Round-up

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The Consensus on Inflation Targets

As ‘round-up’ discussant, I was asked to summarise the main themes of the conference and identify areas of consensus. I initially found this assignment daunting, but it has proven easier than expected. This is because an unusually clear consensus has emerged about many issues. There is a set of broad conclusions about inflation targets that most conference participants accept.

Current policies are pretty good!

The consensus at this conference is a happy one. There were few complaints about Australia’s current system of inflation targeting, and few proposals for major changes. We certainly didn’t hear any fiery speeches in favour of fixing the exchange rate or returning to money-supply targets.

I was a fan of inflation targets before the conference, so the discussion largely confirmed my prior beliefs. However, the conference also resolved one nagging doubt about current policy. This doubt concerns the practice of interest-rate smoothing discussed by Lowe and Ellis. I have suspected that this policy is suboptimal – that central banks move interest rates slowly because of some kind of inertia or timidity, causing unnecessary delays in policy. I am reassured by Lowe and Ellis’s finding that interest-rate smoothing has only small effects on the variances of output and inflation. Their explanation makes sense: the policy stance that is relevant to the economy is measured over a long period, so the precise timing of adjustments is unimportant. I still doubt that there are major benefits of interest-rate smoothing, but there do not seem to be major costs either.

The key benefits of inflation targets

The conference produced a consensus not just that inflation targeting is desirable, but also about why. Nobody claimed that this policy has magical effects such as eliminating the output-inflation tradeoff. But the discussion isolated two practical benefits of inflation targets. These two points are spelled out nicely in Mishkin’s paper.

First, inflation targets are a sensible response to the policy dilemma of rules versus discretion. Unlike rigid rules such as money targets, inflation targets allow appropriate responses to various kinds of shocks. But the scope for irrational policies or political mischief is much smaller than under pure discretion, because policies must be justified as moving inflation toward its target. As Bernanke and Mishkin (1997) put it, inflation targets are ‘constrained discretion’. They combine strong points of the rules and discretion approaches that have traditionally been viewed as incompatible.

The second, related advantage of inflation targets is that they focus policy discussions in a healthy way. Mishkin gives an example from Canada, where a political debate about whether to loosen policy was channelled into a discussion of what the inflation target should be and how quickly to achieve it. These are the right issues to debate. Mishkin's example concerns discussions among politicians, but inflation targets are also important for focusing discussions within central banks. The governor can start a policy meeting by noting that the inflation target is 2.5 per cent and current inflation is 3.2 per cent. The rest of the meeting can focus on how much tightening is needed to reduce inflation by 0.7 per cent – again, the right question. My impression is that policy meetings in countries without inflation targets, such as the United States, are more meandering. At FOMC meetings, people review a variety of statistics and present various rationales for tightening or easing. Different people at the table have different ideas about where inflation should go – different implicit inflation targets – and some may have quite idiosyncratic agendas or models of the economy. In this environment, there is a greater risk of erratic policy.

Inflation targets should be flexible

A stereotype is that inflation targeting means pushing the variance of inflation to its absolute minimum regardless of anything else. At this conference, however, participants agreed that inflation targets should be flexible, and are in practice. Policy stabilises inflation in the medium run, but it tolerates some short-run variability if doing so helps the real economy. In particular, 'caveats' to inflation targets allow flexible responses to supply shocks.

The target inflation rate should be positive

It is a stretch to say there is consensus on this point, but there is at least a majority. Although we heard arguments on both sides, the proposition 'Australia should lower its inflation target to zero' would lose a vote of conference participants. Haldane is ambivalent about the idea, but the arguments against zero inflation came out forcefully in the discussion of his paper.

