A SYMPOSIUM OF VIEWS

Inflation Targeting

Should the Federal Reserve in its conduct of monetary policy follow the European Central Bank and adopt some form of inflation target range? TIE *asked thirteen distinguished experts.*

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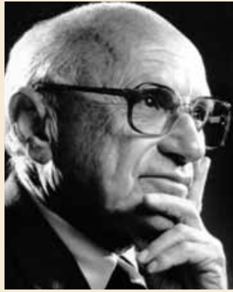
Some argue that while Fed Chairman Alan Greenspan, in office since 1987, has been an extraordinarily subtle and skillful manager, his successor may not enjoy these unique skills. Thus, the system needs eventually to agree on a series of guiding benchmarks if not a target for use in the conduct of monetary policy. Globally, such an additional tool might help in the convergence process and potentially create more stability for exchange rates.

Others counter that it is not wise to lock the system into a simplistic rule, or set of rules, particularly at a time of continued geopolitical uncertainty. Still others counter that the European Central Bank established provisions that have successfully anticipated such external shocks to the system.

Is the time approaching for the U.S. central bank to adopt an inflation target or inflation target range? Or does the U.S. monetary system require a more pragmatic and intuitive approach? To what extent should an inflation target be discretionary?



Inflation targets are not a necessity yet are highly attractive.

MILTON FRIEDMAN
Senior Research Fellow, Hoover Institution, and recipient, 1976 Nobel Memorial Prize for Economic Science

Central banks the world over performed badly prior to the mid-1980s not because they lacked the capacity to do better, but because they pursued the wrong goals according to the wrong theory. Once they recognized that inflation is a monetary phenomenon and accepted price stability as their primary goal, there was a major improvement in performance. Since the mid-1980s, inflation has been decidedly lower and less volatile than earlier. That has been true for monies issued both by central banks that adopted explicit inflation targets and for those, like the U.S. Federal Reserve, that did not. Inflation targets are clearly not a necessary ingredient of a good central bank policy yet they are highly attractive as a means of codifying the responsibilities of central banks and enhancing their accountability.

The ECB's strategy has worked well.

OTMAR ISSING
Member of the Executive Board, European Central Bank

It is, of course, a source of satisfaction to me that the European Central Bank—after only five years of operation—is mentioned as a possible model for other central banks to follow. At the same time I have always been convinced that there is no unique, universal recipe for successful monetary policy. The institutional environment and the major characteristics of economies differ substantially. In any case we would not give advice, especially not in public, on what other central banks should or should not do.

I will therefore simply sketch out what has worked well for us at the ECB. We announced our monetary policy strategy in October 1998. As a new institution responsible for a new currency area, the ECB decided not to simply copy an existing strategy, such as monetary targeting or inflation targeting. Instead we developed our own approach, best suited to our particular challenges.

The main elements of the ECB's strategy are the announcement of a quantitative definition of price stability and a two-pillar framework for the analysis of risks to price stability. The two pillars consist of *economic analysis,* which looks at the determinants of short-to-medium term price developments, and *monetary analysis,* which focuses on the monetary factors driving inflation at longer horizons. This two-pillar framework facilitates the systematic cross-checking of information from complementary analytical perspectives.

The ECB's definition of price stability—year-on-year increases in the Harmonized Index of Consumer Prices of below 2 percent—provides a firm anchor for expectations and a clear benchmark for accountability. In the context of our evaluation of our strategy in May 2003, we have clarified that we aim at inflation rates below but close to 2 percent in order to underline that a sufficient safety margin against deflation is taken into account.

The ECB does not identify a specific policy horizon but aims at maintaining price stability over the medium term. This reflects the long and variable lags in the transmission mechanism and the fact that the appropriate monetary policy response depends on the nature of shocks hitting the economy. Our experience to date has been positive despite major price shocks; measures of inflation expectations have been very stable and in line with the ECB's definition.

Overall, the ECB's monetary policy strategy has worked well. It provides a systematic framework and a clear focus for policy, but is also robust and flexible to deal with an uncertain and ever-changing environment.

Inflation targeting—yes. But don't target the ECB.

EDWIN M. TRUMAN
Senior Fellow, Institute for International Economics, former Assistant Secretary of the U.S. Treasury for International Affairs, and author of* Inflation Targeting in the World Economy *(IIE, 2003)

If the Federal Reserve were to adopt inflation targeting as its framework for the conduct and evaluation of U.S. monetary policy, it would modestly benefit the performance of the U.S. and world economy, as I argue in my recent study, *Inflation Targeting in the World Economy.* Federal Reserve monetary policy would be marginally more predictable and transparent within its current mandate to achieve full employment and price stability. As a result, the overall performance of the domestic economy should improve and economic policymakers in other economies would have an improved basis for formulating their policies.

