What Type of Inflation Target?

Lawrence H. White

For much of monetary history, inflation targeting was unnecessary.[1] There was no need to worry about constraining the central bank's inflationary proclivities because no central bank existed. The quantity of basic money was constrained by the mints' commitment to full-bodied gold and silver coinage (at least where the mint-owners lacked monopoly status or chose not to exploit that status through debasement). The quantity of bank-issued money was constrained by the commercial banks' commitment to gold- and silver-redeemability for banknotes and deposits. Together these commitments prevented excessive monetary expansion and thereby price inflation.[2] Today (since 1971) the commitments are gone, and a substitute is needed.

Constraining Central-Bank Discretion

Inflation targeting has been much discussed in recent years as a proposal for constraining the Federal Reserve's monetary policymaking. As proposed constaints on central banking go, it is relatively weak. Inflation targeting doesn't abolish the central bank, and—at least in the well-known version recommended by Bernanke et al. (1999)—doesn't even fasten a strict rule on it. In both the Bernanke version and in the versions actually practiced in other developed countries, the central bank authorizes inflation within a range of positive rates, typically 1 to 3 percent. At the midpoint rate of 2 percent, inflation is higher than experienced historically under commodity-standard regimes, and is too high to promote optimal money-holding. As David Laider (2006: 3) has recently pointed out,

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[1]Irving Fisher (1920), however, hoped to combine a gold standard with price-level stabilization in his "compensated dollar" scheme.

[2]For the historical contrast between commodity-standard and fiat-standard inflation rates, see Rolnick and Weber (1997).

"A 2 percent inflation rate is a far cry from anyone's (or at least any retiree's) idea of price-level stability: this seemingly low rate in fact reduces the purchasing power of a fixed-money income at a noticeable pace . . . over the duration of the current 'low inflation' regime [since 1991 Canada has had an inflation target of "under 2 percent" and an average inflation rate of 2 percent per year] the [Canadian] dollar has lost a quarter of its purchasing power."

But, to emphasize the half-full part of the glass, 2 percent inflation is better than 10 percent inflation, and a predictable 1 to 3 percent is better than an unpredictable 2 to 20 percent. Even if, in Bernanke's language, inflation targeting is a "framework" for "constrained discretion" rather than a rule, it is nonetheless a small step toward a rule for constraining the central bank, and constraining the central bank is a step toward the first-best regime of doing without a central bank. I would characterize Bernanke-style inflation targeting as *an overly timid step in the right direction*. My fear is not that inflation targeting will "tie the Fed's hands" too tightly, but that it will perpetuate our long-standing failure to tie them tightly enough.

Under the present discretionary regime, we don't know what monetary policy to expect. At his confirmation hearing, Ben Bernanke told the Senate Banking Committee: "With respect to monetary policy, I will make continuity with the policies and policy strategies of the Greenspan Fed a top priority." No doubt Bernanke meant to reassure us. Unfortunately, we never knew what Greenspan's policy strategy was, and in his confirmation hearing Bernanke didn't tell us.

Given that Bernanke, in contrast to Greenspan, has been an outspoken advocate of explicit inflation targeting, it will be interesting to see whether Bernanke will actually move to implement inflation targeting. Skeptics may note that Greenspan in his younger days was an outspoken advocate of the gold standard, but as Fed chairman he never took any steps toward re-instituting it. On the other hand, Greenspan reportedly commented once in a Congressional hearing that he would have been the only member of the Board of Governors favoring a return to gold.[3] Bernanke doesn't have the problem of being in a minority of one, particularly since his co-author Frederic Mishkin has joined the Board and the last of the Clinton appointees has departed.

[3]Bradford (1997) reports the following exchange between Sen. Paul Sarbanes and Alan Greenspan: "The Senator could scarcely believe his ears. 'Now my next question is, is it your intention that the report of this hearing should be that Greenspan recommends a return to the gold standard?' Greenspan responded, 'I've been recommending that for years, there's nothing new about that. . . . It would probably mean there is only one vote in the Federal Open Market Committee for that, but it is mine.'"

Inflation targeting is not a panacea. In a recent issue of *Newsweek*, Stephen S. Roach (2006) of Morgan Stanley characterizes the proponents of inflation targeting as holding the view that under inflation targeting "Presto—the economy is cured of any and all ailments." Actually, the objective of CPI inflation targeting is much more modest: to cure the economy of one ailment, lack of assurance that the CPI inflation rate will not be higher than desired. We will know that we have regained the degree of assurance that we once enjoyed under the gold standard when there once again exists a thick market for thirty-year corporate bonds.

The Credibility Problem

Does inflation targeting work? Cross-country evidence indicates that inflation fell by more percentage points in the 1990s in the countries that targeted inflation. But as Ball and Sheridan (2003) found, since those were the countries that began with higher inflation, it isn't clear what caused what. The desire to bring about a comparatively large drop in inflation may have caused the adoption of inflation targeting, rather than inflation targeting causing a comparatively large drop in inflation.