As discussed by Haldane, Feldstein (1997) and others present calculations suggesting that the gains from disinflation outweigh the costs. But these calculations depend on the prediction that reducing inflation from two per cent to zero will cause a large increase in capital accumulation (because inflation raises the effective tax rate on capital). If Feldstein is right, imagine the tremendous rise in capital accumulation if inflation fell by a much larger amount, from 10 per cent to 2 per cent. Then realise that decreases of this magnitude were achieved in the 1980s and 1990s, with no apparent surge in capital accumulation (indeed, savings fell in many countries). This experience should also make us suspicious of Feldstein's calculations.[1]

Feldstein's cost-benefit analysis also understates the cost of disinflation, for at least two reasons. First, as Haldane points out, Feldstein assumes the costs are transitory, while in fact they may be long-lived – there may be hysteresis. Second, Feldstein measures the welfare cost of disinflation by the loss in aggregate output. This would be appropriate if a five per cent fall in GDP meant that every individual loses five per cent

1. Charles Goodhart made this argument at a recent conference at the Bank of Italy.

of his income. In reality, the losses fall disproportionately on certain individuals, such as those who become unemployed. If utility is concave in income, this concentration of losses implies a larger fall in average utility.

Convergence in monetary policies

The consensus about inflation targets is not limited to this conference. A consensus is growing around the world as more and more countries adopt similar policies. Countries such as New Zealand with relatively rigid targets have become more flexible, while 'just do it' countries such as the United States may be moving toward targets, at least implicitly. The worldwide picture is rosy: countries are converging toward the current best practice in monetary policy.

An Open Question

While we understand a lot about inflation targets, it is not yet time to disband the Economic Research Department at the Reserve Bank of Australia. There are still open questions that require research. I want to emphasise one unanswered question that is especially important. This is the choice of policy horizon – of the speed with which policy moves inflation toward its target. If a shock raises inflation, for example, should policy tighten sharply to bring inflation back quickly? Or should disinflation be gradual? This question came up several times at the conference, but here there was little progress toward consensus.

My views on this question, which are related to those of de Brouwer and O'Regan, are ambivalent. Suppose we believe that policy-makers face a fixed, linear Phillips curve. As shown by Taylor (1994) and others, this assumption implies a trade-off between the variance of output and the variance of inflation. Such a trade-off arises in de Brouwer and O'Regan's model, for example. Choosing a target horizon or adjustment speed means choosing a point on the output-variance/inflation-variance frontier. Slower inflation adjustment makes inflation more variable, but it smooths the path of output.

This analysis implies a strong case for slow adjustment, because output fluctuations are costly. We do not know whether the analysis is correct, however, because we do not know how the Phillips curve would change if policy changes. This point is the 'Lucas critique' discussed by de Brouwer and O'Regan. Suppose that policy-makers increase the speed with which they return inflation to target. Once this policy becomes established, people might anticipate the rapid mean-reversion in inflation, and this shift in expectations might steepen the short-run Phillips curve. If this effect is strong enough, adjusting inflation as quickly as possible would minimise the variance of output as well as the variance of inflation. In this case, such a policy is clearly the best.

This idea is speculative. In practice, we have not observed inflation targeting for long enough to know whether faster adjustment leads to more or less output variability. We should look for clues in the future experiences of inflation targeters.[2]

2. Ball (1994) presents some relevant evidence: in OECD countries, rapid disinflations have had smaller output costs than slow disinflations.

What We Did Not Discuss

The conference addressed lots of important issues, but one *very* important problem received little attention: the high unemployment in Australia and elsewhere. Ian McDonald and John Pitchford mentioned the issue, but most of us ignored it. The reason, presumably, is not indifference to unemployment, but rather the view that monetary policy cannot affect unemployment in the long run. To make an analogy, I am worried about whether Saddam Hussein will acquire nuclear weapons, but I am not surprised that the issue did not come up at this conference. If Saddam does try to get the bomb, there is not much that Ian Macfarlane can do to stop him.

