Inflation Targets Reconsidered
Comments

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Outline

1. Should inflation targeting (IT) be reconsidered?

   Yes. Review arguments

2. Which features of IT should be changed?

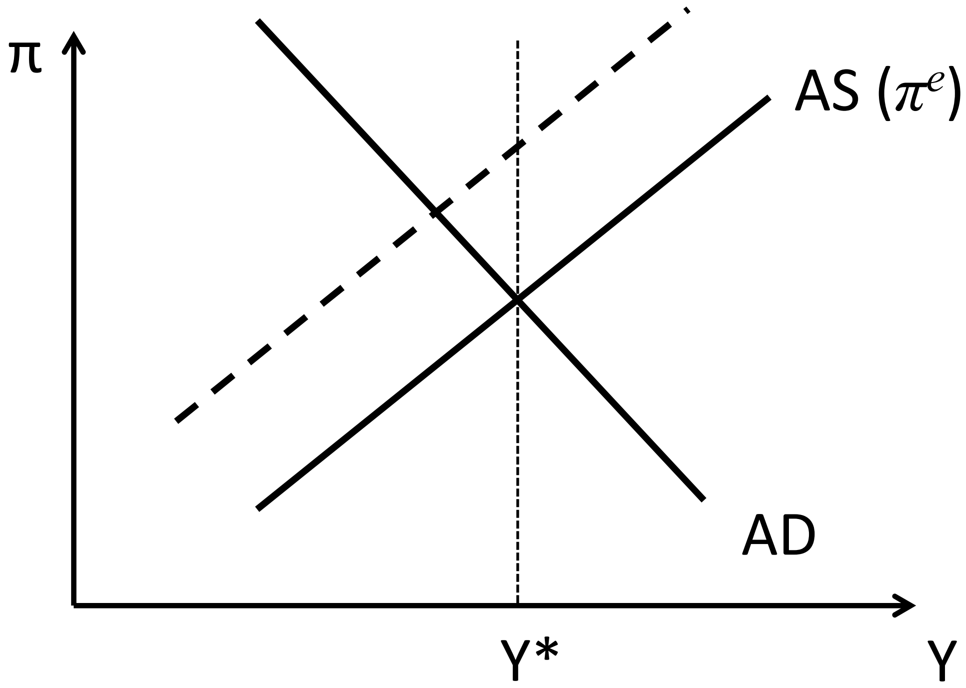
   Other aspects of IT framework more important than π^*

A low inflation trap?
Economics

Clarification (Eggertsson Giannoni 2013)

