

Inflation Targeting for the United States

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May 19, 2003

1. Introduction

During the early months of 2003, there was something of a buzz in monetary policy circles about the prospect of a move toward inflation targeting as a policy regime for the Federal Reserve. One leading manifestation was a prominent article in the Wall Street Journal on March 31 concerning the different points of view recently expressed by Fed Governors Ben Bernanke and Donald Kohn.¹ Of course, there was little or no direct disputation; the WSJ article was based on substantial comments presented by Bernanke and Kohn at different conferences but released at about the same time. Kohn's comments were delivered at a January 24-25 conference, sponsored by the National Bureau of Economic Research, at which he was the formal discussant of a paper by Marvin Goodfriend (2003).² The specific item by Bernanke, mentioned in the WSJ article, is evidently his speech given at a March 25 conference of the National Association of Business Economists. Although there has not been direct disputation, there are significant differences of opinion expressed in the two Governors' writings, as well as the paper by Goodfriend, differences that mirror important issues and call out for discussion.

As it happens, the aforementioned buzz was substantially muted when it was announced on April 22 that President Bush intends to ask Alan Greenspan to accept

¹ See Ip (2003). Other especially notable articles appeared in the Financial Times [Rogoff (2003)], the New York Times [date], and Business Week [Dec. 16, 2002].

² Bernanke was present and served as the discussant of another paper. Goodfriend is Senior Vice President and Policy Advisor at the Federal Reserve Bank of Richmond.

another appointment as Chairman of the Fed's Board of Governors. Greenspan's opposition to more formal commitments to an explicit policy framework has been voiced several times and his unprecedented influence makes that opposition virtually decisive. Indeed, the fact that the end of his current term is upcoming in June 2004 had been one of the leading stimulants prompting the buzz.

Before continuing, let us pause to define "inflation targeting." One possible interpretation would be that the central bank behaves in a manner that involves monetary policy responses only to deviations of inflation from some specified target value, with fluctuations or "gaps" in output or employment calling for no response (unless they are viewed as indicating the likelihood of future inflation). That is not, however, the way that the term has come to be used by most monetary economists including Bernanke, Kohn, and Goodfriend. Instead, the term is now understood to characterize a monetary policy regime that includes the following two requirements: (i) The central bank adopts an explicit and quantitative inflation-rate target expressed in terms of some specified general price index. (ii) The central bank provides regular (usually quarterly) publication of a public report that includes data, forecasts, analysis, and expository articles that together serve to explain recent and pending monetary policy actions. Some inflation targeting (IT) regimes include additional features—the New Zealand arrangement is famous for providing that the central bank Governor can be discharged if inflation goes outside the specified target range—but these are not necessary to the concept.

The recent decreased emphasis on the possibility of inflation targeting in the United States, occasioned by the prospect of continued service by Greenspan, is

unfortunate.³ Members of the SOMC have argued repeatedly that the United States would benefit from a more institutionalized, i.e., less personalized, commitment to low inflation as the cornerstone of a sound macroeconomic policy.⁴ There are various advantages offered by an inflation targeting regime including (i) increased transparency that should enhance public understanding of monetary policy, (ii) a clearer focus by the monetary authority on its goals and tradeoffs, and (iii) an increased likelihood that sound policies will be followed in the future under chairmen possibly less astute or less devoted to non-inflationary policy than Alan Greenspan.⁵ These are the main advantages of an IT regime that are claimed by its proponents, including Bernanke (2003) and Goodfriend (2003).

What are the alleged disadvantages of an IT regime of the general type that has been successfully employed by the Bank of England, Bank of Canada, Reserve Bank of New Zealand, Swedish Riksbank, and European Central Bank?⁶ As Kohn was for years the main monetary policy advisor to Greenspan, the written version of Kohn's (2003) contribution to the NBER conference should provide a reasonably authoritative account. An examination of that paper indicates that much of it is taken up with the question of whether Goodfriend (2003) is correct in his claim that during the Greenspan years the Fed has in fact practiced implicit inflation targeting. Kohn disagrees with that claim, the point most relevant for our concern being his argument that the performance of monetary policy during these years would have been less desirable under an explicit IT regime.

³ This statement does not imply or suggest that the prospect of continued service by Greenspan is unfortunate.

⁴ See, for example, my SOMC paper "The United States Deserves a Monetary Standard" (McCallum 2000).

