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Time for Central Banks to Consider Higher Inflation

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OVERVIEW

Bottom Line: Throughout the slow global recovery from the Great Recession, central banks have struggled to provide sufficient monetary stimulus to meet their targets for inflation and growth. It is time now to debate whether a higher inflation target in normal conditions improves the operation of monetary policy and allows for a better response to future crises.

Boston Federal Reserve President Eric Rosengren caught the attention of markets last month when, in a speech in London that mostly focused on the need for discretion in monetary policy at a time of substantial uncertainty, he suggested that the Fed's inflation target of two percent may be too low. Since interest rates at full employment should compensate for inflation and provide a normal real return, a higher inflation target would result in higher nominal interest rates in normal times. This means the Federal Reserve would be less likely to reduce its policy rate (the federal funds rate) to zero in response to future shocks.

Much of the subsequent discussion of Rosengren's speech focused on predicting when the Fed would begin the process of normalization. It is unsurprising that Rosengren—considered one of the more dovish members of the Fed's policy board—would be resistant to simple rules, such as those advocated by John B. Taylor of the Hoover Institution, that call for an early rate hike because the rapid decline in unemployment and shrinking economic slack could cause inflation to rise above the Fed's target. But this focus on the short term is misleading. As interest rates normalize, the Fed should draw lessons from the financial crisis to meet its overarching aim: to "promote effectively the goals of maximum employment, stable prices and moderate long-term interest rates." As Rosengren implied in his speech, this includes considering whether the Fed has set the right inflation target. However, it will be difficult for the Fed to publicly discuss possible shifts in long-run policies without disrupting financial markets, which remain focused on the immediate path of interest rates.

THE 2 PERCENT SOLUTION

Over the past several decades, there has been a convergence of thinking within the central banking community: the desired goal of price stability is best supported by a firm public commitment to a low inflation target. For many central banks, given typical biases in the measurement of inflation, that means an inflation target close or equal to 2 percent. In the context of this consensus, seeking inflation above 2 percent would seem the height of irresponsibility. Certainly no respectable central bank would be comfortable going it alone in raising their inflation targets.

> *The Fed should draw lessons from the financial crisis to meet its overarching aim.*

One implication of a low inflation target is that, in response to a significant shock requiring a substantial reduction in real interest rates to restore full employment, interest rates of zero might not be low enough. Unconventional monetary policies such as quantitative easing (QE) could fill the gap and provide the needed additional stimulus, but there is a growing recognition of the limits of successive rounds of QE.

In 2010, Olivier Blanchard, the International Monetary Fund's chief economist, caused a storm when he suggested that major central banks should consider higher inflation targets. He suggested 4 percent. Although his argument prompted substantial pushback from central bankers at the time, he subsequently received analytical support from a number of economists, most recently Larry Summers, whose argument that the United States faces "secular stagnation" suggests that real interest rates are too persistently high to restore full employment. The case for secular stagnation in the United States is highly contentious, but even critics acknowledge that central banks need the capacity to respond to large shocks and that extended periods of zero interest rates can be distortive.

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It is hard for the Federal Reserve to debate inflation targets publicly at this stage. If the Fed were to announce an increase in its inflation objective, it would mean committing to a much more sustained period of extraordinary stimulus to get there. Somewhat counterintuitively, that would necessitate interest rates remaining at zero for a long period of time, one more likely to be measured in years than in months. This comes at a time of increased concern among some economists about the financial stability risks and distributional consequences associated with zero interest rates. By lowering interest rates, any easing cycle shifts income from savers to borrowers, but long-term periods of zero interest rates—including the current post-2008 period—have unusually profound consequences for savers, including those on fixed income. The challenge is how to have the long-term debate without distorting markets in the short term. The solution lies to the north.

CANADA TAKES THE LEAD

In a little noticed move, the Bank of Canada may have taken the first step toward a sea change in central banking policy. Canada targets 2 percent inflation, the midpoint of a 1 to 3 percent inflation–control target range. By law, it must formally review this mandate every five years; the next review is scheduled for 2016. In an exercise of unusual transparency, the Bank of Canada has explicitly acknowledged "the experience of advanced economies with interest rates near the zero lower bound has put the 2 percent target under increased scrutiny. After taking all factors into consideration, the Bank will undertake a careful analysis of the costs and benefits of adjusting the target." The papers presented in preparation for the Bank of Canada's review make the case that communication of an inflation target above current levels can be stimulative, identify reasons why inflation is mismeasured, and highlight the costs of unconventional policies. Together, my read of the analysis presented is that the case is being prepared to raise its target next year. If so, and if well received by markets, Canada could become a laboratory for a more comprehensive change in central banking policy.

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Looking Ahead: Kahn’s take on the news on the horizon

Ukraine economic outlook worsens
In Ukraine, concerns of a spring offensive are adding to downward pressures on the economy; meanwhile, negotiations with its creditors appear to have stalled.

Greece crisis deepens as creditors wait on deal
Optimism in Greece for a May agreement with creditors has failed to stem deposit outflows, as domestic payments difficulties mount and payments to the International Monetary Fund loom.

Trade authority stalled
In the United States, the president is still short of votes needed to pass trade promotion authority, which is necessary for concluding the Trans-Pacific Partnership (TPP) agreement.