FEDERAL RESERVE BANK OF SAN FRANCISCO

ECONOMIC RESEARCH

PUBLICATIONS

FRBSF Economic Letter

1998-18 | May 29, 1998

More Economic Letters

U.S. Inflation Targeting: Pro and Con

Glenn D. Rudebusch and Carl E. Walsh

In recent years, monetary economists and central bankers have expressed growing interest in inflation targeting as a framework for implementing monetary policy. Explicit inflation targeting has been adopted by a number of central banks around the world, including those in Australia, Canada, Finland, Israel, New Zealand, Spain, Sweden, and the U.K. In the United States, there has been little public debate over inflation targeting, although some bills have been introduced in Congress to mandate the use of explicit targets for inflation.

Issues and questions surrounding inflation targeting formed a major focus of a recent conference on Central Bank Inflation Targeting jointly sponsored by the Federal Reserve Bank of San Francisco and the Center for Economic Policy Research at Stanford University (Rudebusch and Walsh 1998). In this *Economic Letter*, we set out some of the arguments for and against adopting inflation targeting in the United States discussed at the conference. (For further discussion, see Bernanke and Mishkin 1997, Bernanke, et al., forthcoming, and Keleher 1997.)

What would inflation targeting mean in the U.S.?

There has been some ambiguity about the precise definition of an inflation targeting policy regime, in part because certain institutional arrangements have differed from one inflation targeting country to another–most notably with regard to how the inflation target is set and how deviations from the target are tolerated. For our discussion, we define inflation targeting to be a framework for policy decisions in which the central bank makes an explicit commitment to conduct policy to meet a publicly announced numerical inflation target within a particular time frame. For example, at the start of 1993, Sweden's central bank announced an inflation target for the consumer price index of between 1 and 3 percent by 1995. Similarly, if the Federal Reserve wanted to adopt inflation targeting, it would publicly commit to achieving a particular numerical goal for inflation (a target point or range) within a set time span of, say, a couple of years. Also, as part of an ongoing policy framework for targeting inflation, the Fed's semiannual Humphrey-Hawkins report, which currently provides a near-term (one-year) outlook for inflation, could be augmented to include a discussion of whether the medium-term (two- or three-year) inflation forecast is consistent with the announced medium-term inflation target. Inflation targeting would not impose a rigid simple rule for the Fed; instead, policy could employ some discretion to take into account special shocks and situations. However, the organizing principle and operational indicator for monetary policy would be focused on inflation and (in light of lags in the effects of policy) inflation forecasts.

Given some earlier ambiguity, it is important to be clear about how we interpret the ultimate goals of inflation targeting monetary policy. In particular, an inflation targeting central bank need not care only about inflation. Indeed, most inflation targeting central banks continue to recognize multiple goals for monetary policy with no single primary one. (In New Zealand–an exception–the start of inflation targeting coincided with a legislative mandate that the central bank's "primary function" was price stability, while in Canada–as is more typical–such legislation was never passed.) Accordingly, an operational policy framework of inflation targeting would still be consistent with the Fed's current legislated objectives of low inflation and full employment. An inflation targeting regime can accommodate a goal of output stabilization by having wide inflation target bands, long inflation target horizons, and explicit exemptions for supply shocks. Thus, the adoption of an inflation targeting regime does not necessarily require that price stability or low inflation be the preeminent goal of monetary policy. As with monetary targeting, inflation targeting is an operational framework for monetary policy, not a statement of ultimate policy goals. (For further discussion, see Rudebusch and Svensson, 1998.)

Arguments pro

By focusing attention on a goal the Fed can achieve, by making monetary policy more transparent and increasing public understanding of the Fed's strategy and tactics, by creating institutions that foster good policy, and by improving accountability, the adoption of inflation targeting would represent a desirable change in the U.S. monetary policy.

1. The announcement of explicit inflation targets for the Fed would provide a clear monetary policy framework that would focus attention on what the Fed actually can achieve. Bad monetary policy often has resulted from demands that central banks attempt to achieve the unachievable. Most notably, few macroeconomists believe that monetary policy can be used to lower the average rate of unemployment permanently, but central banks often are pressured to achieve just that through expansionary policy; such policy instead only results in higher average inflation without leading to a systematically lower average rate of unemployment. In contrast, implementing explicit inflation targets would help to insulate the Fed from such political pressure.

2. Transparent inflation targets in the U.S. would help anchor inflation expectations in the economy. When making real and financial investment decisions and planning for the future, businesses and individuals must form

expectations about future inflation. Inflation targets would provide a clear path for the medium-term inflation outlook, reducing the size of inflation “surprises” and their associated costs. Inflation targets also likely would boost the Fed’s credibility about maintaining low inflation in the long run, in part, because they mitigate the political pressure for expansionary policy. Since long-term interest rates fluctuate with movements in inflation expectations, targeting a low rate of inflation would lead to more stable and lower long-term rates of interest. Together, the reduced uncertainty about future medium-term and long-term inflation would have beneficial effects for financial markets, for price and wage setting, and for real investment.

3. The establishment of inflation targets in the U.S. would help institutionalize good monetary policy. Recent U.S. monetary policy has been generally considered excellent, but earlier in the postwar period, monetary policy clearly failed by allowing inflation to ratchet up significantly several times. To some extent, the quality of policy over time has reflected the skills and attitudes of the people involved in the policy process. Monetary policy is an area in which it is especially important to implement institutional structures that will help to avoid bad policies. Inflation targets can provide this institutional structure and help ensure that monetary policy is not dependent on always having the good luck to appoint the best people.

