Why Japan should not \(^{(1)}\)
Adopt Inflation Targeting

Benjamin M. Friedman

It is a privilege to contribute a paper in honor of Professor Ryoichi Mikitani. Through his teaching, his leadership, and his personal example of scholarship, Professor Mikitani has made a valuable — and, one hopes, lasting — contribution to the development of the practical science of monetary economics, and also to the understanding and public discussion of monetary policy, in Japan. He has shown how to distinguish the genuinely important issues from matters that are subsidiary, and he has consistently focused his attention on what is important. His concern for his students has spanned generations. And throughout, but most evidently in his work on practical questions of monetary policy and the design and regulation of financial institutions, he has been dedicated to advancing the welfare of his country. He is a true patriot, in the best sense. Our profession is the richer for his contribution and his presence.

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The Bank of Japan’s monetary policy, over the past dozen years or so, \(^{(2)}\) has been a disappointment of major proportion. The Japanese economy has

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\(^{(1)}\) This paper was written for the special issue of the *Kobe Gakuin Economic Papers* in honor of Professor Ryoichi Mikitani. Parts of the paper draw on Friedman (2003). I am grateful to numerous colleagues and friends for helpful discussions, but the responsibility for the ideas expressed here is mine alone.

\(^{(2)}\) See, for example, the discussion in Bernanke (2000).
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now endured well over a decade of stagnation, and as of the time of writing there is little prospect of a revival of vigorous business expansion any time soon. A country that has traditionally known only negligible unemployment now has a jobless rate approximately the same as that of the United States (despite the fact that the U.S. experienced a recession last year and has yet to mount a cyclical recovery). In the meanwhile, during much of this period the prices of goods and services in Japan have been gently falling. Apparently fearful of either overstabilizing the economy or igniting a new asset price bubble, the Bank of Japan was slow to lower interest rates when the country was still experiencing moderately positive inflation. Since then it has reduced short-term interest rates effectively to zero, but because prices were falling the corresponding real interest rate remained positive. By waiting until inflation was zero or negative, the BOJ missed its opportunity to spur the economy through a negative real interest rate.

To be sure, the persistent failure of economic recovery in Japan has not been solely due to the BOJ’s monetary policy. Japanese fiscal policy has sometimes given the outward appearance of a stimulative stance, though mostly without real stimulative substance. And at some key points, fiscal policy has been outright contractionary. The collapse of the 1980s bubble in both equity and real estate prices badly impaired the balance sheets of both Japanese banks and Japanese businesses. Hence the banks have been less able to lend, and firms less willing to borrow, regardless of prevailing interest rate levels. (The limited progress to date in removing these nonper-

forming credits from the banking system is failure of Japanese economic policy during for another paper.) Even so, monetary policy too. Indeed, there is room to worry. Japan’s mistakes of the 1990s may enter the Federal Reserve System’s mistakes of the 1990s policy that was not just wrong but was

Any time a central bank makes a prof mistake, there are bound to be calls for th of simple rule that—whatever else its r least render that kind of mistake less like as in the U.S. in the 1930s, a key element to allow persistently declining prices. Pa experience of the 1930s, many economist World War II period advocated some for growing at a steady rate. True, that kind be sub-optimal in a more general sense, ment went) prevent deflation.

As it turned out, in most countries ar relationships between money and either inc decades ago, and so today there is little rule. But the idea of having some easy

(3) By contrast, in Japan’s earlier post-war experience, as well as in the experience of many other industrialized countries (including, for example, the United States), central banks have often pushed short-term real interest rates to negative levels at times when they have sought a stimulative monetary policy.

(4) See, for example, the discussion in Posen (1998).

(5) See, for example, the extended discu the many references cited there.

(6) I have written about this problem in

(7) The classic treatment of Federal I Friedman and Schwartz (1963). But the for a recent example, see Eichengreen (2
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forming credits from the banking system is a further, also well understood, failure of Japanese economic policy during this period; but that is a subject for another paper.) Even so, monetary policy clearly has been part of the problem too. Indeed, there is room to wonder whether in time the Bank of Japan's mistakes of the 1990s may enter the textbooks along with the Federal Reserve System's mistakes of the 1930s, as classic examples of monetary policy that was not just wrong but wrong-headed.