Is there a similar reason for ignoring long-run unemployment? Is unemployment really like nuclear proliferation, a problem for which monetary policy is irrelevant? Friedman's natural-rate hypothesis says yes: if long-run unemployment is eight per cent, this fact is explained entirely by imperfections in the labour market. In my view, however, there is considerable evidence against this theory and in favour of the hysteresis effects discussed by Haldane. In particular, today's high unemployment in Australia is partly a legacy of the tight policy that has reduced inflation since the 1980s. So I do not think central bankers can completely wash their hands of the unemployment problem.[3]

I am not going to argue that the Reserve Bank of Australia should promptly reinflate to fight unemployment. (Among other reasons, I want to be invited back to this and other central banks.) I believe, however, that monetary policy may have a role in attacking unemployment at some point. Most economists believe that reducing unemployment requires reducing distortions in the labour market, such as open-ended unemployment insurance. Suppose we accept this view, and suppose that some day it is politically feasible to reform the labour market. At that point, monetary policy will have an important supporting role in lowering unemployment. When people lose unemployment benefits, they can go in two directions: they can rejoin the labour force, or they can stay unemployed and become more impoverished and cut off from society. If benefits are cut, the numbers that go in each direction will depend on the state of the economy – on whether jobs are available for people leaving unemployment insurance. Since labour-market reforms work best in a high-pressure economy, they should be accompanied by expansionary monetary policy.[4]

Such a policy would not *necessarily* raise inflation. In the best-case scenario, policy would just increase demand to match the supply of new workers, and the economy would not overheat. However, any monetary expansion, even one co-ordinated with supply-side reforms, creates a risk of higher inflation. We do not fully understand the forces causing changes in long-run unemployment, so we do not know how much expansion would be needed. In my view, some risk of higher inflation is acceptable given the importance of reducing unemployment.

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3. For cross-country evidence on hysteresis, see Ball (1997). For a discussion of Australia, see Gregory (1986).
4. This proposal is similar to the 'two-handed approach' to unemployment advocated by Blanchard *et al.* (1986).

Therefore, despite my generally warm feelings for inflation targets, I do not believe they should *always* be the focus of monetary policy. There may be circumstances in which a central bank's top priority is contributing to a major structural change – a decrease in unemployment. In such circumstances, the normal practice of inflation targeting should be modified to help meet this goal.

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2. General Discussion

The discussion focused on two practical aspects of implementing an inflation target:

- the stance of monetary policy while the labour market is being reformed; and
- the interaction of the inflation target with employment and economic-growth objectives.

There was no consensus about how monetary policy should respond to reform of the labour market. One view was that monetary policy should stimulate growth during the reform process so as to reduce the possibility that reform led to higher unemployment in the short run. Other participants thought that labour-market reform should be treated no differently to other 'shocks'. If reform eases inflationary pressures, policy could be relatively more accommodative since the expected inflation rate should be lower. But if reform is associated with higher short-run wage pressures, then policy may need to be tighter than otherwise.

Whatever the case, most participants thought it undesirable to prescribe a monetary-policy response to labour-market reform before some informed judgments about the effects of the reform could be made. Moreover, as market structure changes, policy-makers need to be aware that economic relationships which held in the past may change, and so existing rules-of-thumb may no longer be relevant.

The other practical issue that captured discussion was the interaction between inflation and economic-growth objectives. Some participants thought that more attention should be devoted to the employment and growth consequences of monetary policy. In response, others noted that a system based on some form of inflation target did not preclude policy actions to mitigate the business cycle; indeed arguably that is required by an inflation target. Again, the very rationale for low inflation was to improve the medium-term growth prospects for the economy.

While there was widespread agreement that unemployment remains Australia's main economic problem, a number of participants thought that there was a tendency by some to be unduly pessimistic about the prospects for the present macroeconomic policy regime delivering reductions in unemployment. They argued that declines in interest rates over the past year had contributed to an environment in which the economy was well placed to grow more strongly, and that this should see the unemployment rate decline. It was also noted that steady growth, rather than 'stop-start' growth, was more effective in reducing unemployment. Steady growth can eliminate problems associated with 'speed-limit' constraints and can reduce the probability of hysteresis in the labour market. The issue was what rate of growth could be sustained.

Finally, participants noted that a consensus now seems to have developed in favour of maintaining low and stable inflation, not just in Australia but through the world. In Australia's case, participants agreed that policy-makers should maintain inflation at an average rate of two to three per cent. This meant that inflation rates below the target need to be taken as seriously as inflation rates above the target; apart from being good public policy this was seen as important in maintaining public support for the inflation target.