ECO 407
Competing Views in Macroeconomic Theory and Policy

Lecture 9
Should Central Banks Be Targeting Inflation?

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Is Inflation Always "Bad"?

- What are the main costs of inflation? Who bears these costs?
  - It erodes the value of money
  - By creating greater uncertainty, it reduces investment
- The costs of ***hyperinflation*** are undisputable
  - For example, Germany (1920s), Hungary (1945), Argentina (1980s), Zimbabwe (2008), Venezuela (2017)
- Mainstream economists have exploited people's fear of high inflation to push for excessive anti-inflationary policies
  - Only zero inflation is both ***low*** and ***stable***
- Some studies suggest that inflation rates up to 10 percent do not affect economic growth, while others suggest rates of up to 20 percent

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What Are the Cause of Inflation?

- ***Orthodox economists*** believe that "inflation is always and everywhere a monetary phenomenon" (Friedman)
  - Too much money chasing too few goods
  - Inflation is the result of excessive demand due to too much money in the economy
  - The solution then is to implement contractionary monetary policy

- ***Post-Keynesian economists*** believe that inflation is not demand-determined but rather the result of cost considerations
  - Therefore, contractionary monetary policy will not have the desired effects

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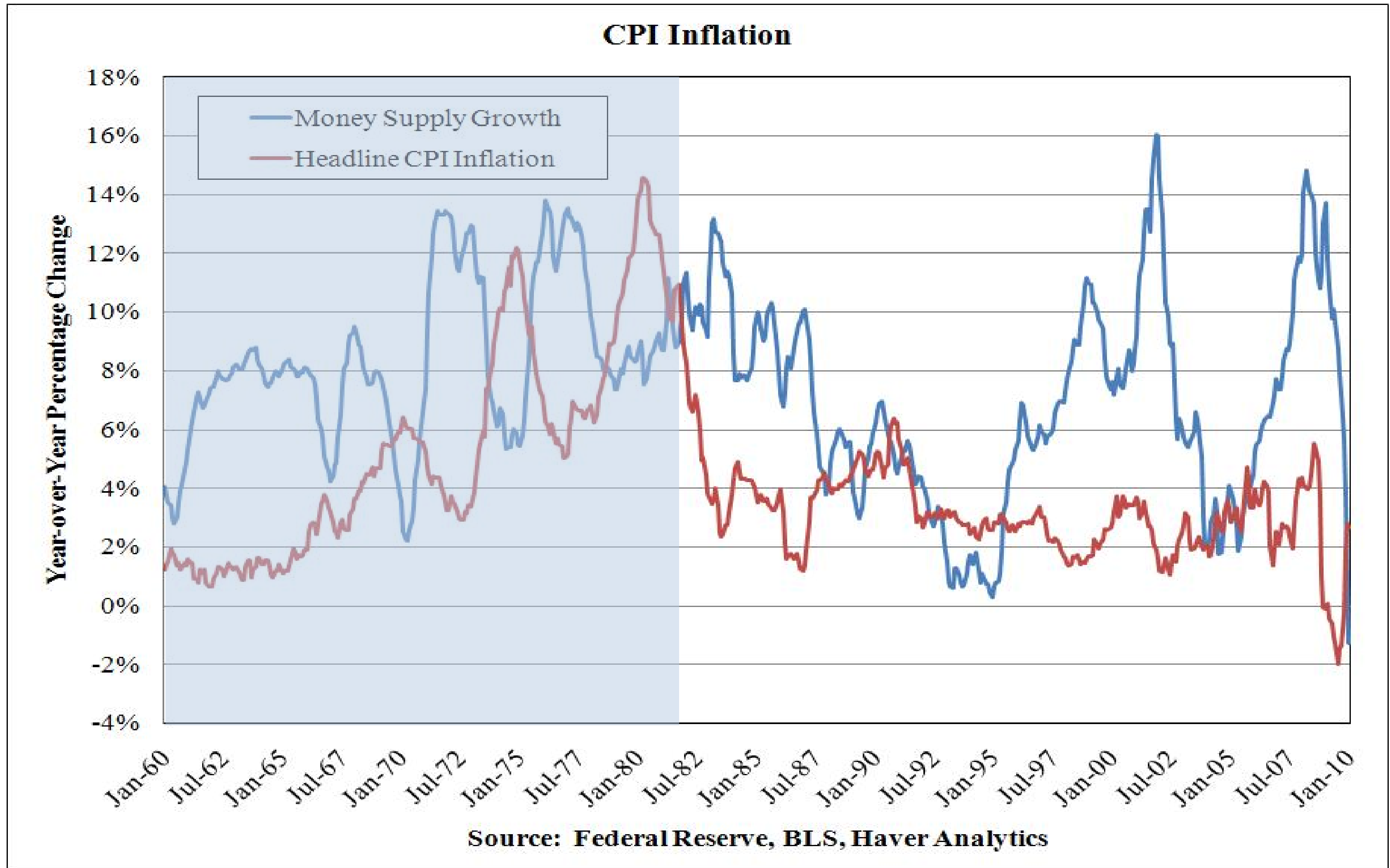
Money Supply and Inflation in the U.S.



