The case for raising the inflation target

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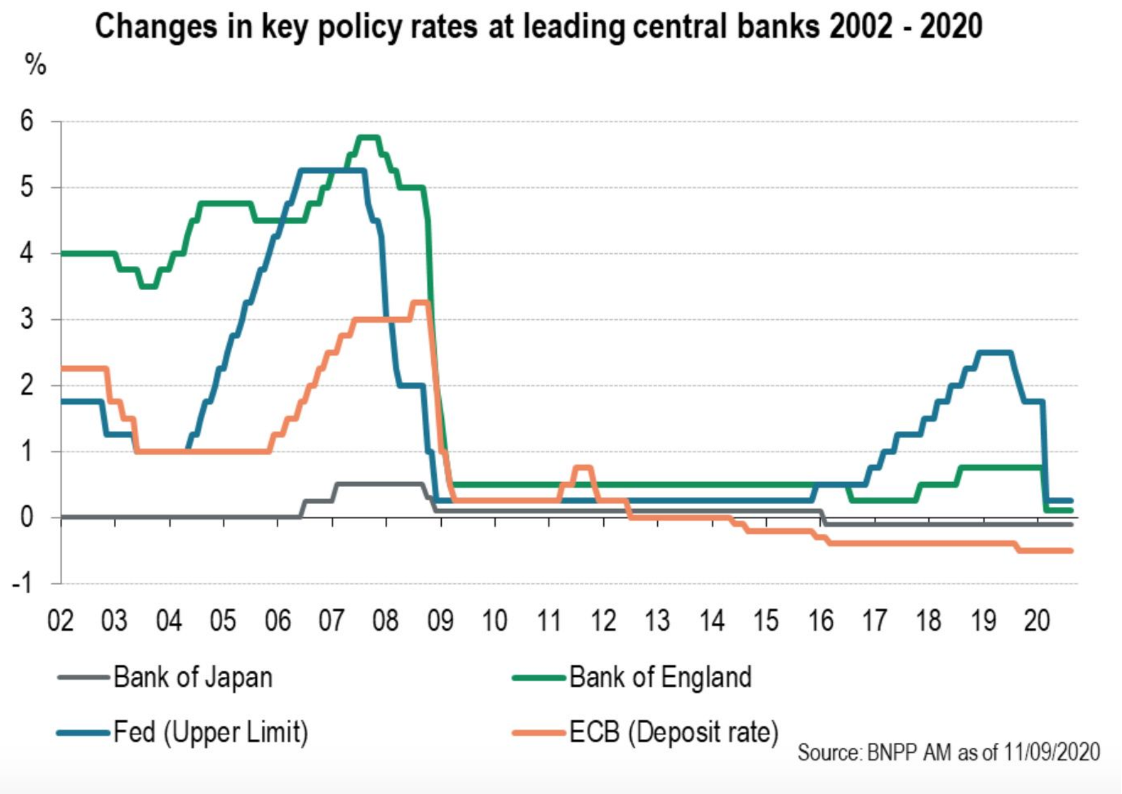
March 2022

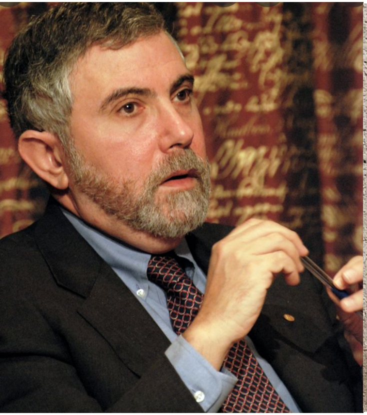
1990s 2% inflation target

- Friedman rule [-r%]
- Menu costs [0%]
- Downward nominal rigidities [>0%]
- Overstatement of inflation by CPI measures. [+bias%]
- Zero bound. [>-r%]

Long, protracted period at the lower bound



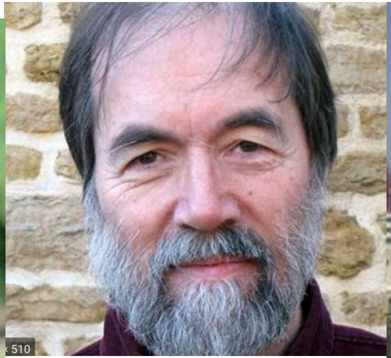
Source: [Investors' Corner, BNP Paribas Asset Mgt.]()












Raise the target by 2pp to 4%

- Higher inflation/expected inflation leads to higher nominal rates in the long run to compensate investors in a nominal bond.

- Lower rates initially; higher in the long run.

- More room to cut in response to future -’ve shocks.

Alternatives/complements to raising the inflation target

- More use of QE
- Abolish cash + taxing digital money
- Fiscal policy
- More inflation / real economy variability

Costs of raising the target

- Costs of higher inflation: why we choose low inflation in the first place
  - Menu costs, shoe leather costs, unit of account erosion, etc…
  - Costs rise gently away from the optimum

- Credibility
  - Moving the goalposts
  - When inflation was undershooting - central banks set themselves up for more failure.
  - When inflation is high [ie now] - authorities accused of opportunism.

Higher *and* more credible target?

- Periodic, 5 year reviews of evidence
    - Forces that drove the natural rate down may go into reverse

- If higher target is superior, could be more widely supported and expected to endure.

Reform of fiscal policy

- 200 basis points following a 2% to 4% target increase won’t be enough

- Systematize use of fiscal policy at/near the lower bound

    - BoE invites HMT to stimulate if interest rates can’t fall far enough.
    - HMT either devises stimulus / declines
    - OBR reviews stimulus and unwind for sustainability.