On the other hand, it would be a grave mistake for the Federal Reserve to mimic the European Central Bank. The ECB is not an inflation targeting central bank. It has adopted a definition of price stability that is confusing and provides no guide to ECB policy in practice. It has redefined price stability, its long-term goal, as inflation of less than 2 percent but close to 2 percent. What the implications are for the ECB's actual monetary policy is anyone's guess. At one extreme, it means that if inflation is more than 2 percent the ECB will tighten, or not ease policy, but if inflation is below 1.75 percent it will ease or not tighten. At the other extreme, it means nothing for current policy because price stability is only a longer-term goal. We know that the ECB worries about inflation and budget deficits and cares little about employment and economic activity, but we know little else.

It is the ECB, not the Federal Reserve, that would gain more from the adoption of inflation targeting as a meaningful framework for its policy. One of the major contributions of inflation targeting as a framework for monetary policy is as a communications device. The Federal Reserve can do better in this area, but it is kilometers ahead of the ECB in this regard.

There's no downside to flexible inflation targeting.

LARS E.O. SVENSSON
Professor of Economics, Princeton University

Inflation has been brought down to a low and stable level in the United States. It should not be allowed to turn into deflation, and it should not be allowed to drift back up to higher levels. Therefore, the U.S. Federal Reserve needs to decide what average long-run inflation rate is appropriate and hence what rate it should aim for. This means deciding on an explicit inflation target. Transparency and accountability of the Fed's policy then requires that this target is announced to the general public and the market.

As in the rest of the world, an explicit inflation target is needed in the United States as an anchor for private-sector inflation expectations, for reducing uncertainty about future inflation, and for providing the best environment for the real economy. It is sometimes said that inflation targeting would not allow enough flexibility to U.S. monetary policy. This is wrong. Inflation targeting, as practiced in, for instance, Canada, the United Kingdom, and Sweden, is in practice quite flexible, with a medium- rather than short-term inflation target and with considerable weight on stabilizing the real economy as well as inflation. This allows a flexible and appropriate response to the various small and large shocks that may hit the economy. Furthermore, nothing prevents the Fed from introducing an inflation target while giving even higher relative weight to the stability of the real economy than to existing inflation targets.

Inflation targeting in the United States would lock in the good aspects of the Greenspan era for the future, and reduce or eliminate some less good aspects, for instance, the dependency of U.S. monetary policy on the specific qualities of the chairman of the Fed's board of governors. There is simply no downside to flexible inflation targeting.

A lot of questions first need to be answered.

SUSAN M. PHILLIPS
Dean and Professor of Finance, School of Business and Public Management, George Washington University, and former member of the Federal Reserve Board of Governors

Where you sit determines where you stand on European-style inflation targets. In the face of high inflation, central bankers generally agree that the most constructive course of monetary policy is to get inflation down. Inflation targets, to the extent they are well specified and widely accepted, assist the central bank in staying the course through painfully high interest rates. Credible targets may also facilitate changing price expectations, thereby minimizing the additional challenge of entrenched inflation psychology.

But, if inflation is low, there are many more questions surrounding the utility of inflation targets. How low should the targets be set? How low can inflation fall before the risk of dreaded deflation becomes too great? How wide should a target range be set? While there has been considerable progress in addressing the various bias problems of inflation calculation and price sampling, there is always the possibility of new biases as new retail and wholesale distribution channels become available. Then, there is the issue of what is the best measure of inflation—CPI? Core CPI? Some version of a production or consumption deflator? Finally, under what circumstances can the Fed deviate from strict pursuit of the targets? If the Fed sees a developing real economic slowdown or such a serious disorderly financial market situation or other external systemic shock as to threaten or disrupt the flow of money and credit, I believe Fed policymakers would act even if it meant abandoning the targets. In fact, with a mission of sustainable economic growth, the Fed is obligated to act.

In short, while inflation targets deserve much commendation, until the above questions and issues are more fully addressed, I do not see how they can be implemented in the United States. Focusing only on inflation would mean that the Fed's other goal of sustainable growth would be compromised.

For the Fed, it would be totally inappropriate.

