Inflation Targets Reconsidered
Comments

Guido Tabellini
Bocconi University

Outline

1. Should inflation targeting (IT) be reconsidered?

   Yes. Review arguments

2. Which features of IT should be changed?

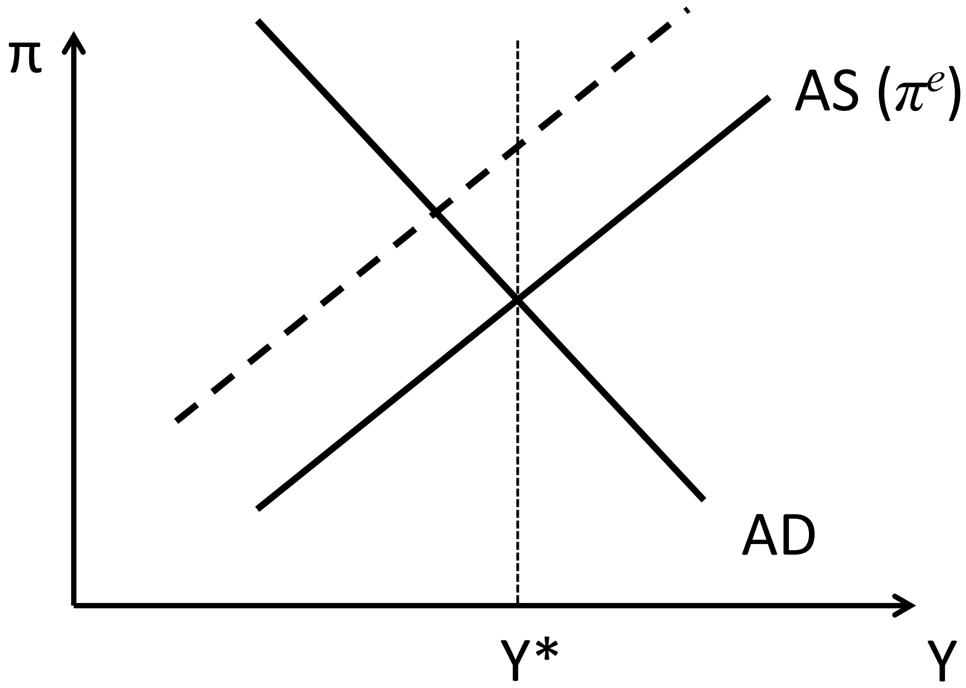
   Other aspects of IT framework more important than π^*

A low inflation trap?
Economics

Clarification (Eggertsson Giannoni 2013)