Any time a central bank makes a profound and (in hindsight) obvious mistake, there are bound to be calls for the adoption of some form or other of simple rule that—whatever else its merits or lack thereof—would at least render that kind of mistake less likely. In Japan since the early 1990s, as in the U.S. in the 1930s, a key element of mistaken monetary policy was to allow persistently declining prices. Partly in response to the deflation experience of the 1930s, many economists in the early decades of the post World War II period advocated some form of rule to keep the money stock growing at a steady rate. True, that kind of simple rule-based policy might be sub-optimal in a more general sense, but at least it would (so the argument went) prevent deflation.

As it turned out, in most countries around the world the empirical relationships between money and either income or prices collapsed about two decades ago, and so today there is little interest in such a money growth rule. But the idea of having some easy-to-follow principle that would at

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(5) See, for example, the extended discussion in Hoshi and Kashyap (2001) and the many references cited there.

(6) I have written about this problem in, for example, Friedman (2000).

(7) The classic treatment of Federal Reserve policy errors in the 1930s is Friedman and Schwartz (1963). But the subject continues to attract attention; for a recent example, see Eichengreen (2002).
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least prevent ongoing deflation has persisted nonetheless. In recent years, the most frequently suggested simple principle for guiding monetary policy — although it is hardly an easy-to-follow rule — has been "inflation targeting." In the wake of the Bank of Japan's recent poor policy record, including in particular Japan's experience of stagnation and deflation, it is not surprising that many observers have urged the BOJ to adopt inflation targeting as well.

It is important to be clear that, the label notwithstanding, "inflation targeting" need not mean that the sole objective guiding monetary policy is to achieve a specified rate of price inflation. In principle, an inflation-targeting regime is consistent not only with directing monetary policy toward real objectives like output and employment but, indeed, with giving priority (although not absolute priority) to such matters over concerns about the rise or fall of prices and wages. But in that case, why put the matter in terms of an inflation target?

The rationale for inflation targeting emerges as the joint consequence of two lines of thought within the economics of monetary policy. First, because the central bank in effect has only one instrument at its disposal — it can be either open market operations or the interest rate the bank charges on advances — the standard Tinbergen-Theil logic implies that it is possible to express the policy chosen at any time in terms of the intended outcome (or, in a dynamic setting, the intended trajectory) of any single economic magnitude that monetary policy affects: inflation, output, employment, the economy's foreign balance, even some magnitude of no intrinsic importance whatsoever (the obvious example is the level or growth rate of some measure of "money").

But, then, why choose inflation? The second line of thought within the field that underlies the concept of inflation "natural rate" model of aggregate supply services. Under most familiar versions of this exists between real outcomes like output outcomes like prices and inflation — and, central bank can exploit — but only over a short horizon. By contrast, in the long run least not one subject to exploitation by outcomes depend on such real factors technologies. In the long run only monetary influences. The conceptual appeal to express the objective of monetary policy for just any randomly selected logic would permit, but in terms of the monetary policy can presumably affect in the

(8) In fact, the evidence for the natural rate the prevailing consensus within the econo case for inflation targeting) has let on. As rate model seems a good description of II War II period, but only that — and in pa experience, nor of either the U.S. or the Theoretical work (by Blanchard and others) numerous ways in which some part of the purely temporary departures of output, at equilibrium level induce permanent, or at equilibrium itself. Empirical work based that the evidence for a negatively sloped or for a positive link between inflation (Ahmed and Rogers, 2000), is at least as neutrality. But the evidence is hardly c moment the logic of the natural rate mo
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has persisted nonetheless. In recent years, a simple principle for guiding monetary policy—"inflation targeting"—has been "inflation Bank of Japan's recent poor policy record, experience of stagnation and deflation, it is... have urged the BOJ to adopt inflation

at, the label notwithstanding, "inflation targeting" is the objective of monetary policy is to inflation. In principle, an inflation-targeting strategy directs monetary policy toward real growth and balance of trade, but, indeed, with giving priority to such matters over concerns about prices. But in that case, why put the matter in

getting emerges as the joint consequence of economics of monetary policy. First, because only one instrument at its disposal—it can s or the interest rate the bank charges on en-Theil logic implies that it is possible to time in terms of the intended outcome (or, trajectory) of any single economic magni-

factors: inflation, output, employment, the one magnitude of no intrinsic importance is the level or growth rate of some mean-