⁵ Note that there is no contradiction between the statement here and the one on page 2 since the latter refers to explicit and formal commitments.

The principal reason given by Kohn is that actual Fed practice since 1987 has been marked by a degree of flexibility that would have been precluded by an IT regime. Indeed, this is evidently the only substantive objection offered by Kohn, though there are some political issues emphasized in his discussion. (These will be mentioned below.)

Is it true that an IT regime would have entailed less flexibility and been less desirable than actual Greenspan-era policy? In developing his argument, Kohn admits that since the mid-1990s inflation has been low and stable, as Goodfriend emphasizes. Kohn states, however, that “the level and stability of core PCE inflation since 1997 is as much a consequence of unexpected developments as of deliberate policy choices.” Thus “the speedup in productivity growth ... seemed to have greater disinflationary force than anticipated; the broad-based strength of the dollar and the weakness in global commodity prices that accompanied the East Asian crisis that began in 1997 put substantial downward pressure on prices in the United States; and more recently, the recession and resulting output gap have provided another unexpected source of disinflation.” Kohn goes on to argue that in every year during 1997-2001 the Fed was projecting inflation for the year ahead to exceed 2 percent and yet “the FOMC took no action to bring inflation down; tightening from mid-1999 through mid-2000 was seen as necessary to forestall a sustained acceleration in prices [i.e., increased inflation]. It was not until July 2002 that the FOMC projected inflation to remain within the [1-2 percent] range Marvin [Goodfriend] takes to be its implicit target.” Therefore, Kohn’s argument goes, it was unexpected good luck that kept a 1-2 percent inflation target from interfering with the Fed’s actual policy over the years 1997-2001. If it had not been for unexpected favorable

⁶ Some commentators would emphasize differences pertaining to the ECB framework as compared with the others mentioned. In my opinion, these differences are minor in the present context.

developments, he suggests, Fed policy would have permitted more inflation than actually occurred over these years.

Kohn goes on to argue that “in addition, at a few key junctures in the past five years, the Federal Reserve exercised a more flexible monetary policy than inflation targeting probably would have suggested or allowed.” The episodes mentioned include the Russian debt default during the late summer of 1998 and the sharp easing of policy throughout 2001, “even before September 11.”

With respect to this issue, the extent to which IT regimes impair central bank flexibility is a matter of professional dispute. Goodfriend (2003) and Bernanke (2003) contend that extra credibility is provided and enables central banks to move more aggressively, at times at which policy easing is desired to prevent output reductions, without igniting fears of renewed inflation. There is probably no way that this disagreement can be settled in the present state of economic knowledge, but it is worth noting that leading proponents of IT do not envision policy rules that ignore fluctuations in output or employment. Notable in this regard is the case of Mervyn King, the economist who has been appointed as the next Governor of the Bank of England. A few years ago, King led the BOE’s design of procedures that have resulted in its being regarded, together with the Reserve Bank of New Zealand and the Swedish Riksbank, as the epitome of “best international practice” inflation targeting (Svensson, 2001). King certainly does not interpret this system as requiring the BOE to be unconcerned with fluctuations in output and employment. Indeed, he is widely credited with introduction of the derogatory term “inflation nutter” to refer to someone whose concern is only with

inflation performance.⁷

The main implication of Kohn's argument, that it was unexpected developments rather than policy that held U.S. inflation down to the levels experienced over 1997-2001, seems to me to be quite different than that intended. For if such was the case, then the regime that was in place during those years was much less desirable than suggested by Goodfriend. That might negate the positive part of Goodfriend's argument, that the Fed's regime amounted to implicit IT, but it adds support to the normative thrust of his argument—i.e., that adoption of an explicit IT regime would be desirable. If the excellent inflation performance of recent years was accidental, then an explicit inflation targeting regime would seem even more attractive than under Goodfriend's assumption.

