Revised
December, 2003

Discussion of Jon Faust and Dale W. Henderson, "Is Inflation Targeting Best-Practice Monetary Policy?"[1]

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Macaulay – not Frederick Macaulay, who did economic research on interest rates, but the great historian of the British empire, Thomas Babington Macaulay – wrote that the benefactors of mankind are customarily attacked by "the dunces of their own generation" for going too far, as well as by "the dunces of a future generation" for not going far enough.[2] The consensus on display at today's conference, and perhaps more broadly in the economics profession as well, is that inflation targeting where it is already in practice is, and wherever it is adopted in the future will be, a great benefactor of, if not mankind, then at least monetary policy. Compared to that apparent consensus, and to today's paper by Jon Faust and Dale Henderson, my view is that of Macaulay's dunces both of the present and of the future: I will argue that Inflation targeting goes too far – or, what in this context amounts to the same thing, takes us in a direction we should not want to go. And I will also argue that while Faust and Henderson's paper contains many valid and important criticisms of inflation targeting, they do not go nearly far enough in following the

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[1]Discussion presented at the conference on "Inflation Targeting: Prospects and Problems," Federal Reserve Bank of St. Louis, October 16, 2003.

[2]Cited by Clive (1973), p. 481.

logical implications of the criticisms they offer.

A good place to begin is the paper's first sentence. Faust and Henderson open their paper by flatly declaring, "The inflation targeting framework (ITF) has been a great success around the world" (p.1). This is, of course, an empirical statement, and to be sure there is some support for such a claim. The paper presented at this conference by Andrew Levin, Fabio Natalucci and Jeremy Piger concludes that "... inflation targeting (IT) has a substantial impact in anchoring long-run inflation expectations and in reducing the intrinsic persistence of inflation" (p. 0). But there is also plenty of conflicting evidence. The recent paper by Laurence Ball and Niamh Sheridan, for example, offers a quite different interpretation of the same experience that Levin et al. study: "This paper asks whether inflation targeting improves economic performance, as measured by the behavior of inflation, output, and interest rates. ... Once one controls for regression to the mean, there is no evidence that inflation targeting improves performance" (p. 0).[3] Is regression to the mean – in plain language, not drifting off into hyperinflation – all there is to the "great success around the world" that Faust and Henderson claim? The empirical success of inflation targeting is, at the least, subject to more debate than their unqualified declaration of worldwide success lets on.

The main issues in Faust and Henderson's paper, however, are conceptual. In particular, they continually – and rightly – highlight the role of inflation targeting as a way for the central bank to communicate with the public:

"... the ITF is mainly about setting goals and communicating about them" (p. 10).

"... it is primarily a framework for improving communication (p. 10, referring here to the

[3]Ball and Sheridan (2003).

view of Bernanke, Laubach, Mishkin and Posen[4]).

"... we emphasize that ITF central banks have been at the forefront of the recent trend toward increasing transparency in central banking" (p. 14).

"... the ITF makes great strides toward increasing understanding" (p. 14).

"... ITF central banks [are] among the most transparent in the world" (p. 1).

And so on.

I disagree with every one of these claims. As typically practiced, inflation targeting is a framework not for communicating the central bank's goals and policies 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.

The key issue here, as Faust and Henderson clearly understand, 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 policymaker is doing, and why.

Faust and Henderson's way of putting this matter – which I like very much – is to think in terms of the mean inflation rate and the variability of inflation. Inflation targeting communicates well about mean inflation. As they point out, however, "... agreement regarding

[4]Bernanke et al. (1999).

the mean inflation rate has very few practical consequences at any finite horizon" (p. 2). By contrast, inflation targeting does not communicate at all well about how much inflation should vary, or why.

There are at least two reasons why policymakers should expect, indeed want, inflation to vary. One, of course, is the unpleasant fact of technical errors. More central to this entire line of argument is the policymaker's concern for other goals of monetary policy. (Within the literature of inflation targeting this issue is made most explicit in Lars Svensson's formulation, in which the key decision is how rapidly to bring inflation back to the desired rate after some departure from it.[5]) 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 also 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, as I have argued elsewhere, I believe that this failure is fully intentional on the part of the central banks that adopt this framework.[6] Faust and Henderson 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'" (p. 24). They go on to say, "... the ITF 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" (pp. 24-25).

They obviously have in mind, for example, the Bank of England. The BofE, however, is

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[5]Svensson (1997).

[6]See Friedman (2003).

by no means the only central bank to exhibit this form of anti-transparency. For example, the Bank of Canada's one-page public explanation of its policymaking 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."[7] 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.)

What is the import of all this? As Faust and Henderson write, "... the ITF involves communication policy that is literally inconsistent with best practice and in any case obfuscates some relatively simple issues" (p. 14). Further, "... any discussion of stability of prices or inflation must inevitably raise issues of other goals. ... [T]he ITF does not provide a natural and straightforward framework for communicating this issue" (p.17).

Given this assessment – which I believe is correct – two questions follow: Is this aspect of the inflation targeting, as actually practiced, 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?

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[7]Bank of Canada, Monetary Policy Report, April, 2003, inside front cover page.

Faust and Henderson imply – and elsewhere I have argued more directly – that the connection is deliberate.[8] As they note, inflation targeting appeared on the policymaking scene at a time when the pressing need, throughout the industrialized world, was to reduce the ongoing rate of inflation. As I have also argued, the 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 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 policymaker's likely actions – if it is possible to do so – can induce beneficial behavior. But the same implication s 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 favorable is the trade-off between inflation and output that the policy maker faces in the present (in other words, 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. It is no surprise, for example, that in Section 1 of Michael Woodford's paper for this conference (on "Advantages of an Explicit Target for Monetary Policy"), Section 1.1 is titled "Central Banking as the Management of Expectations" (emphasis added). This is not the place to go over yet again the concerns I have expressed elsewhere about this way of thinking about monetary policy.[9] The

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[8]See again Friedman (2003).

