WHY THE FEDERAL RESERVE SHOULD ADOPT INFLATION TARGETING

Frederic S. Mishkin

Uris Hall 619
Columbia University
New York, New York 10027
Phone: 212-854-3488, Fax: 212-316-9219
E-mail: fsm3@columbia.edu

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Under Alan Greenspan, the Federal Reserve has achieved extraordinary economic performance: inflation has become low and stable, while over the last twenty years the economy has experienced only two relatively mild recessions in 1990-91 and 2001. Although the Federal Reserve has not articulated an explicit strategy, a coherent strategy for the conduct of monetary policy exists nonetheless. This strategy involves an implicit, but not an explicit nominal anchor in the form of an overriding concern by the Federal Reserve to control inflation in the long run. In addition it involves forward-looking behavior in which there is careful monitoring for signs of future inflation using a wide range of information, coupled with periodic "pre-emptive strikes" by monetary policy against the threat of inflation or deflation.

Because of the long lags from monetary policy to aggregate economic activity and inflation, monetary policy needs to be forward-looking and preemptive: that is, depending on the lags from monetary policy to inflation, monetary policy needs to act well before inflationary or deflationary pressures appear in the economy. For example, suppose it takes roughly two years for monetary policy to have a significant impact on inflation. In this case, even if inflation is currently low but policymakers believe inflation will rise over the next two years, they must now tighten monetary policy to prevent the inflationary surge. This is exactly what the Fed has done. For example, the Fed raised the federal funds rate from 3 to 6% from February 1994 to February 1995 before a rise in inflation got a toehold. As a result, inflation not only did not rise, but fell slightly. In January 2001, the Fed reversed course extremely rapidly, cutting the federal funds rate by 100 basis points (1 percentage point) in January even before the business cycle peak in March, and then proceeded to cut the fed funds rate by another 350 basis points before the end of November when the NBER declared that a recession had indeed occurred. The recession then turned out to be very mild, especially given the adverse shocks of the September 11 terrorist attacks and the negative impacts of the Enron and other corporate scandals on the credit markets.

The main argument for the the Fed’s pre-emptive monetay policy strategy, which I like

to call the "just do it" approach, is simply its demonstrated success. In addition, the approach is flexible and appropriately makes use of all available information in setting policy instruments. A natural question to ask then is why the Federal Reserve should consider any other other monetary policy strategy. In other words, "If it ain't broke, why fix it?" The answer is that the "just do it" strategy has some disadvantages that may cause it to work less well in the future, particularly when Alan Greenspan steps down from the Fed, something that will almost surely occur by the time his term expires in two years.

An important disadvantage of the "just do it" strategy is a lack of transparency. The constant guessing game about the Fed's goals created by its close-mouthed approach creates unnecessary volatility in financial markets and arouses uncertainty among producers and the general public. A case in point is the recent sharp swings in long-term interest rates during the late spring and summer of 2003: because the market was confused about the Fed's intentions, the ten-year bond rate dropped from a level near 4% at the beginning of May to 3.2% in the middle of June and then rose over 100 basis points to 4.5% by the end of July. The Fed has been struggling recently with how to communicate its plans with regard to interest-rate policy and how it should structure its formal statement immediately after each FOMC meeting. If the markets had a clearer picture of the Fed's longer-run objectives, particularly on inflation, then they would focus less on what the Fed's next policy move would be, making it less likely that Fed policy moves or changes in its formal statement would lead to whipsawing of the market.

In addition, the opacity of its policymaking is hardly conducive to making the Federal Reserve accountable to Congress and the general public: The Fed can't be held accountable if there are no predetermined criteria for judging its performance. This lack of accountability also is inconsistent with democratic principles. There are good reasons – notably, insulation from short-term political pressures – for the central bank to have a high degree of independence, as the Federal Reserve currently does, and empirical evidence does generally support central bank

independence.[1] Yet the practical economic arguments for central bank independence coexist uneasily with the presumption that government policies should be made democratically, rather than by an elite group.

The lack of an explicit nominal anchor is also a potential problem for the "just do it" strategy: For example, it may be that the Fed risks greater exposure than is necessary to "inflation scares" -- the spontaneous increases in inflation fears described by Goodfriend (1993) that can become self-justifying if accommodated by the Fed. Indeed, as Goodfriend (forthcoming) points out, even Alan Greenspan faced an inflation scare shortly after becoming the Fed Chairman.

