Should we raise the inflation target ?

Grégory Claeys, Research Fellow, Bruegel

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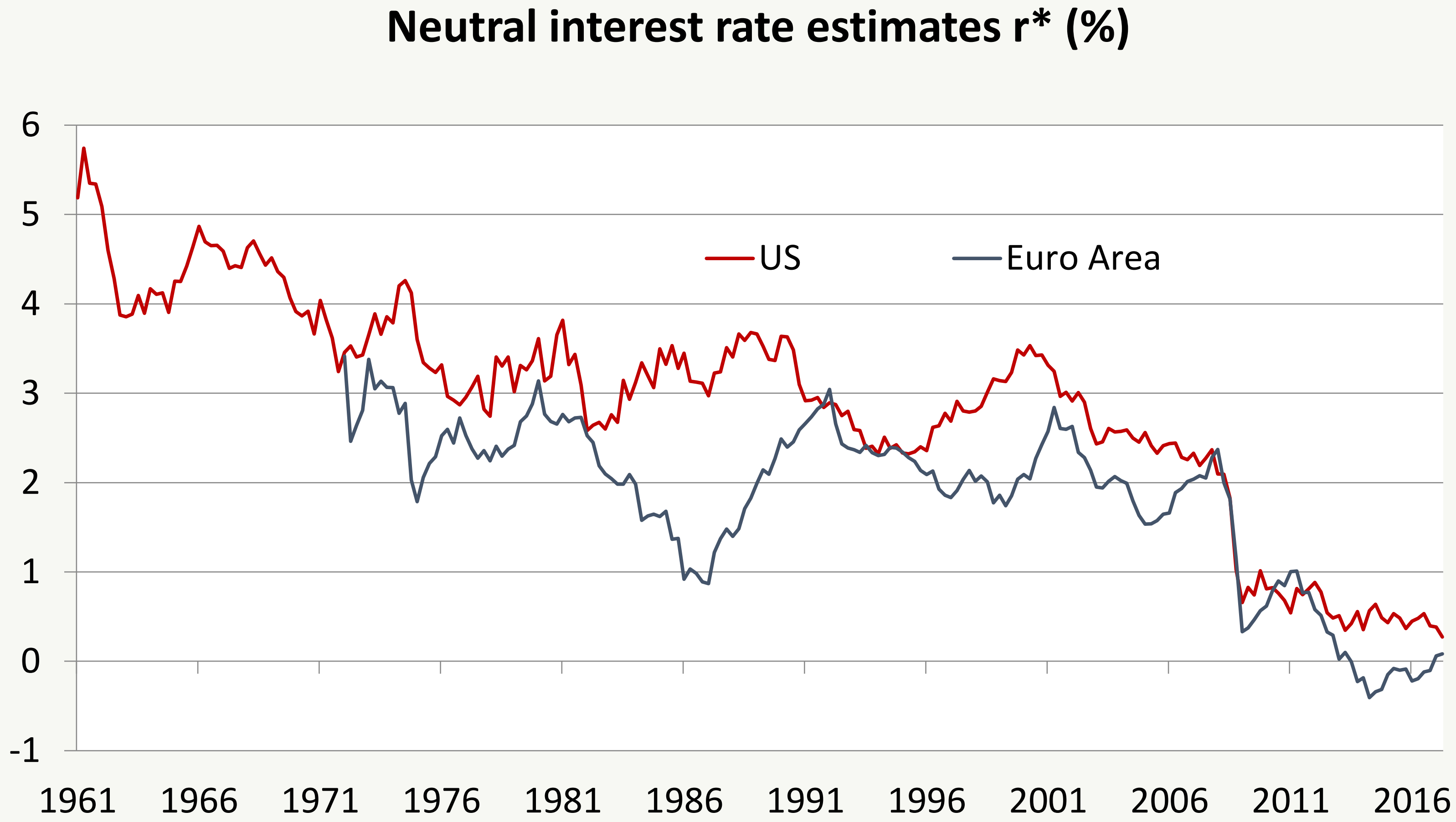
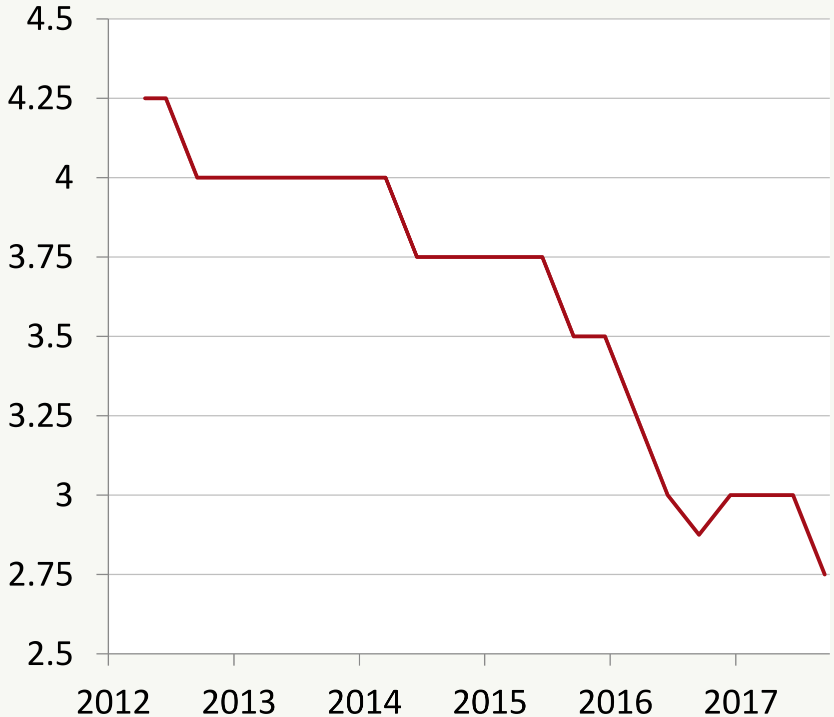
Issue: Secular decline in the neutral rate