Traditional lack of credibility problem: π^e too high

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

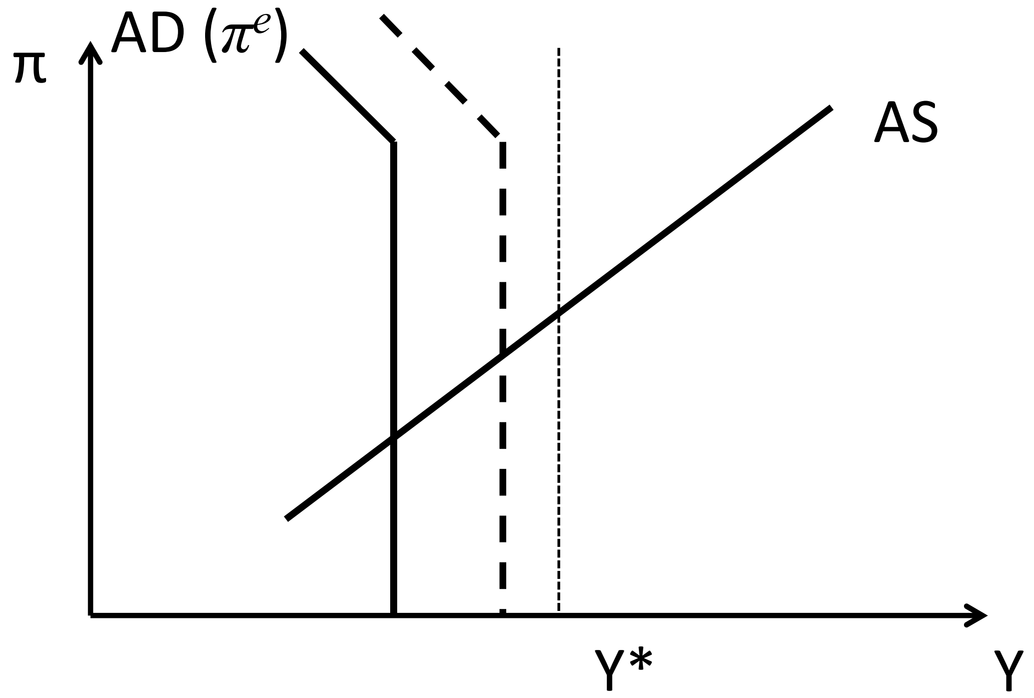


A low inflation trap?
Economics

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

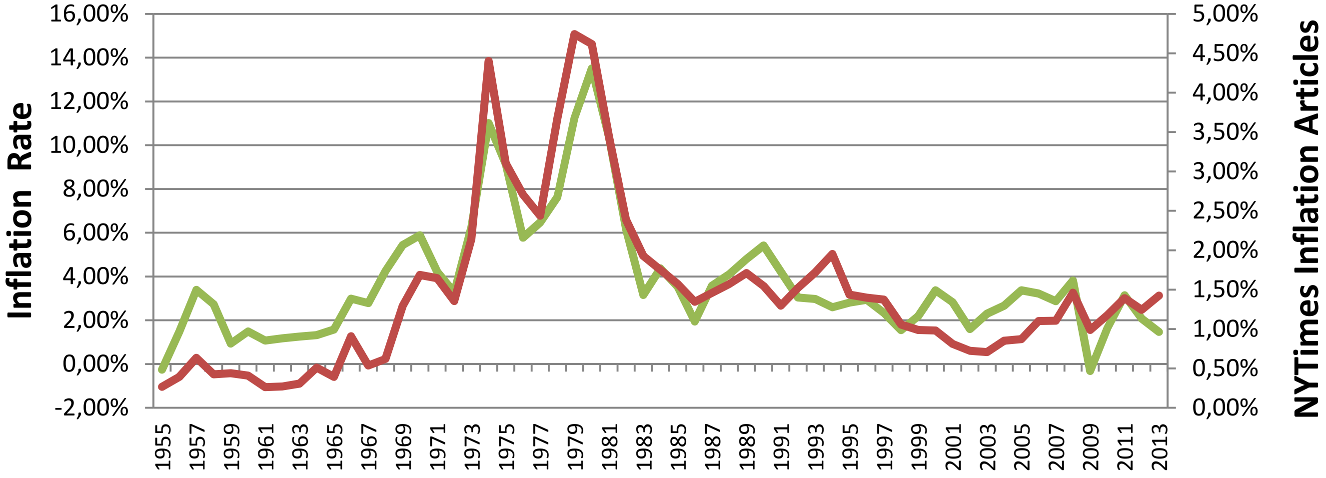
↑π^e => aggregate *demand* shifts right, and so does equilibrium Y

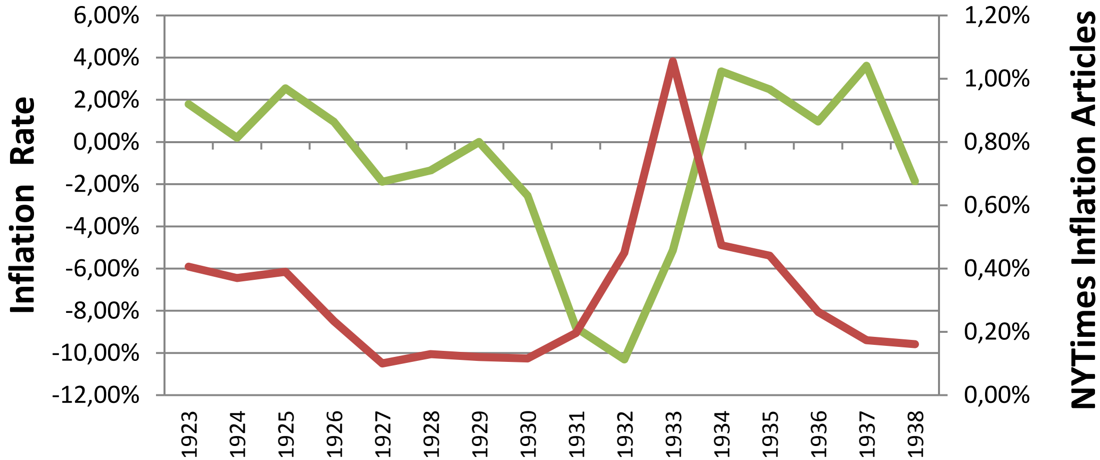
Suboptimal ex-post => lack of credibility in raising π



A low inflation trap?