Traditional lack of credibility problem: π^e too high

↑π^e => aggregate *supply* shifts left

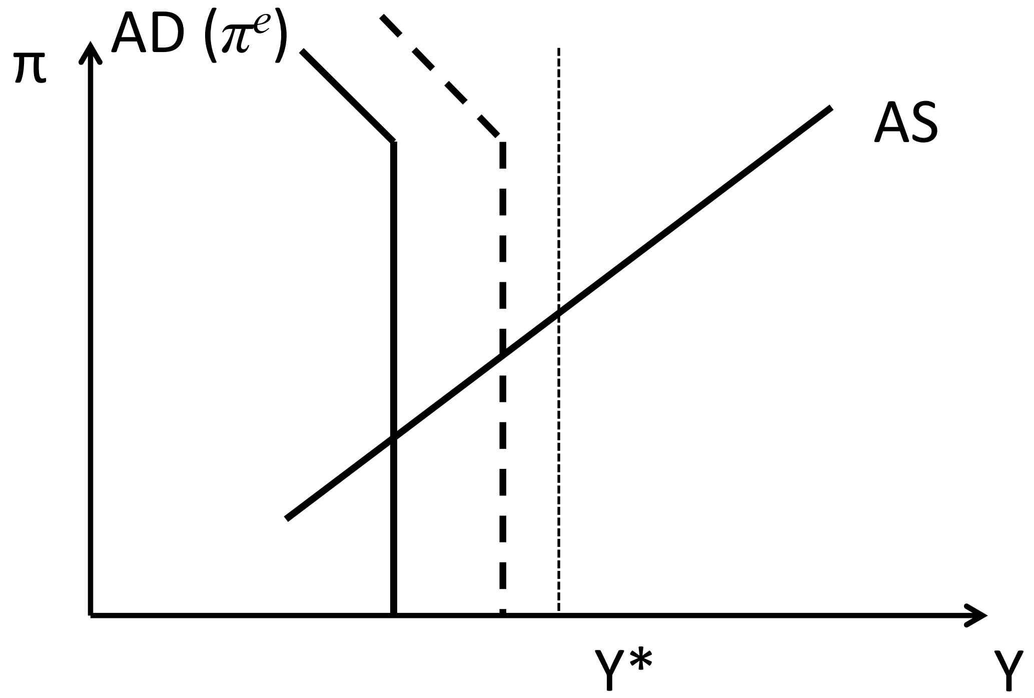


A low inflation trap?
Economics

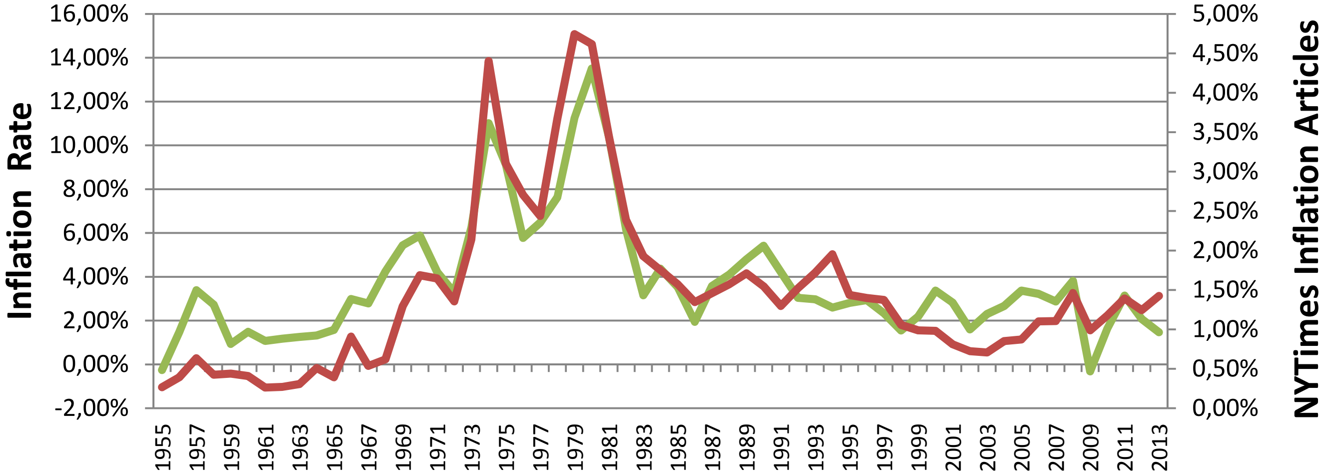
At ZLB, π^e too low and ***Y* is demand determined**

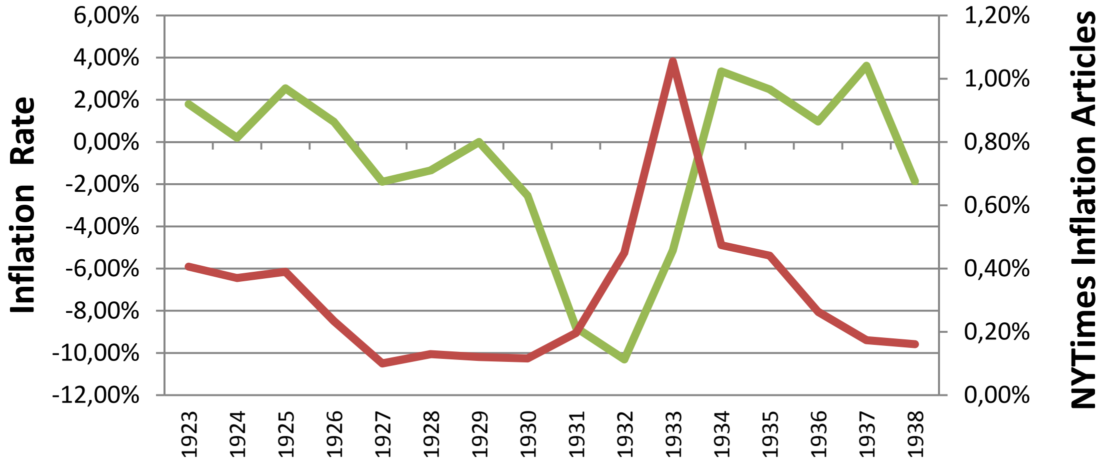
$\uparrow \pi^e$ => aggregate *demand* shifts right, and so does equilibrium Y