Probably the most serious problem with the "just do it" approach is that its success is based on highly capable individuals rather than good institutions. In the United Sates, Federal Reserve Chairman Alan Greenspan and other Federal Reserve officials have emphasized forward-looking policies and inflation control, which has been key elements in their success. The Fed's prestige and credibility with the public have risen accordingly, with Greenspan having been given the title of "maestro" in the media.[2] I have acknowledged elsewhere in Mishkin (2000) that the Fed currently does not suffer from having a weak nominal anchor, but the strong nominal anchor is embodied in Alan Greenspan. Unfortunately a nominal anchor based on an indivual cannot last forever. Greenspan's tenure at the Fed will come to an end soon and there might be some doubts that the new Chairman will be committed to the same approach, just as there were some doubts in the markets that Greenspan would be as serious about controlling inflation as his predecessor, Paul Volcker.[3] Nor is there any guarantee that the relatively good

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[1]For example, see Alesina and Summers (1993), Cukierman (1992), and Fischer (1994). However, there is some question whether causality runs from central bank independence to low inflation, or rather, whether a third factor is involved, such as the general public's preferences for low inflation that create both central bank independence and low inflation (Posen, 1995).

[2]Woodward (2000).

[3]See Goodfriend (forthcoming).

working relationship now existing between the Fed and the executive branch, which started with the Clinton administration, will continue. In a different economic or political environment, the Fed might face strong pressure to engage in over expansionary policies, raising the possibility that time-inconsistency problem of Kydland and Prescott (1977) and Calvo (1978) may become more serious in the future. In the past, after a successful period of low inflation, the Federal Reserve has reverted to inflationary monetary policy -- the 1970s are one example -- and without an explicit nominal anchor, this could certainly happen again in the future.

WHY INFLATION TARGETING?

Inflation targeting has the potential to avoid the above problems in the Fed's current approach. To be clear, inflation targeting involves the following five elements: 1) public announcement of forward-looking medium-term numerical targets for inflation; 2) an institutional commitment to price stability as the primary, long-run goal of monetary policy and to achievement of the inflation goal; 3) an information inclusive strategy; 4) increased transparency of the monetary policy strategy through communication with the public and the markets about the plans and objectives of monetary policymakers; and 5) increased accountability of the central bank for attaining its inflation objectives.[4]

Inflation targeting has many of the desirable features of the current Fed approach. It is forward looking, uses all information in deciding on the setting of policy instruments and does focus on achieving long-run price stability. However, it goes beyond the current Fed approach and this provides several advantages. First, an inflation target is readily understood by the public and is thus highly transparent. Framing the discussion of monetary policy around an inflation goal makes it easier for the Fed to communicate with the public and the markets. It can help

[4]Detailed analyses of experiences with inflation targeting can be found in Leiderman and Svensson (1995), Haldane (1995), Mishkin and Posen (1997) and Bernanke, Laubach, Mishkin and Posen (1999).

decrease uncertainty about future monetary policy moves, thereby decreasing market volatility. It can help focus the political debate on what a central bank can do in the long-run – that is control inflation, rather than on what it cannot do, which is permanently increase economic growth and the number of jobs through expansionary monetary policy. Thus, inflation targeting has the potential to reduce the likelihood that the central bank will fall into the time-consistency trap, trying to expand output and employment in the short-run by pursuing overly expansionary monetary policy. Indeed, inflation targeting has been able to change public debate in countries that have adopted it, with an increased focus on the long-run rather than on the short-run issue of "jobs, jobs, jobs" as in the U.S.[5]

Because an explicit numerical inflation target increases the accountability of the central bank, inflation targeting is also more consistent with democratic principles. Sustained success in the conduct of monetary policy as measured against a pre-announced and well-defined inflation target can be instrumental in building public support for a central bank's independence and for its policies. The granting of operational independence to the Bank of England in 1997 illustrates this point. On May 6, 1997, the new Chancellor of the Exchequer, Gordon Brown, announced that the Bank of England would henceforth have the responsibility for setting interest rates, which previously was done by the Chancellor of the Exchequer. In the press conference, Gordon Brown explained that the inflation targeting regime justified the government's decision: the Bank had demonstrated successful performance over time as measured against an announced clear target, and was now more accountable, making it more responsive to political oversight.

OBJECTIONS TO INFLATION TARGETING?

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[5] See Mishkin and Posen (1997) and Bernanke, Laubach, Mishkin and Posen (1999).

Of course not everyone sees inflation targeting positively, as is evidenced by Ben Friedman's companion piece in this journal. There are several important objections to inflation targeting that require a response.

First, inflation targeting might be too inflexible, leading to higher output fluctuations. Ben Friedman has taken this position, especially in Friedman and Kutner (1996), in which they worry that inflation targeting might be a rigid rule that would fare as badly as Milton Friedman's constant-money-growth-rate rule would have if it had been implemented. As Ben Bernanke and I have argued elsewhere (Bernanke and Mishkin, 1997), this is a mischaracterization of inflation targeting which can be quite flexible and is very far from a rigid policy rule. Instead, we have argued that inflation targeting is best described as "constrained discretion".