Source: Holston, Laubach, Williams (2016)

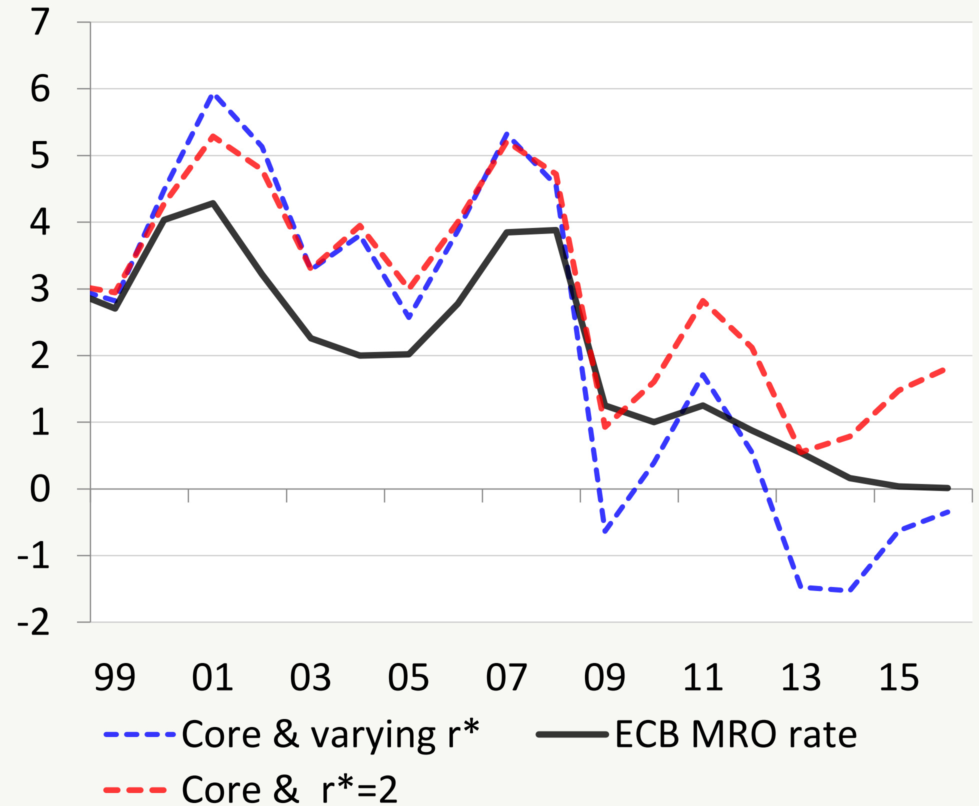
Consequences for the conduct of monetary policy