Suboptimal ex-post => lack of credibility in raising π



A low inflation trap?
Politics





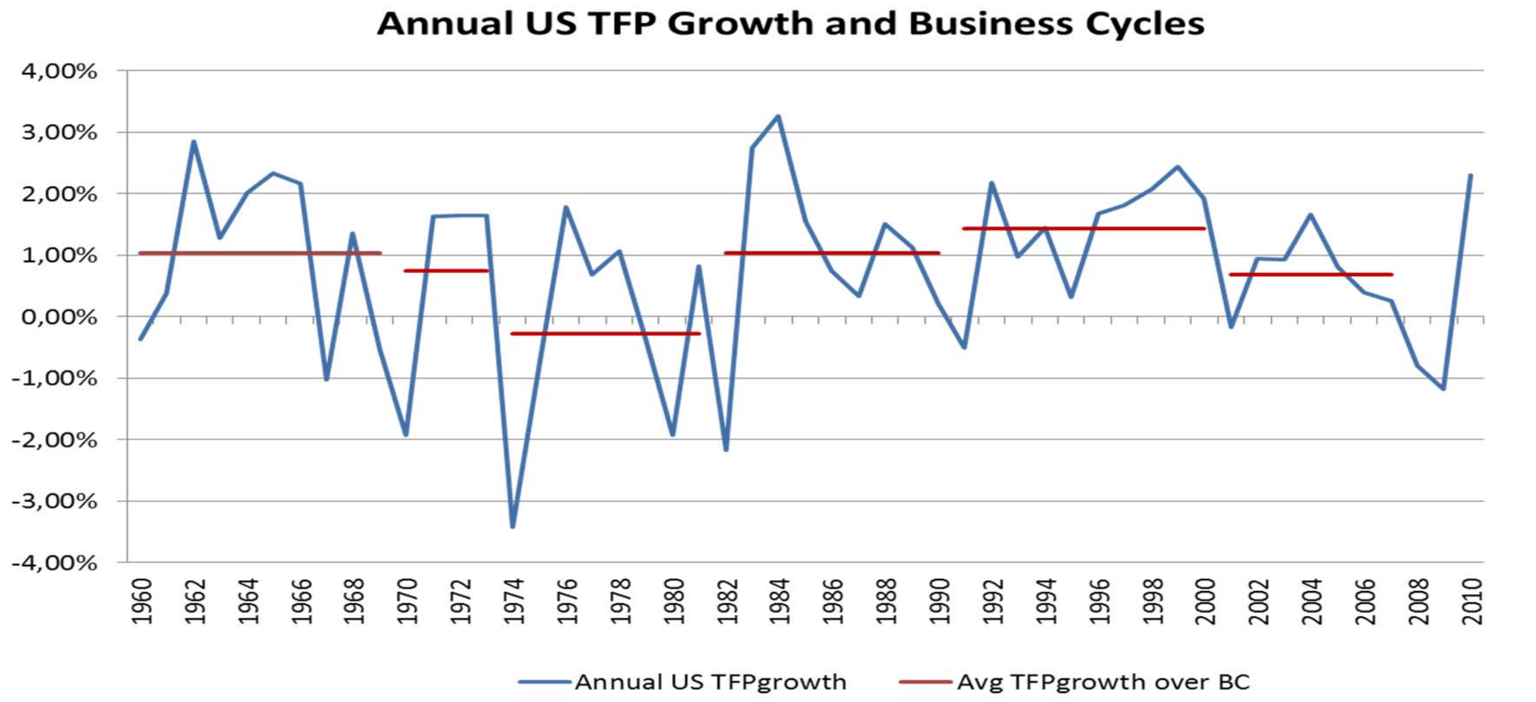
Inflation Rate   NYTimes Inflation Articles

Source: *Inflation Rate* is the variation in annual US CPI for All Urban Consumers, from BLS. *NYTimes Inflation Articles* is the number of NYTimes articles containing the word "inflation" over the total number of NYTimes articles in a given year, from NYTimes Archive.