[9]Interested readers can refer to my discussion of Eggertsson and Woodford (2003).

question to pose, however, is whether, 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 – we should call this kind of communications policy the management of expectations or the manipulation of expectations.

As Woodford and many others have ably shown, the public's expectations matter for economic behavior, including the efficacy of monetary policy, and so even if all that the obfuscation inherent in inflation targeting did were to affect expectations, that in itself would be important. But there is also ground to believe that inflation targeting may distort not just what the central bank says but what it does.

One reason for thinking so, which Faust and Henderson emphasize, is the accountability argument: "The ITF contention ... is that the proper use of public announcements can increase public scrutiny" (p. 23). "The idea is that if the performance of the staff and board is easier for the public to scrutinize, they will all work harder to make better policy" (p. 19). But, "The ITF communication framework is tilted heavily toward emphasis on stabilizing inflation" (p. 18). As a result, "... we see no reason to suppose that the ITF framework will facilitate hitting a proper balance of multiple goals. It seems at least as likely that the skewing of communication toward inflation will have undesirable consequences" (p. 24).

I have nothing to add to this important (and, I believe, correct) line of argument, other than to suggest that it calls back into question an often-made claim that Faust and Henderson dismiss out of hand at the outset of their paper: namely, that in many contexts the debate over inflation targeting is really a debate over what properly belongs in the central bank's preference function. Faust and Henderson are at pains to distinguish what Mervyn King has colorfully

called "inflation nutters" from what they here label "NETers."[10] For practical purposes, however, these two positions are isomorphic. Their respective implications for monetary policy are observationally equivalent.

There is also a second reason for thinking that the inflation targeting framework affects not just what the central bank says but also what it does. Put simply, the point is that language matters. 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, had this to say 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."[11]

We are all familiar with instances in our own day of the same phenomenon. For 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 labeled "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

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[10]See King (1997).

[11]Hume (1741).

inflation trajectory will be that concern for real outcomes will atrophy, or even disappear from policymakers' consideration altogether. Nor is it unreasonable to suppose that the hope that this eventuality will ensue is, for some advocates, a motivation for favoring inflation targeting in the first place.

I shall turn in closing to three narrower and more specific comments on Faust and Henderson's paper. First, they write, "... as a profession we are most confident of our advice regarding the mean of inflation" (p. 2). Even taking into account their point (which I have already noted) about the absence of practical policy implications of the mean of inflation, a reader of the relevant theoretical and empirical literature is entitled to ask just how confident we are on this score. At the conceptual level, there are at least five reasons for choosing a mean inflation rate different from zero: (1) measurement bias; (2) the "stabilization buffer" argument that Michael Woodford and Gauti Eggertsson have recently analyzed at length;[12] (3) the role of inflation as "grease to the labor market," as famously argued in James Tobin's AEA presidential address and more recently highlighted by Akerlof, Dickens and Perry;[13] (4) the distortionary tax argument, to which Stephanie Schmitt-Grohe has already referred in her comments on Michael Woodford's paper at this conference; and (5) the fact that in the United States today the principal asset bearing a permanently fixed nominal interest rate (zero) is currency, together with the apparent facts that much of the outstanding U.S. currency is held outside the country and that much of the rest is used by drug dealers and other criminals on whom we should <u>want</u> to impose distortionary taxes. At the empirical level, there is no evidence that mean inflation even quite far

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[12]Eggertsson and Woodford (2003).

[13]Tobin (1972); Akerlof et al. (2000).

above zero by the standards of today's industrialized world retards economic growth; Robert Barro's work on this question has shown no effect on growth associated with mean inflation up to 15% per annum, and Michael Sarel's work has shown no effect up to 8%.[14]

Second, Faust and Henderson's introduction of the "long and variable lags" argument is at best out of place in this discussion and, more likely, misleading. Milton Friedman's classic argument applied not merely to the attempt to vary the policy instrument in order to control output, but also to control inflation. Nothing is lost, or even changed, by rewriting the notation in Friedman's 1953 paper to make the left-hand-side variable π and the key right-hand-side variable either r or M. The force of the long-and-variable-lags argument is the implied optimality of a constant instrument rule (most famously, a constant money growth rule). Long and variable lags do not constitute an argument for inflation targeting.

Third, Faust and Henderson's point about the symmetry of costs applying not just to the mean of inflation but also to the variability of inflation is both interesting and important. Referring to the target range that the central bank announces for inflation, the rightly point out that "... excessive frequency of being inside the range is also evidence of misbehavior." An appropriate analytical framework recognizes that "... excessive smoothness and excessive volatility of inflation are equally costly at the margin in equilibrium" (p.16, emphasis added).

In conclusion, I disagree, sharply, with what increasingly looks like an emerging consensus that inflation targeting is, if not the optimal framework for monetary policy, then a close enough approximation to be about as good a framework as any real-world central bank can practically hope to have. More specifically, I do not believe that inflation targeting is a

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[14]Barro (1995); Sarel (1996).

framework that the Federal Reserve System should adopt for the United States. For the many reasons I have explained in the course of discussing Faust and Henderson's paper, my view of inflation targeting is that of Macaulay's dunce of the present: I think inflation targeting would take U.S. monetary policy too far, in a direction in which we should not want to go. And in regard to their paper, I am content to be a dunce of the future. Faust and Henderson have all the right insights. They fall short only in not following the implications of these insights far enough.

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