Inflation targeting is not a market-based policy. Contrary to economist-blogger Stephen Kirchner (2006), Ben Bernanke is not a prophet of "the view that markets and not monetary policy should determine growth rates in broad money, credit aggregates, and asset prices." In a fiat money regime, the central bank controls the monetary base, and broad money is geared to the base via the money multiplier, so monetary policymakers and not markets determine growth rates in broad money. Under inflation targeting, the Fed would adjust the base and thereby broad money to support the targeted price level path. *In that sense* the quantity of money becomes endogenous. It's not really helpful to call that "markets" determining money growth. Markets did not choose the inflation target.

The fundamental rationale for constraining central bank discretion was provided by Kydland and Prescott (1977). If the public comes to believe that the central bank will want to use surprise inflation to reduce unemployment, then the public's expected inflation rate will rise, shifting out the short-run Phillips Curve. The central bank must then choose from a worse menu of short-run options. Its least-bad current policy choice under those circumstances leaves the economy with higher inflation and no reduction in unemployment. There is no reduction in unemployment because that only happens when inflation

is higher than expected, and the public knows not to expect a rate that the Fed will choose to exceed.

The lack of an explicit commitment to low inflation leads to the problem of a lack of inflation credibility. The public is subject to "inflation scares" that worsen the Fed's options as just described. Alan Greenspan eventually earned his inflation credibility. Absent a formal commitment to a specified low inflation rate, we can only wait and hope that Bernanke will have as much credibility. In the meantime the business press pays more attention to the monthly CPI reports, and we all have to worry when the numbers creep up.

The Choice of a Target

Hence the importance of a precommitment, but a precommitment specifically to what target? Roach raises an important issue when he suggests that the Greenspan Fed was responsible for asset-bubble problems in the U.S. economy. As Roach points out, "Central banks, who have ultimate control over the flow from the liquidity spigot, are responsible for this dangerous state of affairs." Under Greenspan, the Fed "slashed the federal funds rate to 1 percent and spurred the mother of all liquidity cycles." In so doing, Greenspan was exercising his discretion, not pursuing an explicit inflation target. But would an explicitly inflation-targeting Fed be prone to the same problem? As Roach puts the danger: "A CPI-type price rule could compound the negligence of bubble-prone central banks." Friedrich Hayek (1932, 1933) and Lionel Robbins (1934) made a similar argument about Fed policy in the 1920s: in pursuit of CPI stability, credit expansion pumped up the asset price bubble that burst in 1929. Hayek (1932) described the Fed's policy experiment and its consequences in the following way:

> Instead of prices being allowed to fall slowly, to the full extent that would have been possible without inflicting damage on production, such volumes of additional credit were pumped into circulation that the level of prices was roughly stabilized. . . . Whether such inflation [i.e., monetary expansion] merely serves to keep prices stable, or whether it leads to an increase in prices, makes little difference. Experience has now confirmed what theory was already aware of; that such inflation can also lead to production being misdirected to such an extent that, in the end, a breakdown in the form of a crisis becomes inevitable. This, however, also proves the impossibility of achieving in practice an absolute maintenance of the level of prices in a dynamic economy.[4]

[4]A fuller discussion of the theory behind Hayek's statement is beyond the scope of the present essay. For secondary accounts see Garrison (1986) and White (1999).

The remedy for central-bank-generated-asset-bubble problems isn't continued discretion, but rather a better "price rule" (assuming we're stuck with having a central bank). In other words: the problem isn't in having a target, it's in having a target limited to the CPI. A better target would incorporate asset prices, directly or indirectly, rather than only consumer prices. Examples of direct incorporation include a gold standard, a rule targeting an Alchian-Klein-type index that incorporates asset prices,[5] or a rule targeting an index of input prices (wages and/or raw material prices). An example of indirect incorporation would be a rule targeting a broad measure of per capita nominal expenditure (Py), as proposed by George Selgin (1990), rather than only the CPI price index (P).

Conclusion

At this stage in the debate, the case for constraining a central bank's monetary policymaking is well established and widely accepted. An explicit low inflation or nominal income target for the Federal Reserve would be an improvement over the discretionary status quo. The debate can now move on to the question of whether to target a price index, and if so an index limited to consumer prices or one including asset prices, or instead to target an expenditure index.

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[5]Alchian and Klein (1973). See also Goodhart (2001), who argues persuasively that "the theoretical arguments of Alchian and Klein (*op cit*) imply such high weights on volatile asset prices, that the resulting price indices become unstable, unreliable and unusable. But that does *not* eliminate the case for any inclusion of asset prices in price indices. Other, more moderate, weighting schemes which are both analytically defensible and practicable, can be found."

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