Secular stagnation in the US?

In simple New-Keynesian models, equilibrium real natural rate of interest is a function of TFP growth.

But only a small deceleration in TFP before the crisis in the US



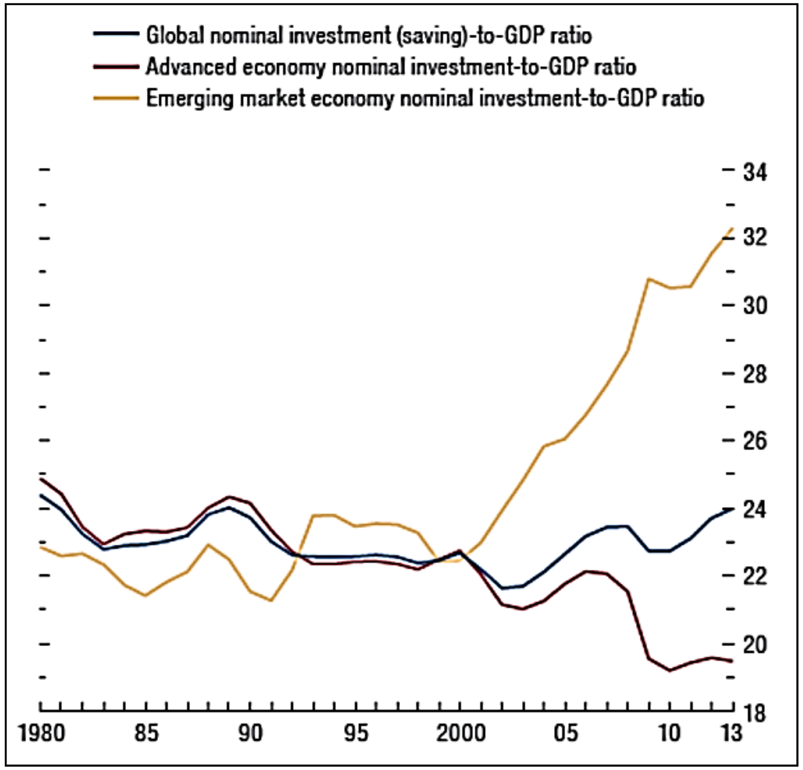
Source: TFP at constant national prices for US, from FRED. Business cycles run from the first year in a recession to the last year before the following recession (a specific year is considered a recession year if it has more than 6 months spent in recession, or if it starts in a recession begun 5 or less months before); monthly recession data from NBER Recession Indicators for the United States, as reported in FRED.