There is a second theme to Kohn's discussion that also warrants attention. Goodfriend's paper, and also Bernanke's (2003), considers problems of practical implementation by the Fed of a regime closer to one of explicit inflation targeting. Several possible specific steps in that direction are contemplated, but even the least ambitious of them would require that monetary policy give priority to low long run (i.e., average) inflation as its main operational objective. An important political difficulty is that any explicit change in this direction might upset the existing equilibrium between Congress and the Fed, which Goodfriend (2003, p. 14) refers to as "don't ask, don't tell" in the following sense: "Congress doesn't ask the Fed whether it places a priority on low long run inflation, and the Fed does not say whether it has such a priority." There exists a widespread impression among monetary analysts, I believe, that Congress would be reluctant to give priority to inflation prevention, even on average, over real-variable goals such as "maximum employment." In my opinion, this is so because the Congress is

⁷ See King (1997). This point is mentioned by Bernanke (2003).

unlikely to understand that adoption of an explicit IT regime—thereby giving priority to inflation prevention—would most likely improve performance in terms of output and employment behavior. There is a considerable amount of interesting and thoughtful discussion of possible strategies and Congressional reactions in the papers of Goodfriend, Kohn, and Bernanke. Some highlights will be briefly reviewed.

Goodfriend (2003, p. 22) faces the last-mentioned conundrum with the following suggestion. “In exchange for a congressional acceptance of a priority for low long run inflation, the Fed could consider participating in a public monetary policy forum where the FOMC (through its Chairman and other representatives) would subject its current assessment of the economy and thinking about recent policy actions to questions from invited academic and business economists expert in monetary policy.” Kohn (2003, p. 7) fears, however, that “this trade is not likely to have great appeal to congressional skeptics, since they already have the authority to get testimony and analysis from outside observers and critics of monetary policy.” Also, “more fundamental is the issue of ‘congressional acceptance.’ Marvin does not specify what he means by this, which is problematic because it could encompass a variety of interactions between the central bank and the legislature.”⁸ Bernanke evidently favors quantification of what the Fed means by “price stability,” i.e., adoption of an explicit inflation target. He adds a caveat, however, as follows. “Despite the potential long-run benefits of such a change, FOMC members may be concerned ... that the Congress and the public would misperceive the

⁸ Kohn also remarks as follows. “The place of an independent central bank in a democratic society is finely balanced. In exchange for insulation from political pressures, the central bank agrees to strive for the objectives it has been given by the elected representatives. The Federal Reserve has already exercised considerable discretion in interpreting its “dual mandate” of price stability and maximum employment in ways it has made clear in its testimonies and reports. In the absence of legislation, going appreciably further in the direction of prioritizing price stability ... would be potentially damaging to the democratic balance and would risk a backlash.”

quantification of price stability as an elevation of the Fed's price stability objective above its employment objective in violation of the dual mandate, even if that were in no way the intention." But, he continues, "the publication of medium-term forecasts does not raise nearly the same difficult political and communication issues that quantification of price stability may, in my view, and so I propose it here as a more feasible short-term step."

Economic analysis does not itself give much guidance in this area, of course. My own reaction is that an attractive approach would be for the Fed to begin, unilaterally but unobtrusively, publication of a quarterly report somewhat like the Bank of England's Inflation Report. This would be a public document of the type described above. It could be used to develop, over time, an understanding of the proposition that monetary policy can be most constructive in terms of real economic growth and stability by maintaining a stable, low-inflation environment in which private enterprise can flourish. Gradually, additional steps could probably be taken if policy continued to be satisfactory or if the need for a stronger stance against inflation again appeared.

Let me conclude with brief reference to the nature of the relationship between inflation targeting and the possibility of deflation—a falling general price level—which has recently been the topic of an outburst of professional and media speculation. The main (and rather obvious) point is that an inflation target of (e.g.) 1-2 percent is designed to prevent deflation, as well as excessive inflation. Such a target should provide a suitable margin for avoiding the zero lower bound on nominal interest rates, assuming that the average real interest rate returns to something in the vicinity of 2 percent. It is the zero lower bound on interest rates that needs to be avoided, to keep monetary policy

from encountering a bothersome (though not fatal) difficulty, not deflation per se.⁹

In any event, the notion that the desirability of avoiding deflation somehow reduces the attractiveness of inflation targeting seems completely devoid of logic. Inflation targeting is explicitly designed to keep inflation from straying too far from the central bank's explicit or implicit target. To make sense, the IT skeptics' actual position must be that a relatively high inflation rate target—and thus a relatively high average inflation rate—is desirable. For any given positive target rate, more accurate control of inflation obviously reduces the likelihood of hitting the zero lower bound.

⁹ On this topic, see McCallum (2003).

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