Politics





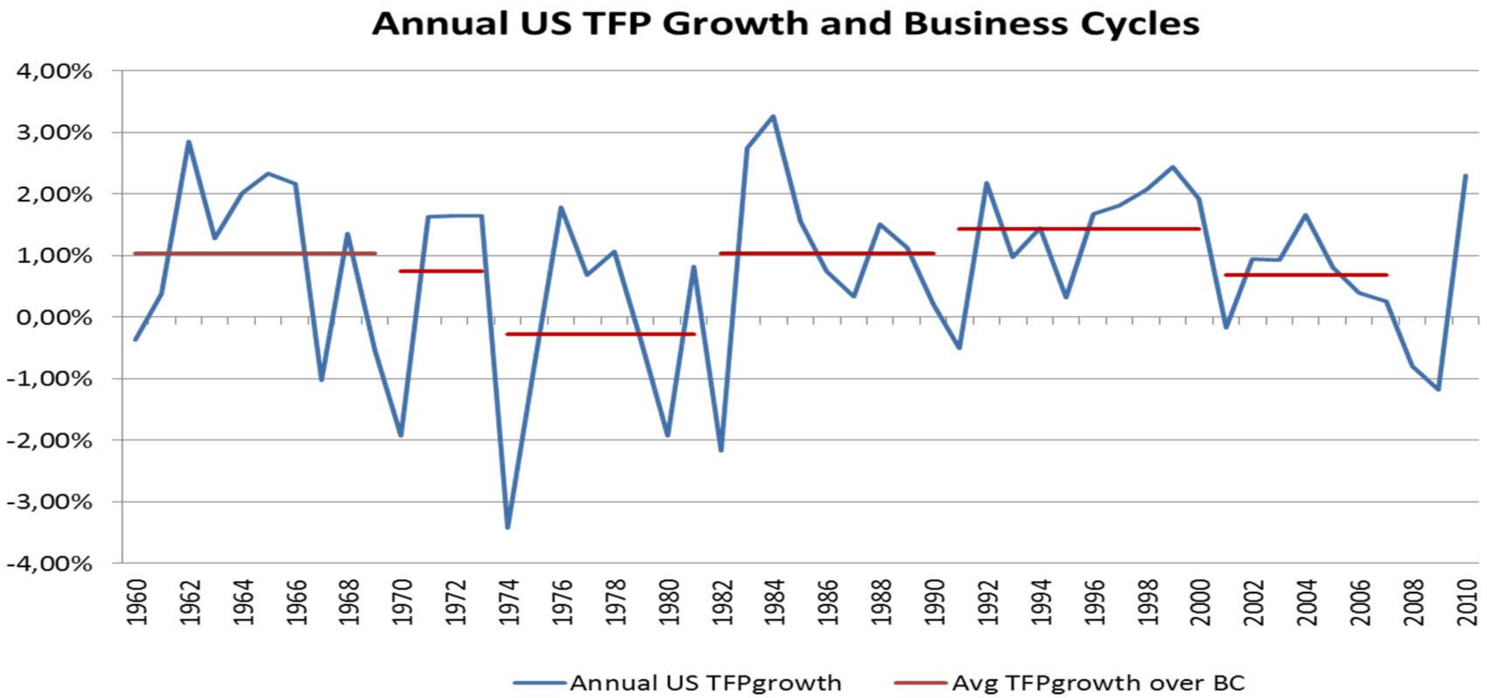
Inflation Rate NYTimes Inflation Articles