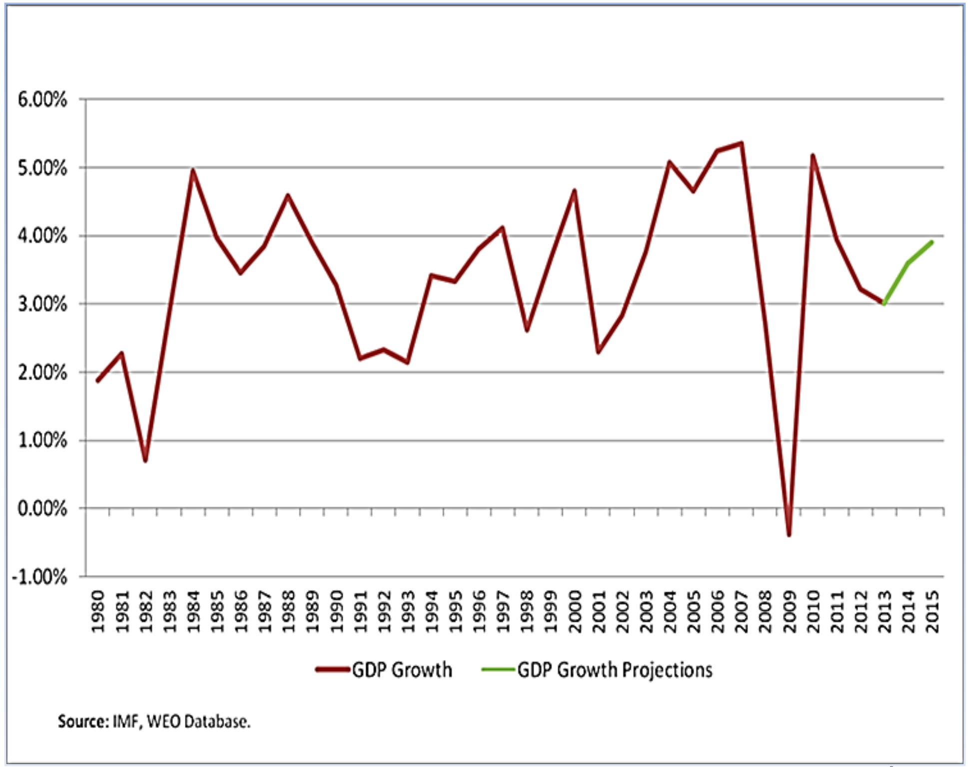
Source: FRED and Groningen data base

Secular stagnation in the world?

Given world integration, a global phenomenon. But…

- No deceleration in global investment / global growth before the crisis





Secular stagnation in the world?

Given world integration, a global phenomenon. But…

- No deceleration in global investment / global growth before the crisis

- Before the financial crisis, return on capital (profit rates / growth of profits) remained high

- A global savings glut? Perhaps…but will it continue?
  - Foreign reserves in emerging countries
  - China's low consumption
  - Savings and growth

The ZLB: a concern anyway?

Even if no «secular stagnation»:

- Recent estimates of natural rate of interest: - 4% < in **last three** US recessions, though not for long

  Cùrdia et al (2014), Barsky et al (2014)

- Slow recoveries from banking crisis (debt overhang)
  - Reinhart-Rogoff 2014: in a sample of 100 crisis, > 8 years on average to return to pre-recovery peak of GDP per capita
  - In Southern Europe likely to take much longer

- Future vulnerability to financial crisis and sudden stops

Features of Inflation Targeting

1. Inflation as a nominal anchor (rather than the price level path, or nominal income)

2. A high /almost exclusive weight on inflation vs output

   A «conservative» CB to offset distorted incentive to inflate

3. Higher implicit penalty if $\pi > \pi^*$ than if $\pi < \pi^*$

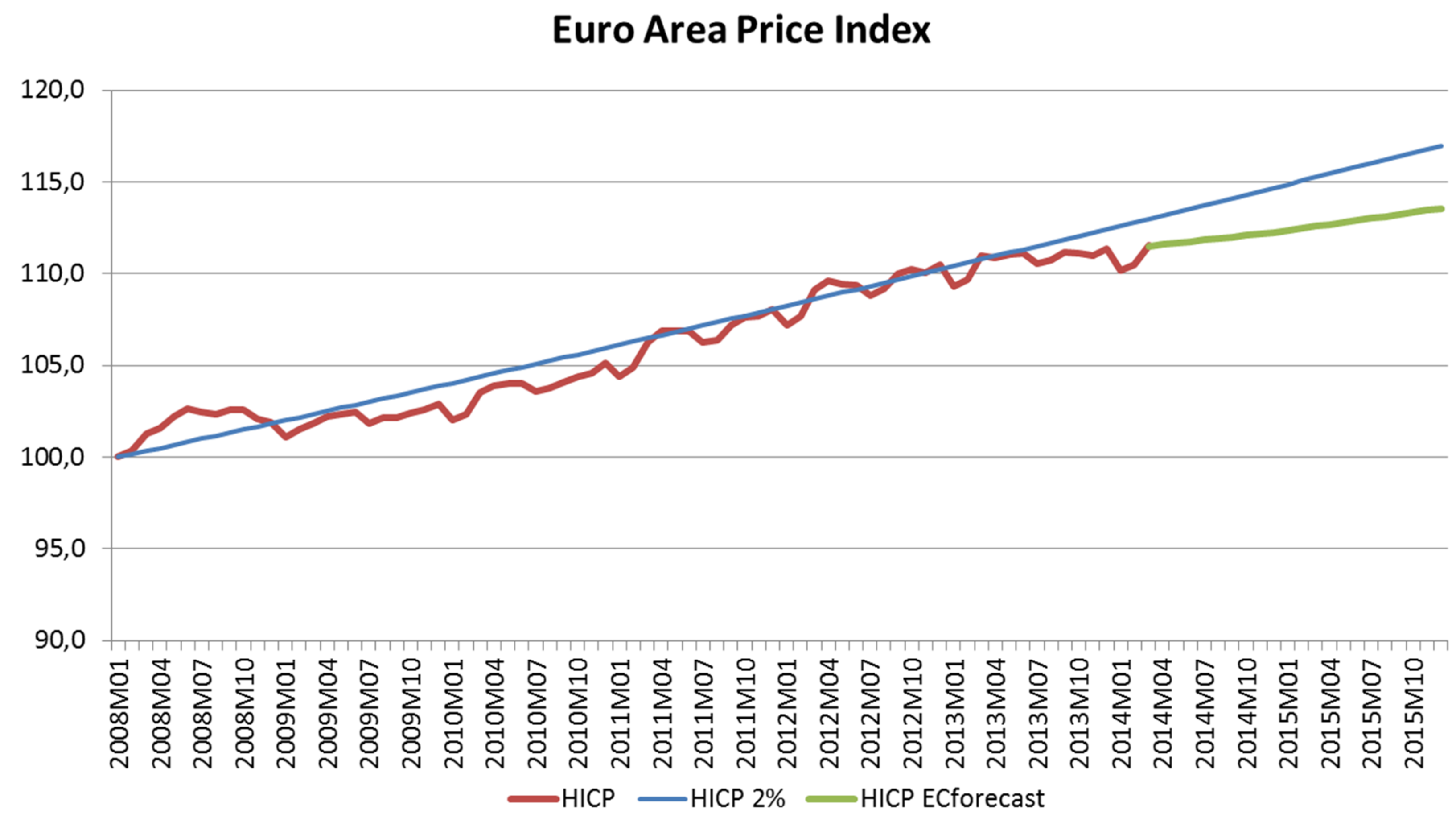
   To gain credibility that inflation will stay low