Median FOMC members' policy rate predictions for the long run (%)



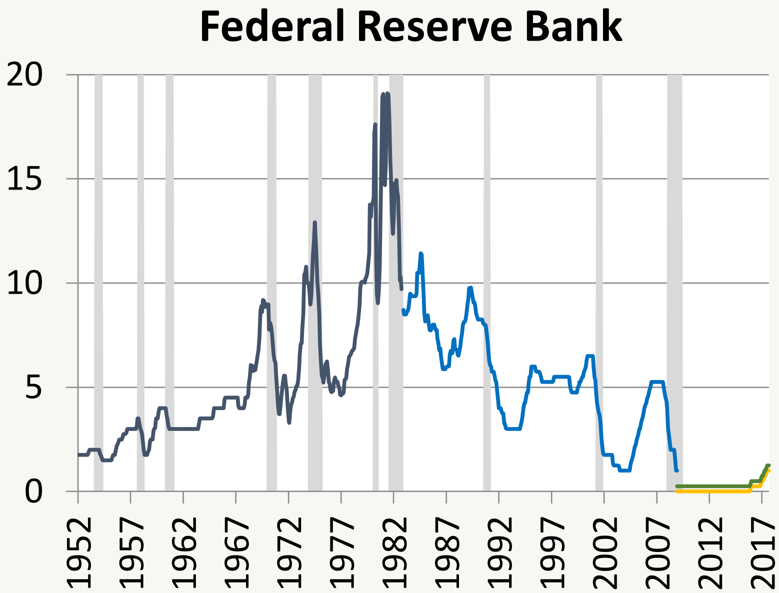
Source: FOMC via Bloomberg

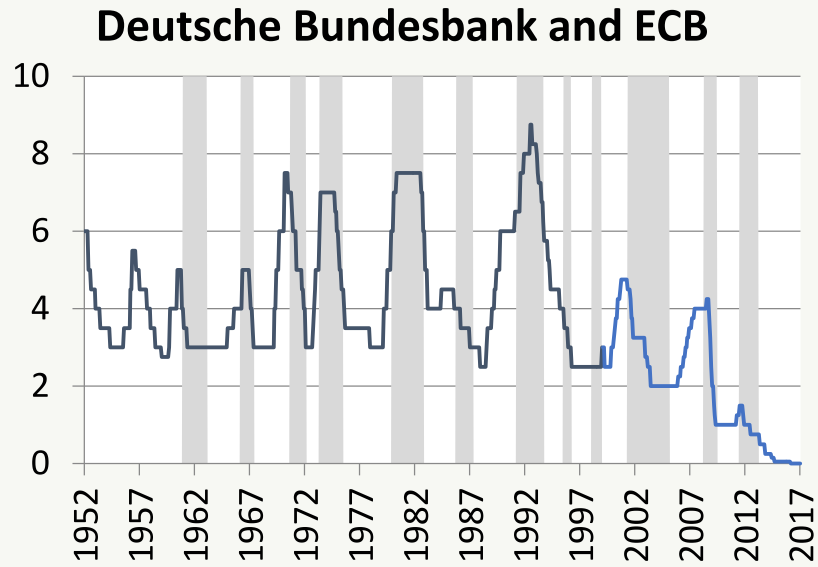
Taylor rule for the ECB with constant & time varying r* (%)

