Commentary

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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.[1] 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 significant benefactor of, if not mankind, then at least monetary policy. Compared with that apparent consensus, and with 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 logical implications of the criticisms they offer.

Whether inflation targeting has led to superior outcomes for monetary policy in countries whose central banks have already adopted this practice is, of course, an empirical matter.[2] The paper presented at this conference by Andrew Levin, Fabio Natalucci, and Jeremy Piger (2004, p. 75) concludes that "inflation targeting (IT) has played a role in anchoring inflation expectations and in reducing the intrinsic persistence of inflation." 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".[3]

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. They approvingly quote Bernanke, Laubach, Mishkin, and Posen to the effect that among the "important features of inflation targeting are *vigorous efforts to communicate* with the public about the plans and objectives of the monetary authorities..." (p. 118, emphasis added by Faust and Henderson).[4] They begin their own paper by saying, "The core requirements of inflation targeting are an explicit long-run inflation goal and *a strong commitment to transparency*" (my emphasis). And they go on to say, "Not only are ITF [inflation targeting framework] central banks among the most transparent in the world, they have experimented aggressively with ways to make communication with the public more effective" (p. 117).

I disagree. As typically practiced today, 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

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

[2] Faust and Henderson opened the version of their paper that they presented at the conference by flatly declaring, "The inflation targeting framework (ITF) has been a great success around the world." In this version they have abandoned that claim.

[3] Ball and Sheridan (2003, abstract).

[4] Bernanke et al. (1999).

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Federal Reserve Bank of St. Louis *Review*, July/August 2004, *86*(4), pp. 145-49.

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 the mean inflation rate has very few practical consequences at any finite horizon" (p. 117). 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 this failure is intentional on the part of the central banks that adopt this framework.[6] As Faust and Henderson put it, "One of the most famous principles of strategic skewing in the folk wisdom of central banking is that central banks should 'do what they do, but only talk about inflation'." They go on to say that "the ITF might be viewed as an application of this folk wisdom. Without the folk wisdom, it is difficult to imagine why a policy of optimization with multiple conflicting goals would be called 'inflation targeting.' Calling reports on all aspects of policy 'inflation reports' is an analogous misnomer. The folk wisdom would also justify discussing goals other than inflation only as they affect the horizon over which one intends to hit the inflation target" (p. 132).

They obviously have in mind, for example, the Bank of England. The Bank of England, however, is 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 primary shortcoming of the ITF communication policy is in making clear the roles and balance of multiple goals...[T]he ITF as implemented often involves elements that are literally inconsistent with best-practice policy and, in any case, obfuscates some basic issues" (p. 124). Further, "any discussion of stability of prices or inflation must inevitably raise issues of other goals...[S]everal aspects of the ITF as practiced do not provide a natural and straightforward framework for communicating this fact" (p. 126).

Given this assessment—which I believe is correct—two questions follow: Is this aspect of 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*?

[5] Svensson (1997).

[6] See Friedman (2003).

[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 is 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 policymaker 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 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 note, is "the ITF premise that the threat of public criticism affects the incentives of the central bank and thereby the course of policy" (p. 129). But as they also rightly point out, "The ITF communication policy is tilted heavily toward emphasis on stabilizing inflation" (p. 126). As a result, "Given the skewing of communication in the ITF...a weak policymaker may find it safest to excessively smooth inflation." Hence, "the ITF seems as likely to complicate as to facilitate achieving a proper balance of multiple goals by a weak policymaker" (p. 131).

I have little to add to this important (and, I believe, correct) line of argument, other than to say that it probably applies to strong policymakers as well as weak ones—what Faust and Henderson call "policymaker aversion to criticism" is pervasive—and to suggest that it calls back into question an often-made claim that they 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

[8] See, again, Friedman (2003).

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

[10] See King (1997).

[11] Hume (1741, p. 72).

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 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 that, "as a profession we are more certain about our advice regarding the mean of inflation" (p. 118) than about what we say regarding the variance (in other words, economic stabilization). This may well be true. But even so, 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: (i) measurement bias; (ii) the "stabilization buffer" argument that Michael Woodford and Gauti Eggertsson have recently analyzed at length[12]; (iii) 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]; (iv) the distortionary tax argument, to which Stephanie Schmitt-Grohé has already referred in her comments on Michael Woodford's paper at this conference; and (v) 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 *want* to impose distortionary taxes. At the empirical level, there is no evidence that mean inflation even quite far 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 percent per annum, and Michael Sarel's work has shown no effect up to 8 percent.[14]

Second, while Faust and Henderson are certainly correct that a belief in "long and variable lags" is nowadays part of the common ground of monetary economics, the familiar attempt to appeal to this argument as a rationale for inflation targeting is at best out of place 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, they 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. 125, 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 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.

[12] Eggertsson and Woodford (2003).

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

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

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