



The Case for “Inflation First” Monetary Policy

Daniel L. Thornton, *Vice President and Economic Adviser*

The widespread adoption of inflation targets by numerous central banks, starting with the Reserve Bank of New Zealand in 1990, prompted several analysts to be concerned that policymakers might pursue price stability at the expense of economic stability. That is, policymakers might become what Mervyn King referred to as “inflation nutters”—policymakers who place “weight only on inflation and none at all on output stabilization” in the conduct of monetary policy.¹ I argue that there are several reasons central banks might want to operate under what Laurence Meyer calls a “hierarchical mandate,” that is, where the principal objective is price stability and policymakers do not pursue economic stabilization policy unless their price stability objective has been achieved.²

The first reason monetary policymakers might be well served to operate under a hierarchical mandate is that changes in the money supply have no long-run effects on the economy. This is referred to as “monetary neutrality.” Although it is not necessarily true that a permanent change in the inflation rate has no permanent effect on the real economy, Bullard and Keating find that in the United States and several other industrialized countries this *is* the case—monetary policy is “super neutral.”³ Moreover, as they note, from the perspective of pure theory, the long-run effect of a permanent increase in the inflation rate is uncertain—it can be positive, negative, or zero. There is no uncertainty about a central bank’s ability to control inflation in the long run; however, effective inflation control depends critically on well-anchored inflation expectations.

The second reason is that the policy option faced by policymakers is a function of the structure of the economy, the source of the shock, and whether the shock is temporary or permanent. For some shocks and some economic structures, policy actions that stabilize output in the short run also stabilize prices. In such fortuitous circumstances, policymakers need not choose between stabilizing output or stabilizing inflation. Unfortunately, for other shocks and other economic structures policymakers are forced to choose between stabilizing output and stabilizing inflation. As Bernanke (2004) notes,

[I]f monetary policies are chosen optimally and the economic structure is held constant, there exists a long-run tradeoff between volatility in output and volatility in inflation.

The ultimate source of this long-run tradeoff is the existence of shocks to aggregate supply...Hence, in the standard framework, the periodic occurrence of shocks to aggregate supply (such as oil price shocks) forces policymakers to choose between stabilizing output and stabilizing inflation. Note that shocks to aggregate demand do not create the same tradeoff, as offsetting an aggregate demand shock stabilizes both output and inflation.⁴

When faced with a supply shock, an attempt to mitigate its effect on prices exacerbates the effect on output and an attempt to mitigate its effect on output exacerbates the effect on prices. A hierarchical mandate would alleviate concerns that policymakers might jeopardize their long-run price stability objective for some short-run gain in economic stability because of political pressure or for other reasons.

Policymakers should not think of price stability and economic stability as competing objectives but as complements—the best way to achieve the latter is to be firmly committed to achieving the former.

Policymakers might also prefer to operate under a hierarchical mandate because of the likelihood that price stability is good for long-term economic growth and economic stability for a variety of reasons. Bernanke (2004) notes that the Great Moderation—the sharp reduction in the variability of real output growth and other economic variables from the mid-1980s to the beginning of the current financial crisis—could not have been a consequence of “a conscious attempt by policymakers to try to moderate the variability of inflation,” because such actions would have led to “higher, not lower, variability of output.” He then

outlines four ways that monetary policy directed at lower and more stable inflation may have caused enhanced economic stability. Low and stable inflation might have (1) “led to stabilizing changes in the structure of the economy,” (2) affected “the size and frequency of shocks hitting the economy,” (3) changed “the sensitivity of pricing and other economic decisions to exogenous outside events,” and (4) reduced the likelihood of destabilizing “inflation scares.”

Finally, policymakers might prefer a hierarchical mandate because the more firmly anchored are inflation expectations, the more aggressively policymakers will be able to pursue economic stability. This approach is reflected in the Fed’s monetary policy in 2003. The Federal Open Market Committee [FOMC] had reduced its target for the funds rate to 1.0 percent, then a historically low level. By December 2003, FOMC meeting economic data indicated that real gross domestic product increased at a 3.3 percent rate in the second quarter and at a very rapid 8.2 percent rate in the third. Chairman Greenspan noted that it “has almost invariably been the case that the Federal Reserve would tighten under such conditions.”⁵ However, with little concern about accelerating inflation, presumably a consequence of well-anchored inflation expectations, the FOMC did not increase its funds rate target until June 2004, when it began increasing the target slowly at a “measured pace.”⁶

For all of these reasons, I suggest the Fed and perhaps other central bankers would do well to adopt a hierarchical mandate. More generally, policymakers should not think of price stability and economic stability as competing objectives that must be somehow weighted in the conduct of monetary policy. Rather they should think of price stability and economic stability as complements—the best way to achieve the latter is to be firmly committed to achieving the former. ■

¹ King, Mervyn. “Changes in UK Monetary Policy: Rules and Discretion in Practice.” *Journal of Monetary Economics*, June 1997, 39(1), pp. 81-97.

² Meyer, Laurence H. “Practical Problems and Obstacles to Inflation Targeting.” *Federal Reserve Bank of St. Louis Review*, July/August 2004, 86(4), pp. 151-60; <http://research.stlouisfed.org/publications/review/04/07/Meyer.pdf>.

³ Bullard, James and Keating, John W. “The Long-Run Relationship between Inflation and Output in Postwar Economies.” *Journal of Monetary Economics*, December 1995, 36(3), pp. 477-96.

⁴ Bernanke, Ben S. “The Great Moderation.” Presented at the meetings of the Eastern Economic Association, Washington, DC, February 20, 2004; www.federalreserve.gov/Boarddocs/Speeches/2004/20040220/default.htm.

⁵ FOMC Transcript, December 9, 2003, p. 88;

www.federalreserve.gov/monetarypolicy/files/FOMC20031209meeting.pdf.

⁶ For more details on the “measured pace” monetary policy, see Thornton, Daniel L. “‘Measured Pace’ in the Conduct of Monetary Policy.” *Federal Reserve Bank of St. Louis Monetary Trends*, March 2006;

<http://research.stlouisfed.org/publications/mt/20060301/cover.pdf>.