4. In the current system, there is some ambiguity about how and why the Fed operates. For example, although monetary aggregates play a very modest role in the policy process,they are the only variables that the Fed is required to set target ranges for and report about to Congress. As noted above, inflation targets would focus discussion on what the Fed actually could achieve. Furthermore, an inflation target provides a clear yardstick by which to measure monetary policy. Given forecasts of future inflation, it is easy to compare them to the announced inflation target and hence judge the appropriate tightness or looseness of current monetary policy. Also, on a retrospective basis, an explicit target allows Fed performance to be easily monitored. Thus, Congress and the public will be better able to assess the Fed’s performance and hold it accountable for maintaining low inflation.

Arguments con

Inflation targeting, even without imposing a rigid rule, would unduly reduce the flexibility of the Fed to respond to new economic developments in an uncertain world. Furthermore, publicly committing solely to an inflation target would not enhance overall accountability or transparency given the multiple objectives of monetary policy.

1. The purpose of inflation targeting is to focus the attention of monetary policy on inflation. However, concentrating on numerical inflation objectives (even with caveats or escape clauses) also reduces the flexibility of monetary policy, especially with respect to other policy goals. That is, inflation targets place some constraints on the discretionary actions of central banks. Such constraints can be quite appropriate in countries where monetary policy has performed poorly, exhibiting sustained unproductive inflationary tendencies; however, this is not the case in the United States. U.S. monetary policy has operated quite well for almost two decades, so limiting the flexibility and discretion of the Fed to respond to new economic developments would be ill-advised. Why change a system that is working? Certainly, adept policymakers are one reason for the good performance of recent monetary policy, but there is also a strong institutional structure–stronger than existed at the start of the 1970s–that is already in place at the Fed that fosters good monetary policy.

2. Monetary policy requires the careful balancing of competing goals–financial stability, low inflation, and full employment–in an uncertain world. There is uncertainty about the contemporaneous state of the economy, the impact policy actions will have on future economic activity and inflation, and the evolving priority to be given to different policy objectives. However, because monetary policy actions affect inflation with a lag, inflation targeting means, in practice, that the Fed would need to rely heavily on forecasts of future inflation. Given the uncertainties the Fed faces, an inflexible and undue reliance on inflation forecasts can create policy problems. For example, most forecasts in the mid-1990s of inflation in the late 1990s over-estimated the inflation we are currently experiencing. If the Fed had been inflation targeting in the mid-1990s, it might well have raised the funds rate based on its inflation forecasts. Yet with today's low inflation and robust economy, it is difficult to argue that the Fed was too expansionary and that the more contractionary policy implied by inflation

targeting would have produced a better outcome. As in this instance, it seems unlikely that a mechanical dependence on inflation forecasts to achieve inflation targets will improve policy.

3. Proponents of inflation targeting argue that it promotes accountability. However, as is generally agreed, low inflation is only one of the objectives of monetary policy. While monetary policy may not affect average real growth or unemployment over time, it does have an important role to play in helping to stabilize the economy. Even if average inflation is the one thing the Fed can control in the long run, it does not follow that the Fed should be held accountable only for its inflation record. Inflation targeting actually could reduce the Fed's overall accountability by allowing it to avoid responsibility for damping short-run fluctuations in real economic activity and unemployment. Making the Fed publicly accountable for only one policy goal may make it harder for Congress and others to monitor the Fed's contribution to good overall macroeconomic policy.

4. Similarly, with regard to the transparency and public understanding of policy, inflation targeting highlights the inflation objective of central banks but tends to obscure the other goals of policy. Just as uncertainty about future inflation impedes good economic decision making, so does uncertainty about the future level of output and employment. Inflation targeting sweeps the latter concerns under the rug (often by adjusting the amount of time that deviations are allowed from the inflation target). Given the multiple legitimate goals of policy, the single public focus of inflation targeting does not enhance overall transparency.

Summary

The debate about the appropriateness of inflation targets in the U.S. continues, but it is likely that the actual experiences of inflation targeting countries will provide the most convincing evidence. The recent record of inflation targeting countries has been good, but many other countries also have reduced inflation and maintained low rates of inflation even without employing a formal targeting framework. The generally benign macroeconomic environment of the past few years still leaves much unknown about how best to reconcile sufficient policy flexibility with the maintenance of low inflation. The oldest inflation targeting regime (New Zealand) is barely eight years old, and there is still much to learn.

Glenn D. Rudebusch
Research Officer

Carl E. Walsh
Professor of Economics, UC Santa Cruz
and Visiting Scholar, FRBSF

References

Bernanke, B. S., and F. S. Mishkin. 1997. “Inflation Targeting: A New Framework for Monetary Policy?” *Journal of Economic Perspectives* 11 (Spring) pp. 97-116.

___, T. Laubach, F. S. Mishkin, and A. Posen. Forthcoming. *Inflation Targeting: Lessons from the International Experience*. Princeton, NJ: Princeton University Press.

Keleher, R.E. 1997. “Establishing Federal Reserve Inflation Goals.” Joint Economic Committee Study (April).

Rudebusch, G. D., and L. E. O. Svensson. 1998. “Policy Rules for Inflation Targeting.” NBER Working Paper No. 6512.

___, and C. E. Walsh. 1998. “Central Bank Inflation Targeting.” *FRBSF Economic Letter* 98-17 (May 22).

More Economic Letters