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field that underlies the concept of inflation targeting is the Phelps-Friedman "natural rate" model of aggregate supply in the market for goods and services. Under most familiar versions of the natural rate model, a trade-off exists between real outcomes like output and employment and nominal outcomes like prices and inflation—and, moreover, a trade-off that the central bank can exploit—but only over some finite (and presumably fairly short) horizon. By contrast, in the long run there is no such trade-off, or at least not one subject to exploitation by monetary policy. Long-run real outcomes depend on such real factors as endowments, preferences and technologies. In the long run only nominal magnitudes are subject to monetary influences. The conceptual appeal of inflation targeting, therefore, is to express the objective of monetary policy not in terms of the intended trajectory for just any randomly selected variable, as the Tinbergen-Theil logic would permit, but in terms of the trajectory for a variable that monetary policy can presumably affect in the long as well as the short run.

(8) In fact, the evidence for the natural rate model has never been as strong as the prevailing consensus within the economics profession (not to mention the case for inflation targeting) has let on. As Solow (1998) has argued, the natural rate model seems a good description of the U.S. experience in the post World War II period, but only that — and in particular, not of the European post-war experience, nor of either the U.S. or the European experience before the war. Theoretical work (by Blanchard and Summers, 1986, for example) has shown numerous ways in which some part of what the natural rate model takes to be purely temporary departures of output, employment or unemployment from the equilibrium level induce permanent, or at least very long-lasting, changes in the equilibrium itself. Empirical work based on fairly long time periods indicates that the evidence for a negatively sloped Phillips curve (King and Watson, 1994), or for a positive link between inflation and the economy's investment rate (Ahmed and Rogers, 2000), is at least as strong as the evidence for long-run neutrality. But the evidence is hardly conclusive on either side, and for the moment the logic of the natural rate model underlies much of the structure of...
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The important point about inflation targeting, however, is that expressing the intended policy outcome in terms of the trajectory for any one variable does not imply that the central bank is indifferent with respect to outcomes for all other variables. This point is most explicit in the inflation targeting framework suggested by Svensson (1997), in which the central bank targets its own forecast of future inflation as if that forecast were a classical intermediate target variable such as money.

In Svensson's formulation, the central bank at each point in time seeks to make its forecast of future inflation follow a specific trajectory. If some economic disturbance or policy error has resulted in an inflation rate different from whatever rate the central bank is seeking to achieve, and if inflation is the only variable about which the central bank is not indifferent, then the optimal trajectory simply involves returning to the desired inflation rate instantly—or more practically, in the presence of lags, as soon as is at all possible. If other variables like output or employment (or even the level or change of interest rates) matter too, the optimal trajectory following a disturbance or a policy error then involves bringing the forecast of future inflation into line with the unconditionally desired inflation rate only over some longer period of time.

Not surprisingly, the length of the interval over which the forecast of future inflation optimally returns to the unconditional formulation—or, equivalently, the optimal formulation considered as asymptotic—depends on the preferences with respect to inflation vis-à-vis the given short-run cost of disinflation in terms of stronger is the preference for being at the rate, the faster the optimal inflation forecast, whereas stronger is the preference for employment, the more slowly the optimal forecast returns to the unconditionally desired rate the smaller is the short-run cost of disinflation returns to the unconditionally desired rate. Hence not only does inflation forecast to the central bank is what King (1997) has: there is an explicit way in which its outcomes can enter the inflation target.

But despite the compatibility in principle of behavioral framework for implementing a outcomes matter as well as inflation, an observable quarter-century of debate about the that a powerful motivation for adopting quarters, is the hope that if the explicit policy is carried out entirely in terms of concerns for real outcomes may somehow be considered altogether. After all, a broad debate, and probably of intellectual discussion in which that debate takes place.

