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COMMENTARY

Why the Federal Reserve Should Not Adopt Inflation Targeting*

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Inflation targeting has become one of the most significant developments of recent decades in both the theory and the practice of monetary policy. A rapidly expanding literature has analysed the *a priori* properties of various 'inflation targeting' strategies, and an increasing number of central banks around the world – the Bank of Canada, the Bank of England, the Swedish Riksbank, and numerous others – have adopted one form or other of this strategy as the basic framework governing the formulation and implementation of their respective monetary policies. It is hardly surprising that we now see frequent calls for the Federal Reserve System to join the parade and restructure US monetary policy too, within the guidelines of some form of inflation-targeting rubric.

I urge our policy makers at the Federal Reserve to reject those calls. The empirical case for the value added by inflation targeting in terms of a country's macroeconomic performance, especially for a country that is already experiencing low inflation to begin with, is unproved to say the

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least. More importantly, I believe the claims commonly made for inflation targeting at the conceptual level – in particular, that inflation targeting usefully enhances the transparency of monetary policy – are not just unproved, but false. To the contrary, as actually practised, inflation targeting is a framework not for communicating the central bank's goals but for obscuring them. In crucial ways, it is not a window but a screen. It promotes not transparency, at least not in the dictionary sense of the word, but opaqueness.

To begin with the empirical issues, early work examining the consequences for macroeconomic performance after the first few central banks had adopted inflation targeting – most prominently, Bernanke et al. (1999), but also individual papers by other researchers – reported mixed results. A fair summary of the evidence was that adopting inflation targeting, in the immediate wake of a sizeable disinflation, perhaps helped to lock in place the gains already made in reducing inflation and also to enhance the public's confidence in the durability of those gains. By contrast, there was little evidence that adopting inflation targeting enhanced the central bank's ability to achieve whatever disinflation took place.

A much larger number of more recent papers lead to the same kind of mixed conclusion when read together, even though individual papers often come to sharply different conclusions. For example, a recent paper by Levin et al. (2003) concludes that 'inflation targeting … has a substantial impact in anchoring long-run inflation expectations and in reducing the intrinsic persistence of inflation'. By contrast, the recent paper by Ball and Sheridan (2003) offers a quite different interpretation of what is essentially the same experience: 'This paper asks whether inflation targeting improves economic performance, as measured by the behaviour of inflation, output, and interest rates. … Once one controls for regression to the mean, there is no evidence that inflation targeting improves performance.'

The more important issues in this debate, however, are conceptual. Advocates of inflation targeting continually highlight the role of inflation targeting as a way for the central bank to communicate with the public. Bernanke et al. (1999), for example, were clear that in their view inflation targeting is primarily a framework for improving communication. Even economists who have offered a more balanced assessment – for example, Faust and Henderson (2003) – have nonetheless taken as fact that central banks that have adopted inflation targeting 'have been at the forefront of the recent trend toward increasing transparency in central banking', that the inflation targeting framework 'makes great strides toward increasing understanding', and that central banks that carry out their monetary policy according to inflation targeting are 'among the most transparent in the world'.

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I believe such claims are simply false. The key issue, which comes as no surprise to any student of monetary policy, is multiple goals. Monetary policy has one instrument: typically today some short-term interest rate, but alternatively the quantitative change in the central bank's liabilities. As Tinbergen showed decades ago, in the absence of degeneracy or other pathologies, the solution to a problem with one instrument and multiple targets can always be expressed in terms of the intended trajectory for any one arbitrarily chosen target. So far, so good. But the question Tinbergen did not address is whether that way of describing the solution promotes or subverts public understanding of what the policy maker is doing. Moreover, Tinbergen's framework certainly provided no rationale for choosing which target variable should be the one to serve as the summary statistic for the optimal policy solution as a whole. In this case, instead of inflation why not output? Or employment? Or the economy's foreign balance? Or any other magnitude of concern to monetary policy makers?

The rationale for inflation targeting instead emerges as a consequence of 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 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.

In principle, as is clear enough from Tinbergen – and as King (1997), among others, has usefully emphasized in the particular case of inflation targeting – 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 key decision is how rapidly to bring inflation back to the desired rate after some departure from it. Not surprisingly, the length of the interval over which 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

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preferences with respect to inflation *vis-à-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.