DAVID M. JONES

President and CEO, DMJ Advisors, LLC, and author of several books on the Federal Reserve including* Unlocking the Secrets of the Fed: How Monetary Policy Affects the Economy and Your Wealth-Creation Potential *(John Wiley and Sons, 2002)

The Federal Reserve should not under any circumstances adopt some form of official rigid inflation target or inflation target range. In contrast with the European Central Bank, which is, by law, required to pursue the single objective of price stability, the Fed is required to pursue the dual objectives of price stability and sustainable economic growth (maximum sustainable output and employment). To be sure, Fed officials currently pursue unofficial guidelines of 1 percent to 2 percent for the major price indexes (core consumer prices or the core personal consumption deflator, year-over-year), which could perhaps be viewed as one definition of price stability. But perhaps a more effective definition of price stability is a functional one, namely, to reduce the rate of increase in prices to a low and steady pace that no longer has a significant impact on either household or business decisions. Parenthetically, the Greenspan Fed has currently achieved price stability by both definitions, without adopting a rigid inflation target.

Most importantly, it would be totally inappropriate for Fed authorities to adopt a rigid inflation target at a time like the present when uncertainty is high and geopolitical risks are substantial. Instead, maximum Fed judgment is necessary, especially at a time when Fed policymakers possess incomplete knowledge about key structural aspects of the ever-changing U.S. economy. It is important to note in this regard, that the ECB was virtually impaled on its official 2 percent inflation target during the recent global downturn. Despite the downturn, the ECB frequently delayed much-needed rate cuts, being made more hesitant by the fact that actual inflation was typically exceeding the official inflation target. As a result, the Eurozone suffered a deeper downturn than would have been the case if the ECB had exhibited greater sensitivity to weakening economic conditions and demonstrated more flexibility in promptly cutting rates.

Rather than following rigid rules that might hamper necessary central bank responses to unforeseen shocks to aggregate demand and output, central bankers should instead seek to be more flexible in their policy actions. At the same time, central bankers should be transparent while seeking to communicate effectively their policy decisions, and, when possible, their policy intentions.

Pursuing flexibility and openness, the Greenspan Fed has currently achieved both price stability and apparently, at long last, sustainable economic growth. With the U.S. economy currently serving as the locomotive for the rest of the world, global convergence can be achieved without the Fed adopting rigid inflation targets.

An inflation ceiling can be quite reassuring to private markets.

HORST SIEBERT

Steven Muller Professor, Johns Hopkins University, Bologna, and President-Emeritus, Kiel Institute for World Economics

The European Central Bank has set a target for the price level in form of a ceiling. The annual increase in the price level should remain below two percent in the

medium run. This lid on the inflation rate can be seen as a promise to the citizens of Euroland and to the markets to deliver a stable money. Yes, such a commitment is recommendable, especially for a monetary authority that has to deal with twelve independent nation states. I am convinced that such an approach would also be appropriate for the U.S. Federal Reserve. It gives a clear signal and it thus prevents inflationary expectations to arise. Such a target is also a lucid message to politicians that the central bank means serious business if they take refuge in high budget deficits and thus increase public debt.

Note that this approach is not an automatic rule on which instruments the central bank will use and when it will apply them. Thus, the ceiling is different from monetary targeting as practiced by the Bundesbank who announced a target corridor, or more precisely a funnel, for the future money stock that would be in line with price level stability. A lid on inflation also should not be mixed up with inflation targeting in which the central bank bases the conduct of its monetary policy on a publicly announced inflation forecast as the Bank of England does. This approach very much depends on the quality of forecasting, and having been in the business of forecasting during a large part of my professional life [as a member of the German Council of Economic Advisers for twelve years], forecasts depend on so many factors including revised GDP data that are likely not increase credibility of a central bank. A ceiling would only be used for the medium term. Thus, the inflation rate is allowed to exceed the ceiling temporarily when the higher rate is expected to come down again. This interpretation gives some flexibility. Even the Bundesbank missed its money stock targets nearly half the time, but it always was able to convince the markets *ex post* that special factors were responsible. In the end, the strategy of using the ceiling approach requires credibility because otherwise the public cannot be convinced why the target was missed. Thus, each central banker has to have some of the qualities possessed by Fed Chairman Alan Greenspan.

It's important to distinguish between inflation targeting and price level targeting.