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(9) Because of the relation between a future outcome and its expectation, however, this particular form of intermediate targeting is not subject to the standard criticisms of the use of money or other such variables as intermediate targets. Moreover, by targeting its own forecast, rather than that of private-sector forecasters, the central bank can avoid potential dynamic instabilities of the kind identified by Woodford (1994), although there is an obvious sacrifice of the efficacy of external monitoring of policy performance.
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future inflation optimally returns to the unconditionally desired rate in this formulation—or, equivalently, the optimal speed of convergence if it is conceived as asymptotic—depends on the strength of the central bank’s preferences with respect to inflation vis-a-vis its other objectives. For a given short-run cost of disinflation in terms of output and employment, the stronger is the preference for being at the unconditionally desired inflation rate, the faster the optimal inflation forecast trajectory returns to it. Conversely, the stronger is the preference for being at equilibrium output and employment, the more slowly the optimal inflation forecast trajectory returns to the unconditionally desired rate. (Similarly, for given preferences, the smaller is the short-run cost of disinflation, the faster the optimal trajectory returns to the unconditionally desired inflation rate, and vice versa.) Hence not only does inflation forecast targeting not necessarily mean that the central bank is what King (1997) has called an “inflation nutter,” but there is an explicit way in which its preferences with respect to real outcomes can enter the inflation targeting framework.

But despite the compatibility in principle of inflation targeting as a conceptual framework for implementing a monetary policy in which real outcomes matter as well as inflation, an observer who has paid attention to the last quarter century of debate about monetary policy is entitled to suspect that a powerful motivation for adopting this framework, at least in some quarters, is the hope that if the explicit discussion of the central bank’s policy is carried out entirely in terms of an optimal inflation trajectory, concerns for real outcomes may somehow atrophy or even disappear from consideration altogether. After all, a broadly familiar characteristic of policy debate, and probably of intellectual discourse more generally, is that the language in which that debate takes place exerts a powerful influence over
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the substance of what the participants say, and eventually even over what they think.

In just this context, one of the most striking developments in monetary economics during this last quarter century has been the renewed attempt to banish from the purview of monetary policymaking any sense of responsibility for real outcomes. This is in fact an old debate, with familiar antecedents in central banks’ response to the depression of the 1930s and well before that. Although there is no necessary link, there is ground for thinking that inflation targeting may in practice be yet the latest incarnation of this effort. Indeed, one reason for suspecting that this is so is the reluctance, within today’s central banking community, to acknowledge openly an interest in or concern for real outcomes.

One frequently stated rationale for eschewing concern for real outcomes is the proposition that there is nothing the central bank can usefully do to affect them anyway: in effect, the neutrality of the natural rate model holds in the short as well as the long run. Today this idea is familiar from many sources, including central banks and central bankers): Maintaining price stability fosters greater output and employment in the long run. And in the short run there is nothing monetary policy can do about either output or employment anyway.

The most immediate problem with such a point of view is that even if inflation were the only aspect of economic activity that the central bank sought to affect, it is unclear how it would go about doing so without in the first instance deliberately influencing the p era some economists believed that simply however measured, in step with some pr lead to a corresponding inflation path for ical relationships between money and pr twenty years ago has mostly removed this monetary policymaking (although money was used as an information variable to help other key variables). Instead, the concept target lies through the short-term aggreg purposes, targeting inflation means in the not because output necessarily matters for in relation to some capacity benchmark i

But once the point is accepted that monetary affect real outcomes in the short run—key to its influence over price inflation bank should not seek to affect real out vacuous. It is then necessary to address tary economics literature provides no su familiar line of thinking on the issue decades has been the argument, base wrong kind of concern for real outcome

(10) Alternatively, even if monetary policy is not neutral with respect to real outcomes in the short run, the familiar problems of uncertainty and lagged effects are sufficiently severe that attempting to exploit this short-run nonneutrality is as likely to do harm as good.

(11) See Friedman (2003) for several examples.

(12) For example, the fact that a central ly follows a “Taylor rule,” with a si unterm in determining its cl imply that the central bank is concern sake. Output or unemployment may be function merely as a source of informati
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Participants say, and eventually even over what the most striking developments in monetary policymaking any sense of responsibility is in fact an old debate, with familiar response to the depression of the 1930s and with familiar reasoning for suspecting that this is so is the central banking community, to acknowledge for real outcomes.

