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RESEARCH SUMMARY

INFLATION TARGETING
A Monetary Policy Regime Whose Time Has Come and Gone

The Federal Reserve's monetary policy relies on inflation targeting to help achieve its goals of price stability, full employment, and long-run economic growth. In a new study for the Mercatus Center at George Mason University, however, Western Kentucky University professor David Beckworth suggests that inflation targeting as a monetary policy regime is inadequate because it is unable to deal with large supply and demand shocks in the economy and contributes to financial instability. Inflation targeting should, therefore, be replaced with a more robust monetary policy regime: one that ignores supply shocks, but responds vigorously to demand shocks.

To read the complete study and learn more about the author, see "Inflation Targeting: A Monetary Policy Regime Whose Time Has Come and Gone."

BACKGROUND

Inflation targeting rose to prominence in the early 1990s. It provided a nominal anchor for monetary policy to avoid the double-digit inflation experienced after the collapse of the Bretton Woods system in the 1970s. The Federal Reserve has implicitly used an inflation rate target of approximately 2 percent since the early 1990s, but it did not officially adopt a policy of targeting inflation until 2012.

Under inflation targeting, inflation expectations became well anchored and the Federal Reserve gained inflation-fighting credibility. Research suggests that other factors—particularly stable productivity growth—may have been responsible for much of inflation targeting's success during this time.

KEY FINDINGS

Inflation-targeting regimes have two major shortcomings: (1) they have difficulty coping with large supply and demand shocks, and (2) they do not promote financial stability.

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1. Inflation Targeting Fails When There Are Big Changes in Demand or Supply

- A positive supply shock, such as a cost-reducing technological innovation that increases productivity, can lead to falling prices. This could be viewed as too-low inflation by an inflation-targeting central bank and cause it to ease monetary policy. Doing so, however, would add excessive monetary stimulus to the technology-driven economic gains and create an unsustainable bubble.

- A negative supply shock, such as a decrease in the supply of oil, would cause an increase in prices overall and lead to higher inflation. This would require an inflation-targeting central bank to tighten monetary policy. Doing so, however, would constrain economic activity, inflicting more harm on an economy already grappling with the effects of higher commodity prices.

- A demand shock that reduces economic activity will cause GDP to decline and create an output gap along with lower inflation. With small demand shocks, inflation targeting is well suited to overcome the output gap by increasing inflation through easy monetary policy, thus spurring economic activity. Inflation targeting has proven less effective in dealing with large demand shocks such as the Great Recession. Even while inflation-targeting central banks have achieved the target they set for inflation, they have been unable to close the output gap and return economic activity and GDP to levels consistent with reaching full employment in the economy.

2. Inflation Targeting Does Not Promote Financial Stability

- Inflation-targeting central banks can foster financial instability when responding to positive supply shocks. To counter deflationary pressures from productivity gains, central banks will ease monetary policy to achieve their inflation target. Easy monetary policy pushes short-term interest rates below the stable, market-clearing level, incentivizing households and firms to take on more debt. The result is unwarranted capital accumulation, too much leverage, soaring asset prices, and ultimately a buildup of financial imbalances. Such booms from easy monetary policy can turn into economic busts.

- From the late 1990s to about 2004, there were several supply shocks that increased the productivity growth rate. The Federal Reserve's inflation-targeting monetary policy tried to offset the effect of these supply shocks and helped fuel the housing and financial-sector booms just before the Great Recession of 2007.

- Even if an inflation-targeting central bank adheres to the Taylor Rule—which says that central banks should adjust interest rates depending on changes in specific economic variables like inflation or output—the innate inability of inflation targeting to adjust to large demand and supply shocks can trigger a boom-bust cycle.

- New recommendations to deal with systemic risk, such as macroprudential regulation—regulations focused on reducing systemic risks as opposed to firm-specific risks—or augmenting inflation-targeting regimes to respond to changing assets prices, fail to address the fundamental inability of inflation targeting to adjust to large demand shocks and positive and negative supply shocks.

RECOMMENDATION

A robust monetary policy regime would ignore supply shocks and respond only to demand shocks. Therefore, central banks should directly target only demand by stabilizing the growth of total dollar spending in the economy instead of focusing on inflation, which masks the distinction between supply and demand shocks.

Since the price level moves inversely with productivity-driven changes in real GDP, targeting directly the growth of total dollar spending allows supply shocks to be reflected in relative price changes rather than falsely triggering action by the central bank when inflation changes.

Focused solely on demand shocks, the central bank can target a growth path of total dollar spending, committing the monetary authority to ease monetary policy when faced with output gaps and tighten it when spending booms emerge. Such a regime would minimize large demand shocks, improve financial stability, and reduce the unpredictability of actions taken by the Federal Reserve.

CONCLUSION

Despite the early success of inflation targeting, it appears this monetary policy regime was dependent on stable and benign economic conditions. As the global economy becomes more financially developed and integrated, the shortcomings of inflation targeting will likely only grow. Targeting the growth of total dollar spending would address the weaknesses of inflation targeting and make the Federal Reserve's monetary policy much more predictable.