RICHARD CLARIDA

C. Lowell Harriss Professor of Economics, Columbia University, and former Assistant Secretary of the Treasury for Economic Policy

The Federal Reserve, I believe, currently and for some time has conducted U.S. monetary policy with reference to a desired range for inflation. However, under existing practice this range is not regularly made public, and thus must be inferred by households, firms, and financial markets. Moreover, while there is at present evident agreement among Fed officials about the range of inflation consistent with price stability and about the desirability of maintaining price stability, such agreement has in the past been more difficult to come by when inflation was higher and when the costs of bringing down inflation had to be incurred 'up front'. To me, the benefits to be derived from a published target range for inflation are greater the further the economy is from price stability in the first place.

It is quite important to distinguish between inflation targeting and price level targeting. My research with Mark Gertler and Jordi Gali has shown that, in general, central bank commitments to target a price level path will not be credible. The requirement to make the target public will not, in and of itself, make it credible. Our work has also shown that inflation targeting is in general consistent with central bank discretion, and consistent with achieving central bank goals in addition to price stability, such as keeping GDP and employment close to their potential levels. Finally, our work shows that inflation targeting will not in and of itself result in a stable long-run level for the exchange rate, although the volatility of exchange rate changes may be reduced depending on how monetary policy is implemented.

The Fed's current approach has some disadvantages.

FREDERIC S. MISHKIN

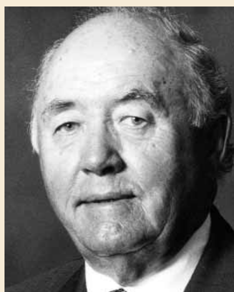
Alfred Lerner Professor of Banking and Financial Institutions, Graduate School of Business, Columbia University, a former Executive Vice President and Director of Research at the Federal Reserve Bank of New York, and author of* Inflation Targeting: Lessons from the International Experience *(Princeton University Press: Princeton, 1999)

In recent years, the performance of the Greenspan Fed has been extraordinary. Inflation has been low and steady, while the U.S. economy has experienced only minor output fluctuations. Why should the Fed abandon its discretionary approach to monetary policy and announce an inflation target? After all, "If it ain't broke, why fix it?"

Complacency can be dangerous, however. Despite its success, the Fed's current approach to monetary policy has some serious disadvantages. First, the absence of an explicit numerical inflation goal makes it harder for the Fed to communicate with the markets and the general public, as recent wild fluctuations in the bond market illustrate. Second, the lack of Fed transparency has meant that Fed accountability is not high: after all, without a criterion to judge the Fed's performance, how can we hold it accountable? Finally, the recent success of the Fed has been based on individuals rather than an institutional framework. Alan Greenspan deserves to be called a "maestro," but the next Federal Reserve chairman may not be. In the past the Fed has fallen off of the anti-inflationary wagon, while the dismal performance of the Bank of Japan under its previous governor shows that a lack of commitment to an inflation target can help push an economy into a vicious deflationary spiral.

The key objection to inflation targeting is that it is a rigid rule which is likely to lead to higher output fluctuations. This objection is way off the mark. Inflation targeting, as it has actually been practiced, is very flexible and therefore has not resulted in greater output fluctuations. Indeed, by emphasizing the floor of the target, inflation targeting enables a central bank to respond more aggressively to negative shocks to the economy since it does not have to fear that aggressive easing will lead to a blowout of inflation expectations.

Obviously, we cannot clone Alan Greenspan, but adoption of an inflation target can help institutionalize the Greenspan Fed's commitment to price stability and lock in its recent success of a low and stable inflation environment that helps promote high economic growth.



Target the quantity of money.

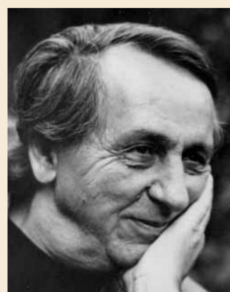
BERYL W. SPRINKEL

Former Undersecretary of the Treasury for Monetary Affairs, and Chairman of the Council of Economic Advisers and Cabinet Member under President Reagan

Since successful monetary intuition varies over time as well as between different practitioners, I much prefer a clear statement as to what central bank actions are all about so the bankers can be held responsible for the difference between results and the basic target even though they may resist. Furthermore, if an explicit target is specified, I would expect market expectations to be stabilizing. For example if the objective were to stabilize prices, and prices were rising, markets would expect a tightening action by the central bank and markets would move in the proper direction. Conversely if prices were declining below the stated objective, markets would expect easing action by the central bank and markets would reflect those expectations.