However, the concern that inflation targeting could lead to increased output fluctuations is one that does have to be taken seriously. If a central bank solely focused on inflation control, something that Mervyn King (1996) has described as being an "inflation nutter", then it could lead to overly high output fluctuations. However, this is not the way inflation targeting is actually practiced. I agree strongly with Larry Meyer (forthcoming) that a central bank needs to adhere to a dual mandate of the type in the Federal Reserve Act that indicates that monetary policy objectives include not only on price stability but also output stability. Indeed, the literature on optimal monetary policy typically specifies an objective function for monetary policy which puts a negative weight on both output as well as inflation fluctuations,[6] and operating with this type of objective function is consistent with what inflation targeting central banks have actually done.[7] The result has been that countries that have adopted inflation targeting have not found that output fluctuations have increased.

The argument that inflation targeting might increase output fluctuations can be turned

[6]For example, see the papers in Taylor (1999).

[7]See Bernanke, Laubach, Mishkin and Posen (1999).

on its head. I would argue that inflation targeting can actually make it easier to reduce output fluctuations and probably has done so. First the presence of an inflation target which provides an effective nominal anchor enables a central bank to be even more aggressive in the face of negative shocks to the economy because the central bank has less fear that these moves will blow out inflation expectations. A classic example of this happened in Australia in July 1997 when the Reserve Bank of Australia lowered interest rates immediately after the currency crisis in Thailand which brought on the East Asian crisis. Despite the prospects of a substantial depreciation of the Austrailian dollar, the Reserve Bank believed that the success of their inflation targeting regime meant that inflation expectations would not rise above their targets with a monetary policy easing and thus they could ease to counter the negative demand shock arising from the deterioration in their terms of trade that was resulting from the East Asian crisis. Second, the emphasis on the floor of the inflation target range that has become a standard feature of inflation targeting in industrialized countries makes it more likely that central banks will be aggressive in combating negative shocks, so that deflationary spirals are less likely. If the Bank of Japan had an inflation target with the appropriate emphasis on the floor of the target range, then it is very likely that they would have avoided the disastrous policies pursued under the leadership of Masuro Hayami and would have been far more expansionary. Also they would have been far more likely to avoid the time-inconsistency problem outlined by Eggertsson (2003) in which the Bank of Japan was unable to commit to a long-run policy of expansion, thereby making temporary expansionary policy ineffective.

Critics of inflation targeting, most notably Don Kohn (forthcoming), who is member of the Board of Governors of the Federal Reserve, have also worried that inflation targeting may be too rigid because inflation-targeting central banks in advanced economies have often adopted a horizon for their inflation targets of two years or so, with the Bank of England being a prominent example. This can give the impression that the horizon for inflation targets is fixed, which could mean that inflation targeting will not be flexible enough. After all, models such as Svensson (1997) and

Woodford (forthcoming) tell us that optimal monetary policy will surely adjust the target horizon and path for inflation depending on the nature and persistence of shocks. This criticism is a valid one. The use of a specific horizon like two years, which is consistent with estimates of policy lags from monetary policy actions to inflation, has not been a problem for inflation targeting in advanced economies like the United Kingdom only because inflation has not been subject to big shocks so that it has remained close to the target level. However, as Svensson (1997) demonstrates, if the inflation rate is shocked away from its long-run target, then the target horizon should be longer than the policy horizon. Although this situation has not occurred yet in advanced-economy inflation targeters, a big shock to inflation will come one day. Then for monetary policy to minimize output and inflation fluctuations optimally, the target path for inflation will have to be adjusted as it has in Brazil recently.[8] This valid criticism of the fixed horizon for inflation targets does not mean that inflation targeting should not be adopted by the Fed. What it does mean is that an inflation targeting regime in the United States should make it clear, even before it is necessary, that the horizon for inflation targets needs to be flexible and will vary depending on the nature and persistence of shocks.