First instance deliberately influencing the pace of real activity. In an earlier era some economists believed that simply keeping the quantity of money, however measured, in step with some predetermined growth path would lead to a corresponding inflation path for prices. But the collapse of empirical relationships between money and prices in many countries roughly twenty years ago has mostly removed this idea from the realm of practical monetary policymaking (although money certainly can be, and often still is, used as an information variable to help predict future inflation as well as other key variables). Instead, the conceptual route to keeping inflation on target lies through the short-term aggregate supply curve. For practical purposes, targeting inflation means in the first instance targeting output—not because output necessarily matters for its own sake, but because output in relation to some capacity benchmark is what matters for inflation.

But once the point is accepted that monetary policy does systematically affect real outcomes in the short run—indeed, so much so that this is the key to its influence over price inflation—the rationale that the central bank should not seek to affect real outcomes because it cannot becomes vacuous. It is then necessary to address the issue on its merits. The monetary economics literature provides no such argument, however. The most familiar line of thinking on the issue in the literature of the past two decades has been the argument, based on time inconsistency, that the wrong kind of concern for real outcomes can lead in the long run (and, hence, in the short run).

(12) For example, the fact that a central bank’s monetary policy actions approxi- mately follow a “Taylor rule,” with a significant role for the usual output or unemployment term in determining its chosen short-term interest rate, need not imply that the central bank is concerned with real outcomes for their own sake. Output or unemployment may be present in the central bank’s reaction function merely as a source of information about future inflation.
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depending on expectations, perhaps in the short run as well) to an undesirable rate of inflation with little (in the limit, no) gain in real terms anyway. But the fact that the wrong kind of concern for real outcomes can have these undesirable consequences does not constitute a generic case against treating output or employment as proper objectives of monetary policy at all.

Nonetheless, the call for monetary policy to adopt an exclusive focus on prices to the exclusion of real outcomes has been widespread throughout this period, including in Japan. In the mid 1990s, for example, BOJ Governor Yasuo Matsushita argued that “Most people agree that the objective of monetary policy is the maintenance of price stability. ... The maintenance of price stability does not conflict with the achievement of stable economic growth and employment conditions. For example, measures to prevent overheating (or recession) of the economy can at the same time contain inflation (or avoid deflation), and provide medium- to long-run price stability; and this price stability in turn, is a prerequisite for achieving sustainable growth of the economy.”

Not surprisingly, outside academic circles most of the talk of banishing real outcomes from the purview of monetary policy took place during an era of sustained economic growth. When business is expanding and profits are strong and jobs are plentiful (even in European countries), it is easy to say that inflation targeting is desirable.

More recently, now that many of the many cases to the point of recession, talk favors of a sole focus on price stability has from the public discussion. But although the lectual campaign to banish real outcomes objectives has clearly persisted. And, in targeting has persisted too.

A further major theme in the discussion today, which is closely connected to the “transparency.” As King (2000) has observed, much has changed over the past decade. Now, given way to transparency and openness speech on domestic or international financial hearing about transparency. ... The commitments with a view to enhancing their credibility and transparency, have also pointed targeting.

Why the recent emphasis on “transparency” targeting really an improvement?

The standard forward-looking aggregate horse of so much of today’s monet

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(13) Matsushita (1996). Governor Matsushita’s remarks clearly admit only the possibility of disturbances to aggregate demand, which influence output and prices in the same direction. As much of the academic literature of optimal monetary policy has emphasized, the more interesting problem arises in the case of disturbances to aggregate supply, which normally influence output and prices in opposite directions.

(14) Even the remarks by Governor Matsushita quoted above date from 1996, when the Japanese economy was enjoying a recovery (which in retrospect turned out to be short-lived). Earlier in the same speech, Mr. Matsushita stated
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Perhaps in the short run as well) to an undesirable (in the limit, no gain in real terms anyway, kind of concern for real outcomes can have as does not constitute a generic case against as proper objectives of monetary policy at monetary policy to adopt an exclusive focus on outcomes has been widespread throughout. In the mid 1990s, for example, BOJ Governor “Most people agree that the objective of price stability. ... The maintenance with the achievement of stable economic conditions. For example, measures to prevent the economy can at the same time contain provide medium- to long-run price stability, is a prerequisite for achieving sus-3" emic circles most of the talk of banishing of monetary policy took place during an h. When business is expanding and profits

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are strong and jobs are plentiful (even in chronically high-unemployment European countries), it is easy to say that inflation is all that should matter. More recently, now that many of the major economies have slowed, in many cases to the point of recession, talk of ignoring real outcomes in favor of a sole focus on price stability has begun to disappear—at least from the public discussion. But although it is less visible, the broader intellectual campaign to banish real outcomes from the list of monetary policy objectives has clearly persisted. And, in parallel, the interest in inflation targeting has persisted too.