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 some supply shock or policy error has resulted in a different actual inflation rate. The reason, following Svensson's analysis, is that doing so would unduly push real economic activity away from equilibrium. 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 this optimal horizon arises: the level of output or employment that policy makers regard as desirable over this horizon and, more importantly, the weight, compared to that on inflation, that they place on such objectives. Whatever 'transparency' the resulting inflation-targeting regimes have delivered is strictly one-dimensional.

An alternative way of stating the problem, suggested by Faust and Henderson (2003), is to think in terms of the mean inflation rate and the variability of inflation. Excessive variability of inflation is costly, but so is excessive smoothness. Inflation targeting communicates well about the central bank's intentions for mean inflation, but not its variability. The failure of most inflation-targeting schemes, as implemented by actual central banks, to say anything about how much inflation variability the central bank will tolerate, or why, is likewise a failure to say anything about any goals of monetary policy other than inflation, or about the relationship between those goals and the inflation goal.

Moreover, I believe that this failure is intentional on the part of the central banks that adopt this framework. Faust and Henderson (2003) pointedly refer what they call 'one of the most famous principles of spin in the folk wisdom of central banking … that central banks should "do what they do, but only talk about inflation".' They go on to say that inflation targeting 'might be viewed as an application of this principle. One should name what one does "inflation targeting", call monetary policy reports "inflation reports", and only discuss other goals as affecting the horizon over which one intends to hit the inflation target.'

They obviously have in mind, for example, the Bank of England. The Bank of England, however, is by no means the only central bank to exhibit this

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particular form of anti-transparency. For example, the Bank of Canada's one-page public explanation of its policy-making framework, entitled 'Canada's Inflation-Control Strategy' and prominently printed on the inside front cover of the Bank's regular *Monetary Policy Report*, has only three sentences bearing on the strategy's underlying rationale: 'Inflation control is not an end to itself; it is the means whereby monetary policy contributes to solid economic performance. Low inflation allows the economy to function more effectively. This contributes to better economic growth over time and works to moderate cyclical fluctuation in output and employment.' There is no mention of any tension, at any horizon, between the Bank's inflation goal and output, employment, or any other matter of potential concern to monetary policy. (The remainder of the statement, devoted to operational considerations, also gives no hint of any reason, beyond technical errors, for inflation ever to depart from the desired rate.)

Two questions follow: Is this anti-transparency aspect of inflation targeting, as actually practised, incidental or deliberate? And, in the end, is it only about how central banks *talk* – although that too is clearly important – or does it also have implications for what central banks *do*?

I believe there is serious ground for thinking that the connection is, at least in part, deliberate. Inflation targeting first appeared on the policy-making scene at a time when the pressing need, throughout the industrialized world, was to eliminate chronic high inflation. Further, the specific intellectual background against which inflation targeting emerged consisted of the time-inconsistency discussion and the forward-looking Phillips curve, and both of these lines of thought naturally lend themselves to the kind of obfuscation that inflation targeting in practice embodies. The crucial implication of time inconsistency, not just for monetary policy but for a broad class of problems (lender-of-last-resort policy, for example), is that misleading people about the policy maker's likely actions – if it is possible to do so – can induce beneficial behaviour. But the same implication is also inherent in any model based on the standard forward-looking Phillips curve: the lower is the public's expectation of future inflation, the more favourable is the trade-off between inflation and output that the policy maker faces in the present (less inflation for given output, or more output for given inflation).

Given the central role in macroeconomics now played by the forward-looking Phillips curve, this logic, in both simple and sophisticated forms, is pervasive. Indeed, the increasing focus of the monetary policy literature on what is now often called the 'management of expectations' is one aspect of that logic. Over the past few decades the literature of our subject has travelled a path from ignoring expectations altogether, to taking expectations into account, to putting expectations at the centre of the analysis, and,

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most recently, to making expectations virtually the entirety of the analysis. In many familiar models of monetary policy today, if the central bank takes actions that do not affect expectations, those actions simply do not matter.