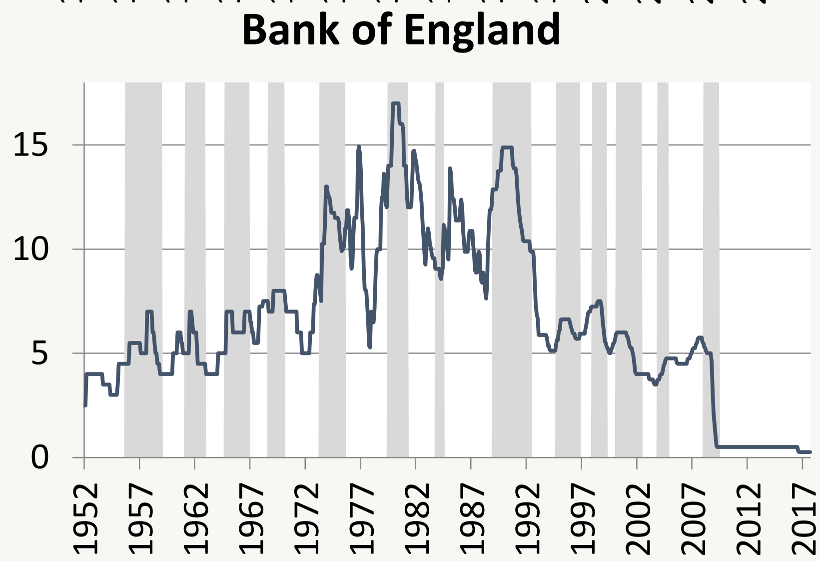


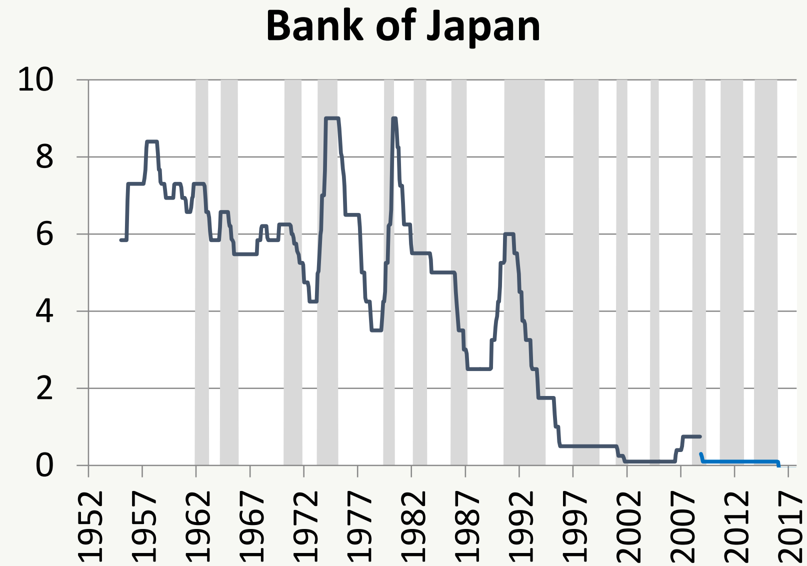
Source: Claeys (2016)

Rate cuts & business cycles since the 1950s









So should we do it? Pros and cons

Pros

- Avoid falling to ZLB in the first place
- Market can clear at a lower real rate ➔ more policy space.
- Rely less on UMP:
  - QE effects uncertain & more difficult to calibrate given relative novelty
  - QE politically controversial in EZ ➔ delay ➔ suboptimal policy
  - Negative rates: less space given cash
  - Potential side effects of UMP on financial stability & inequality
- Cost of higher inflation smaller than we thought (Nakamura et al, 2017)
- Transition: windfall for debtors ➔ help solve current debt overhang

Cons

- Higher target could damage credibility of CB and dis-anchor expectations permanently.
- Change in expectations could be slow. In that case would not increase ability to lower real rates.
- With 2% agents behave as if no inflation. Higher level could revive indexation of contracts and 2nd round effects.
- Permanent or long-lasting change for what might be temporary problem (uncertainty around neutral rate estimates)
- Transition: hurt holders of bonds and non-indexed assets ➔ financial stability risk?

Conclusions

- Personally agnostic about it: more research needed
- We shouldn’t dismiss idea in principle
- Risks seems overemphasized
- Also experiences of changes around the world:
  - Canada: target reviewed every 5 years
  - UK: target fixed every year, revised in 2003
  - Japan changed target in 2012 and 2013
  - US only adopted formal target in 2012
- In EZ: Target not set in stone/defined by ECB itself
  - Time to reassess if target still suitable in case of a fall in neutral rate from 2 to 0-1%
  - Audit of the strategy possible as in 2003 (during which 2 pillar strategy was modified and definition of price stability clarified)