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



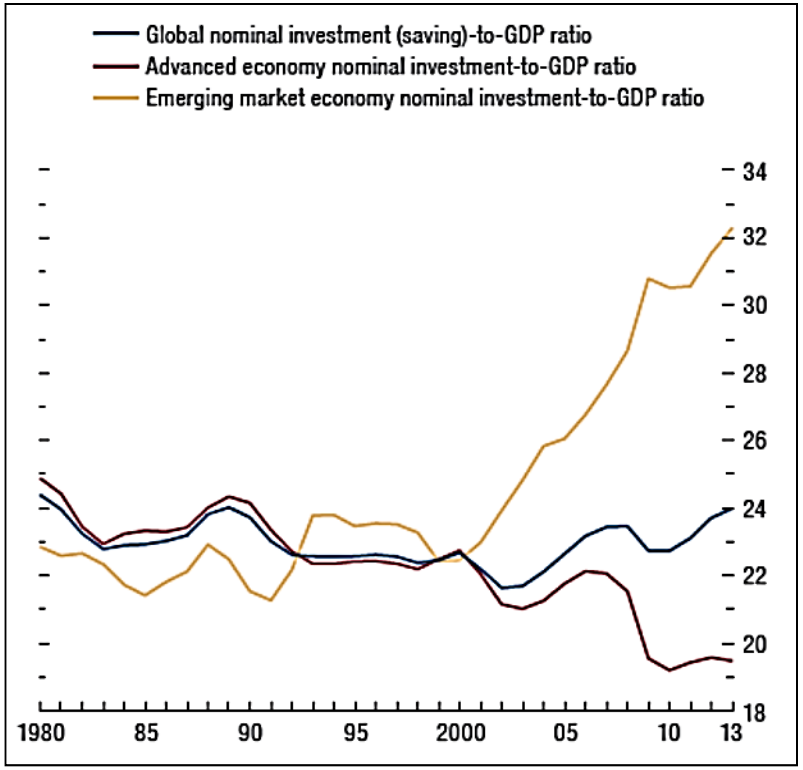
Source: TFP at constant national prices for US, from FRED. Business cycles run from the first year in a recession to the last year before the following recession (a specific year is considered a recession year if it has more than 6 months spent in recession, or if it starts in a recession begun 5 or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