A further major theme in the discussion and practice of monetary policy today, which is closely connected to the strategy of inflation targeting, is “transparency.” As King (2000) has observed, “It is truly remarkable how much has changed over the past decade. The mystery and mystique has given way to transparency and openness. ... It is difficult to listen to a speech on domestic or international financial policy these days, without hearing about transparency. ... The communication of policymakers’ intentions with a view to enhancing their credibility has come to play a central role in monetary policy.” As ample discussion in the literature also makes clear, considerations of communication, including in particular the quest for credibility and transparency, have also been a central motivation for inflation targeting.

Why the recent emphasis on “transparency”? And, more to the point, is inflation targeting really an improvement in this respect?

The standard forward-looking aggregate supply curve that is the workhorse of so much of today’s monetary economics literature expresses that “the risk of a deflationary spiral, which was an issue of concern last year, has been practically eliminated.”
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current inflation as a positive function of (1) the level of output supplied in relation to some benchmark equilibrium, (2) a shock to production costs or sellers’ mark-ups, and (3) price-setters’ expectations of future inflation. All else equal, therefore, lower inflation expected for the future means lower inflation today. Similarly, the lower is expected future inflation, the higher today’s output can be in relation to equilibrium output without resulting in higher inflation today. On both counts (which are really just two ways of expressing the same relationship), as long as the central bank has preferences with respect to real output as well as inflation, it is beneficial to have private-sector decision makers expect that inflation will be low in the future.

But as the experience of many economies in the 1970s harshly demonstrated, merely claiming that inflation will be low in the future is not sufficient to induce the public to expect that this will be so. Indeed, the original point of the time inconsistency argument was that even if policymakers are entirely sincere in their intentions to deliver on such a pledge—and even in the absence of surprise shocks—under some circumstances there is good reason for private-sector decision makers to believe that inflation will be high anyway: the low-inflation pledge will not be “credible.”

Given the context of the historical evolution of this literature, a “credible” central bank has therefore come to mean something more than just a central bank that can be believed to follow through on its declared policy, whatever that policy may be. Specifically, in today’s context a “credible” central bank is one that is believed to be fi

And in parallel, a “transparent” policy means to be “credibly” committed to low inflation. Seen in this light, the connection to inflation targeting by private-sector decision makers’ expectations before them the central bank’s long-run inflation rate and such-and-such a rate. It removes the trade-off that monetary policymakers face: that real outcomes over less than the long run specific sense of making a commitment to low inflation out of the discussion those considered to be qualified, and hence in the sense. It is “transparent” in that it holds doing before clear glass while obscurity partition.

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(15) As Roberts (1995) has conveniently shown, a relationship of this generic kind can emerge as a result of random timing of price increases as in Calvo’s (1983) model, nominal wage contracts as in Taylor’s (1979) model, or convex costs of price adjustment as in Rotemberg’s (1982) model.

(16) The opportunity for the central bank to this way — via its communications strategy — time consistency. The reason is that to private-sector decision makers full but (including parameters describing policy’s short-run aggregate supply curve, and so “credible” depending upon whether it is clear what the public lacks this knowledge, it is possible for the central bank may affect private-sector perception of key parameters, and hence may affect the policy as time consistent and therefore “credibly.”
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central bank is one that is believed to be firmly committed to low inflation. And in parallel, a “transparent” policy means one that the public understands to be “credibly” committed to low inflation.

Seen in this light, the connection to inflation targeting becomes (in the dictionary sense) transparent. Inflation targeting is a way of manipulating private-sector decision makers’ expectations about future inflation. It puts before them the central bank’s long-run objective of achieving inflation equal to such-and-such a rate. It removes from explicit discussion whatever objectives the central bank may hold for output, employment, or other real outcomes, over less than the long run. It likewise removes from discussion the trade-off that monetary policymakers perceive between inflation and real outcomes over less than the long run. It achieves “credibility,” in the specific sense of making a commitment to low inflation believable, by keeping out of the discussion those considerations that would reveal that commitment to be qualified, and hence not completely credible in the usual sense. It is “transparent” in that it holds a part of what the central bank is doing before clear glass while obscuring other parts behind a logical partition.