4. The inflation goal, $\pi^* = 2\%$

1. Inflation or price level targeting ?

In a liquidity trap, want to raise future π^e. This is done automatically if target a path for the price level

Svensson, Woodford



Source: Monthly Harmonized Index of Consumer Prices (*HICP*) for all items in the Euro Area (considering countries using the Euro in any given year), from Eurostat. *HICP 2%* shows the theoretical path of inflation growing at an average annual rate of 2%. *HICP forecast* is the hypothetical future path of inflation growing at the annual rate forecasted by the European Commission for the Euro Area for the years 2014-2015.

1. Inflation or price level targeting ?

In a liquidity trap, want to raise future π^e. This is done automatically if target a path for the price level

Svensson, Woodford

- What about supply shocks?
  - Relatively infrequent in the US (Justiniano et 2013)
  - Target core prices, or PY

2-3. A Distorted loss function?

- Lack of credibility also if π is too low
- Risk and costs of low π trap
- Need to facilitate relative wage changes

A distorted CB loss function is unjustified, particularly in Euro area

=> Remove asymmetry: $\pi < \pi^*$ should be perceived as very costly by CB

=> Increase weight on output (flexible IT)

4. Raise the inflation target above 2%?

Simple and direct, should be done, perhaps to 3%. But….

- Cost of high π even when unnecessary

  Coibion et al. 2012: calibrate NK model

  - ZLB once every 20 years, lasts 2 years (trend π=2%): $\pi^* < 2\%$
  - ZLB once every 7-8 years (trend π=3%): $\pi^* = 3\%$

- Association between high π and π volatility

  In the data and in theoretical models

- If π is high, indexation => some benefits are lost

- Costly to bring π down, once it gets too high for long

4. Raise the inflation target above 2%?

Politically difficult inside EMU - benefits mainly to SE, costs to NE

Same eg. as in paper, but 3 groups of countries, each of size 1/3

SE (π = - 1%) , CE ($\pi = \pi^*$) , NE

Avg Inflation (=CE)	SE inflation	NE inflation	Years to adjust
1	-1	**3**	6.7
2	-1	**5**	4.2
3	-1	**7**	3.3
4	-1	**9**	2.7

Summary

- Agree that IT framework needs to be reconsidered
  - Case for higher π is overwhelming in Euro area now (debt overhang even more important than relative wage changes)
  - Need to strengthen incentives to avoid low inflation trap

- Small increase in π^* is simple and direct way to do it

- But even more important to reconsider other aspects of IT:
  - P level or PY targeting
  - Undistorted loss function