If price stability were adopted, it would be desirable to specify the precise broad index that best measures inflationary trends and also whether precise price stability is the objective or a range of plus or minus a small percentage would be satisfactory. Given the great historical variation in price trends between countries, and variation in price trends within a particular country over time, it would seem very likely that citizens of most countries would be receptive to the adoption of a price objective by their central bank. Other than achieving a high degree of price stability, central banks can do little to positively affect living standards over time. However, high variability in executing policy certainly can affect short-run variability in employment and unemployment. Steady at the helm should usually be the rule.

Since I am a monetarist and believe that excessive inflation will result from persistently high growth rates in the money supply, I believe that acceptance of price stability as the dominant objective of the central bank implies that the central bank should also establish target growth rates for the money supply which they believe will over time result in promoting price stability. Although inflation and monetary growth are not precisely and invariably closely related, the quantity of money can be controlled by the central bank and exerts a greater effect on inflation than does the Fed funds rate, credit volume, or various other monetary variables.



Want a rule? Ignore the bond holders!

WILLIAM GREIDER

National Affairs Correspondent, **The Nation**, *and author of* **The Soul of Capitalism: Opening Paths to a Moral Economy** *(2003)*

Why do the bond holders need an inflation target from the Fed? Didn't Father Greenspan shoot for zero and ignore all other consequences, including the present risk of deflation?

I propose this rule for the Federal Reserve: Ignore the anxieties of the bond holders. Manage the economy for currency stability and full employment, as the law instructs the Fed to do. The Greenspan-Volcker Fed has done enormous damage to the American economy—especially to wage earners—in its long, futile quest to reassure the bond guys. The Fed's relentless deflationary pressures, while ignoring the wild inflation of financial markets, will someday be understood as a fundamentally unhinging error.

Here's a thought: Why not for a change try managing monetary policy on behalf of all Americans?

Try a demand target instead.

WILLIAM A. NISKANEN
Chairman of the Cato Institute, and former Member and acting Chairman of the Council of Economic Advisers under President Reagan

A stable path of nominal aggregate demand is a better target for the conduct of monetary policy than an inflation target. An inflation target requires the central bank to tighten in response to an adverse supply shock and to ease monetary policy in response to a favorable supply shock, compounding the change in real output resulting from the supply shock. With a demand target, in contrast, the central bank should ignore supply shocks; in this case a supply shock would lead to a one-time change in output and the price level.

My suggestion is that demand is best measured by the nominal final sales to domestic purchasers, a magnitude equal to GDP minus the inventory change plus imports minus exports.

By this measure, the Federal Reserve maintained a remarkably stable growth of demand, at a 5.5 percent annual rate, for the six years before the demand bubble started in 1998.

A demand target, of course, reflects the sum of inflation and the rate of increase of real output. Given an expected increase of real output of 4 percent a year, for example, a 5.5 percent demand target would imply an inflation rate of about 1.5 percent, an effective inflation rate probably closer to zero given the incomplete measure of changes in the quality of goods and services. For that reason, I encourage the Federal Reserve to restore a stable 5.5 percent demand path rather than adopt an inflation target.

Forget any kind of numerical inflation targeting.

ALLEN SINAI
Chief Global Economist and President, Decision Economics, Inc.

The United States should not follow the European Central Bank in a kind of numerical inflation targeting as the objective of the central bank. The main reason is that economic growth, economic performance, productivity, and potential growth in Europe and the Eurozone have been subpar, and inadequate, for a country and culture like that of the United States.

Real growth since 1998 has averaged 1.8 percent annually in the Eurozone and 1.9 percent per year in the European Union. In contrast, the U.S. economy, even with a recession, severe in the U.S. business sector, has grown 2.8 percent annually. The U.S. unemployment rate has averaged 5 percent over the same time span; in the Eurozone 8.5 percent. Inflation has averaged 2.5 percent in the United States; the Eurozone 2 percent.

A second reason is the flexibility allowed in using monetary policy under a two-dimensioned objective, the U.S. one of achieving both price level stability and maximization of sustainable growth.

By defining price level stability more flexibly in a risky and uncertain economy, which is most certainly stochastic in nature, rather than adhering rigidly to an inflation target, there is more room, although still constrained by a price level stability objective for monetary policy, to vary the key central bank interest rate, its timing, the number and amount of changes to achieve price level stability, and maximization of sustainable growth.

It is, after all, the maximizing of sustainable, or potential, economic growth that determines the potential standard-of-living of any country, which ought to be the ultimate economic goal of any society. ◆