The second serious objection to inflation targeting is raised in Ben Friedman's companion piece in this journal. He argues that inflation targeting will not lead to transparency because it encourages central banks to avoid discussing reduction of output fluctuations as an objective of monetary policy. I would argue that inflation targeting is not the issue here. Central bankers, whether they inflation target or not, are extremely reluctant to discuss concerns about output fluctuations. Indeed, I like to refer to the fact that central bankers care about output fluctuations but are often reluctant to talk about it as "the dirty little secret of central banking". One remarkable manifestation of this occurred in August of 1994 at the Federal Reserve Bank of Kansas City's Jackson Hole Conference, which is arguably the most prominent central bank conference that occurs on a regular basis. Alan Blinder, then the vice-chairman

[8]See Fraga, Goldfajn and Minella (2003).

of the FOMC, had the temerity to mention that a short-run tradeoff between output and inflation exists and that therefore monetary policy should be concerned about minimizing output as well as inflation fluctuations. Blinder was then pilloried by many central bankers and in the press, with a Newsweek columnist declaring that he was not qualified to be a central banker.[9] From an academic economist's perspective, this was quite amazing since Alan Blinder didn't say anything that was inconsistent with what our models tell us. However, it does indicate the discomfort that central bankers as a group have with discussing the role of output fluctuations in the conduct of monetary policy.

Why do central bankers have difficulty with being transparent about their concerns about output fluctuations. I have touched on this issue in an earlier article for this journal, Mishkin (2002). Central bankers interactions with the political process has shown them that when politicians talk about the need for central banks to reduce output fluctuations, politicians do not focus on the appropriate long-run tradeoff between output fluctuations and inflation fluctuations, but rather on the short-run need to create jobs. Central bankers then fear that if they agree that they should try to minimize output fluctuations as well as inflation fluctuations, politicians will use this to pressure the central bank to pursue a short-run strategy of overly expansionary policy that will lead to poor long-run outcomes. In addition, central bankers know that it is extremely difficult to measure potential output and so being forced to focus too much on output fluctuations can lead to serious policy mistakes, as it did during the Arthur Burns years at the Fed.[10] The response to these problems is that central bankers engage in a "don't ask, don't tell" strategy which Ben Friedman rightfully criticizes.

I do think that Ben gets it exactly wrong when he criticizes inflation targeting for encouraging "don't ask, don't tell". To the contrary, I believe that inflation targeting can actually help deal with the problem that Ben raises, making it easier for central bankers to be

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[9]Samuelson (1994).

[10]Orphanides (2002).

more transparent about their desire to keep output fluctuations low. Because having an inflation target makes it easier for central banks to focus on the long-run tradeoff between output and inflation fluctuations, central bankers will be more comfortable indicating that a dual mandate for monetary policy is completely consistent with pursuit of price stability Recent speeches which advocated a Federal Reserve announcement of an inflation goal by Fed governor Bernanke and former Fed governor Meyer at the Federal Reserve Bank of St. Louis conference in October 2003 did exactly this.[11]

Second, an inflation targeting central bank should announce that it will not try to hit its inflation target over too short a horizon because this would result in unacceptably high output losses, especially when the economy gets hit by shocks that knock it substantially away from its long-run inflation goal. Inflation targeting banks have been moving in this direction: for example, the Reserve Bank of New Zealand has modified its inflation-targeting regime to lengthen the horizon over which it tries to achieve its inflation target.[12] Inflation-targeting central banks can go even farther in this direction by indicating that they are ready to emulate what the Brazilians have done recently when they were faced with a substantial overshoot of their targets (Fraga, Goldfajn and Minella (2003). In January 2003, the Banco Central do Brasil announced that it was adjusting its targets upwards for 2003 from 4% to 8.5%. They also explained that getting to the non-adjusted target of 4% too quickly would entail far too high a loss of output. Specifically, the announcement indicated that an attempt to achieve an inflation rate of 6.5% in 2003 would be expected to entail a decline of 1.6% of GDP, while trying to achieve the previous target of 4% would be expected to lead to an even larger decline of GDP of 7.3%.

By announcing that they would do what the Brazilians have done if a situation arose in

[11] Bernanke (forthcoming) and Meyer (forthcoming)

[12] See Sherwin (1999), Drew and Orr (1999) and Reserve Bank of New Zealand (2000).

which inflation were shocked subtantially away from the long-run goal, central bankers can get the dirty little secret out of the closet that they do have an appropriate concern about output fluctuations. Yet , they will still be able to assure the public that they continue to worry about the long-run and the importance of achieving price stability. In addition, as I argued above, monetary authorities can further the public's understanding that they have an appropriate concern about reducing output fluctuations by emphasizing that monetary policy needs to be just as vigilant in preventing inflation from falling too low as it is from preventing it from being too high.

CONCLUSION: THE FED SHOULD ADOPT INFLATION TARGETING

The bottom line from my commentary here is that the Federal Reserve should adopt a flexible form of inflation targeting in the near future. Although inflation targeting in the United States would probably have provided small benefits in recent years because of the superb performance of the Greenspan Fed and the tremendous credibility that Alan Greenspan has achieved, now is not the time to be complacent. It is time to make sure that the legacy of the Greenspan Fed of low and stable inflation is maintained. Adopting an inflation target is the best way for the Fed to do this.

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