(15) The opportunity for the central bank to affect the credibility of its policy in this way — via its communications strategy — is absent in the standard literature of time consistency. The reason is that this line of analysis usually assigns to private-sector decision makers full knowledge of the relevant parameters (including parameters describing policymakers’ preferences, the slope of the short-run aggregate supply curve, and so on), so that a policy either is or is not “credible” depending upon whether it is or is not time consistent. But when the public lacks this knowledge, it is possible that communications by the central bank may affect private-sector perceptions, including perceptions about these key parameters, and hence may affect whether or not the public sees any given policy as time consistent and therefore “credible.”

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The point is perhaps easiest to see in Svensson’s framework of inflation forecast targeting. Few if any central banks that have adopted an inflation targeting strategy seek, or even say they seek, to return inflation to the unconditionally desired rate immediately (or, in the presence of lags, as immediately as is possible) after a supply shock or a policy error has resulted in some different rate. The reason is that doing so would unduly push real economic activity away from equilibrium.

To recall, the optimal speed of return is a direct expression of the relative weight placed on inflation vis-a-vis real outcomes. But while it is not uncommon for inflation targeting central banks to be open about the time horizon for returning to the unconditionally desired inflation rate (typically two years or more), few are explicit about the underpinnings from which, as Svensson shows, this optimal horizon arises: the level of output or employment that policymakers regard as desirable over this horizon, or, even more so, the weight, compared to that on inflation, that they place on such objectives. The resulting “transparency” is one-dimensional. It is so in order to achieve “credibility.”

Taken at face value—that is, as set forth in theoretical expositions like Svensson’s—an inflation targeting framework holds out the prospect of resolving some of the internal contradictions that have thwarted central banks’ efforts to achieve widely recognized macroeconomic goals in the past. It also offers the promise of introducing a logic and consistency that some central banks’ deliberations sorely missed in the past. And it potentially provides some reassurance that a certain kind of first-order mistake that the Bank of Japan made in the 1980s is not in 2000. But inflation targeting, at least in today’s context, also promotes two further objections: It makes it more likely that policymakers are forced to participate, including both policymakers and the public. Conducting the discussion in a vocabulary per is desirable. So doing it fosters over time the atrophies of policy. In the meanwhile, inflation targeting ever concerns for real outcomes policy
cation is an outcome that Japanese citizens—from their monetary policymakers.

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(17) Whether inflation targeting actually played a role in the achievement of more stable prices, as has occurred in many of the countries that have adopted this framework—but also in others that have not—is an empirical issue that lies beyond the scope of this paper. See, for example, Bernanke et al. (1999).
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er n is a direct expression of the rel-1 vis-a-vis real outcomes. But while it is not central banks to be open about the time conditionally desired inflation rate (typically explicit about the underpinnings from which, nal horizon arises: the level of output or 1 regard as desirable over this horizon, or, pared to that on inflation, that they place on “transparency” is one-dimensional. It is so in

is, as set forth in theoretical expositions like ting framework holds out the prospect of contradictions that have thwarted centraly recognized macroeconomic goals in the of introducing a logic and consistency that ms sorely missed in the past. And it poten-

actually played a role in the achievement of rred in many of the countries that have adopted thers that have not — is an empirical issue that per. See, for example, Bernanke et al. (1999).

ially provides some reassurance that a central bank will not commit the kind of first-order mistake that the Bank of Japan has made over the last decade.

But inflation targeting, at least in today’s inherited monetary policymaking context, also promotes two further objectives that are of more question-able import, and while seemingly contradictory, the two are ultimately related: It forces those who participate in the monetary policy debate, including both policymakers and the interested public more generally, to conduct the discussion in a vocabulary pertaining solely to inflation, and by so doing it fosters over time the atrophication of concerns for real outcomes. In the meanwhile, inflation targeting hides from public view whatever concerns for real outcomes policymakers do maintain. Neither implication is an outcome that Japanese citizens should seek — or, indeed, toler-ate — from their monetary policymakers.

References


WHY JAPAN SHOULD NOT ADOPT INFLATION TARGETING


