly what the inflation-targeting literature was all about avoiding, i.e., allow for positive near-term inflation expectations for some time.

What I am left wondering is if the emphasis of the past few years on inflation targeting has pushed central banks away from considering more seriously the possibility of temporarily increasing inflation in response to shocks that give rise to zero interest rates and very high unemployment. If so, it is quite possible that the whole inflation-targeting debate was a distraction in preparing us for this crisis. After all, the policy of temporarily increasing inflation is far from new (even if it sounds very radical when proposed to people who have a legal mandate to hit 2 percent inflation). That kind of policy is what during the Great Depression was usually referred to as a policy of "reflation," and I think it played a key role in the recovery in 1933–37 (see Eggertsson 2008). Why did no major central bank try, or even seriously consider, a policy of "reflation" in the face of mass unemployment during the current crisis? Should we blame inflation targeting? It is worth pointing out that this is what Friedman warned us of: An inflation target would imply that people would focus on inflation at the exclusion of other policy objectives. Put differently, many were not willing to consider the possibility of a higher medium-term inflation target during the current crisis—a policy of "reflation"—since the whole point of inflation targeting was to always go back to the inflation target over some not "too long" horizon.

References

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