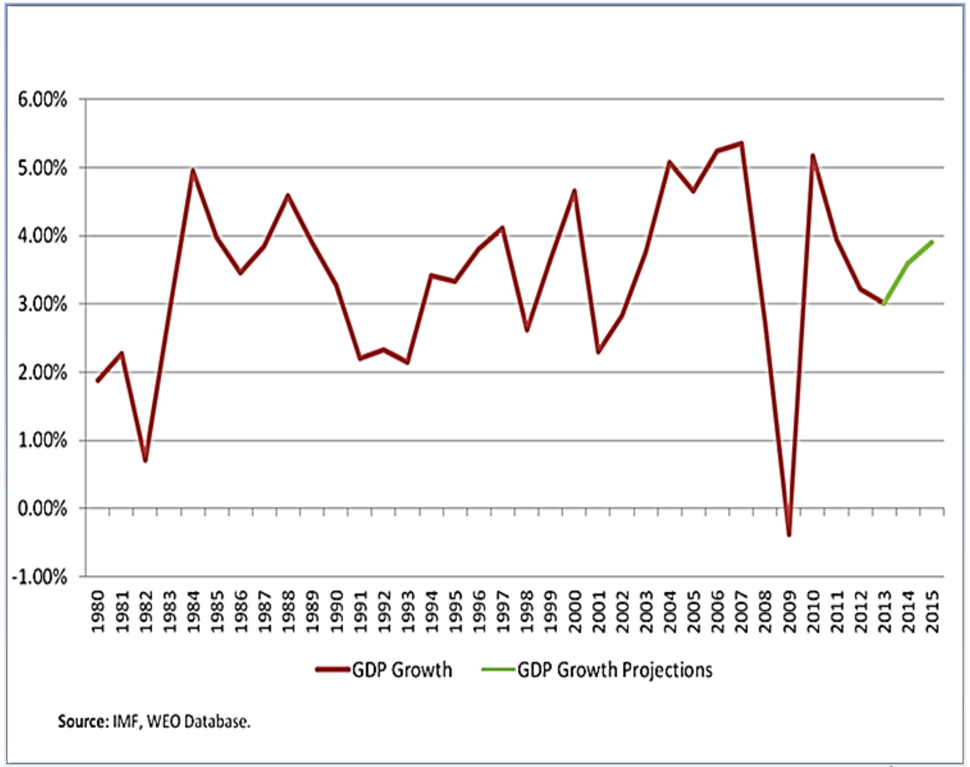
Source: FRED and Groningen data base

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 $\pi < \pi^*$

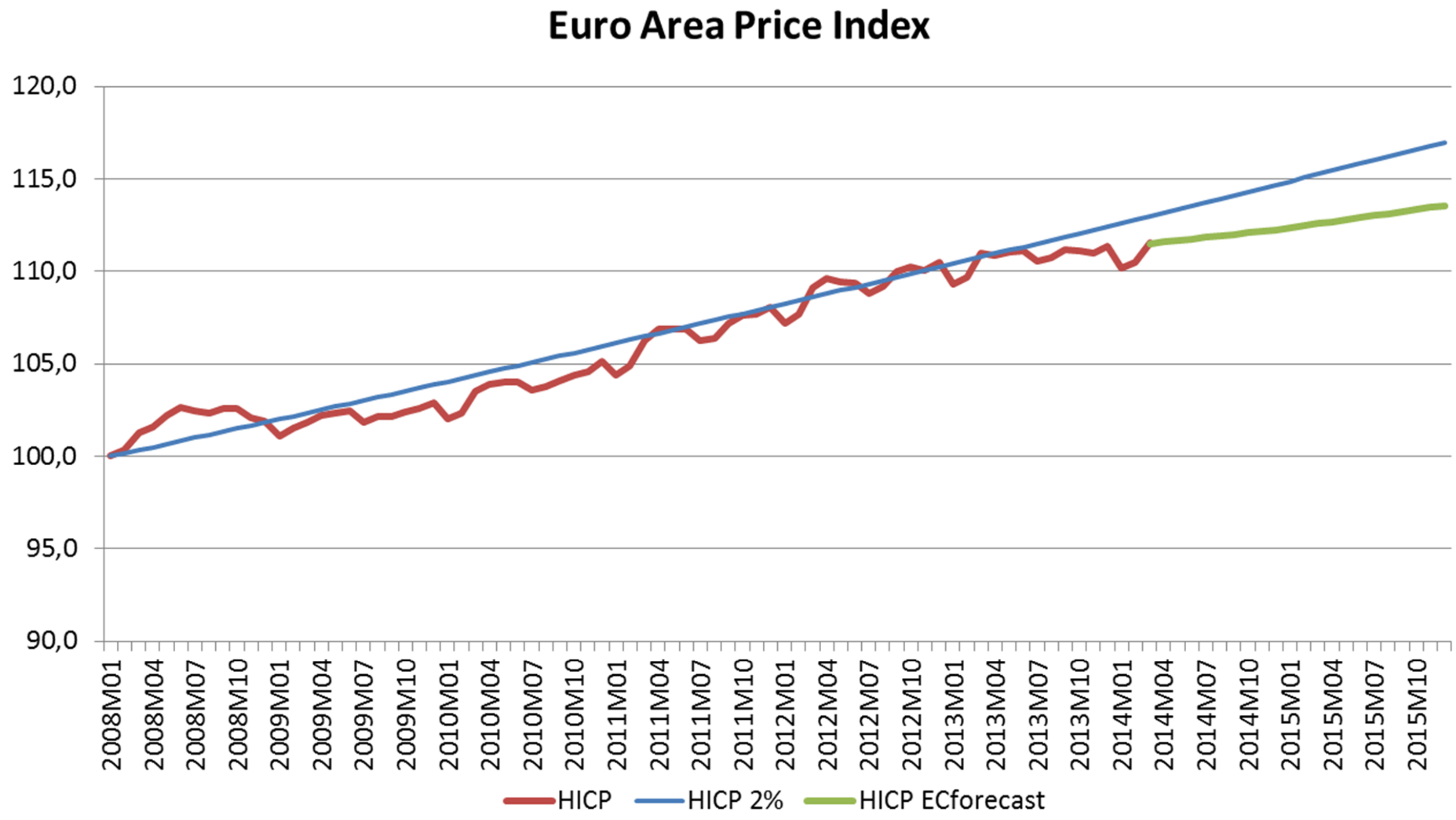
   To gain credibility that inflation will stay low

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