The reverse of this proposition (which, of course, does not necessarily follow from the proposition itself) is that the central bank need not ever *do* anything. All that matters is that it affect expectations – which is just what inflation targeting, in large part, is intended to do. The operating arm of monetary policy is then not the trading desk but the press office. No matter what the central bank is doing, always write the press release to say that the intended purpose is to keep inflation on the straight and narrow because that is what the public needs to believe for the central bank to enjoy the fruits of 'credibility'. Even if inflation is already somewhat higher than desired, but the central bank is cutting interest rates anyway so as to spur the real economy out of a recession (a situation that observers of the US economy will easily recognize from the very recent past), claim nonetheless that the sole purpose of these actions is to preserve price stability. Ridiculous as it sounds when put in plain language, this is precisely the flavour of some of the advice the Federal Reserve was receiving not so long ago. But inflation targeting has much of the same flavour. When the central bank in fact has multiple goals but quantifies only one – indeed, when it refuses to talk explicitly about any of the others except in terms of how they bear on the achievement of that one, as is normally the case under inflation targeting – one is entitled to suspect that the motivation is not just to manage the public's expectations but to manipulate them.

Because the public's expectations matter for economic behaviour, including aspects of that behaviour that bear on the efficacy of monetary policy, even if all that the obfuscation inherent in inflation targeting did were to affect expectations, that in itself would be important. But there is, in addition, ground to believe that inflation targeting may distort not just what the central bank says but what it does. Put simply, the point is that language matters. In debate over public policy, as well as in intellectual discourse more generally, the language in which that debate takes place exerts a powerful influence over the substance of what the participants say, and eventually over what they think.

David Hume, who importantly influenced the shaping of our discipline in its formative years, both directly and even more so through his influence on Adam Smith, offered this observation about how skewed language affected the central political issue in the Britain of his day (monarchy versus republic): 'The Tories have been obliged for so long to talk in the republican stile that they … have at length embraced the sentiments as well as the language of their adversaries' ([1741]1985). We are all familiar with instances in our own day, and in our own line of enquiry, of the same phenomenon. For

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example, how might research on monetary policy (and macroeconomics more generally) have evolved differently if the particular assumption about expectations introduced by Muth and Lucas had been labelled 'super-smart-agents expectations', or, perhaps more even-handedly, 'model-consistent expectations', rather than the far more compelling 'rational expectations'? Might the work now exploring the implications of 'bounded rationality' have developed earlier, or differently, under a less biased label?

To return to the case at hand, it is not too great a leap to conjecture that one consequence of constraining the discussion of monetary policy to be carried out entirely in terms of an optimal inflation trajectory will be that concern for real outcomes will atrophy, or even disappear from policy makers' consideration altogether. Nor is it unreasonable to suppose that the hope that this eventuality will ensue is, for some advocates, a key motivation for favouring inflation targeting in the first place. The renewed attempt to banish from the purview of monetary policy making any notion of responsibility for real outcomes is one of the more striking developments in monetary economics during the last quarter century. This is, as students of the subject well know, an old debate, with familiar antecedents in central banks' response to the depression of the 1930s and well before that. The push for inflation targeting may, in practice, be merely the latest incarnation of this long-standing effort, which one not infrequently sees in more explicit form in the statements of central bankers, as well as in legislative proposals bearing on monetary policy, throughout the world.

The theory and practice of monetary policy have advanced enormously over the past few decades. Inflation targeting has emerged as one of the most salient new developments on both the theoretical and the practical fronts. Taken at face value, this 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, together with the promise of introducing a logic and consistency that some central banks' deliberations have often sorely missed. (As I noted at the outset, however, whether inflation targeting in practice contributes to superior macroeconomic performance is an empirical issue that remains unresolved.)

But inflation targeting – at least as actually implemented by real-world central banks – also serves two further objectives that are of more questionable import. While they are seemingly contradictory, in fact, the two are ultimately related. By forcing participants in the monetary policy debate to conduct the discussion in a vocabulary pertaining solely to inflation, inflation targeting fosters over time the atrophying of concerns for real outcomes. In the meanwhile, inflation targeting hides from public view whatever concerns for real outcomes policy makers do maintain, thereby not fostering transparency in policy making but undermining it.

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Given today's inherited monetary policy-making context, both objectives are understandable. Whether either is desirable on economic grounds is at best questionable. Surely neither is consistent with the role we should seek for monetary policy in a democracy.

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