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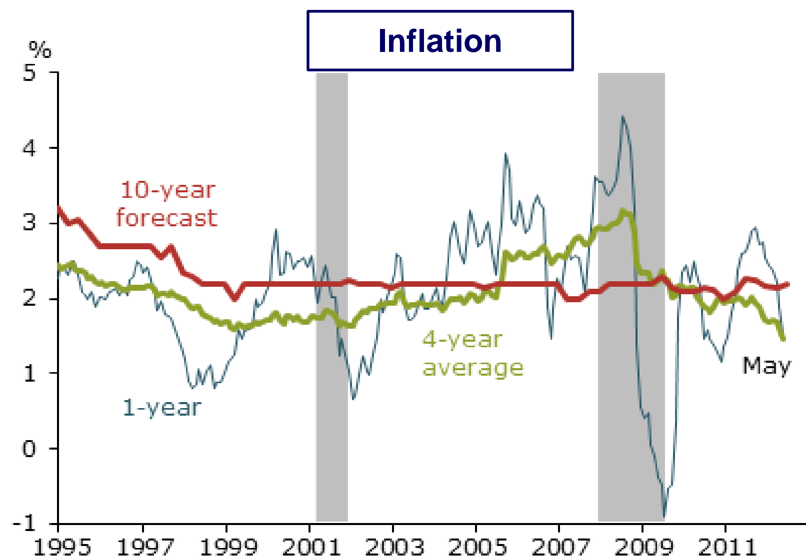

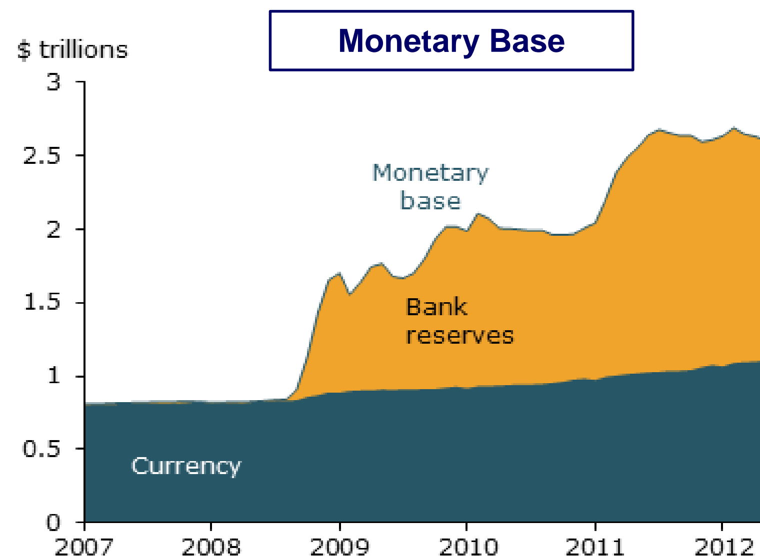

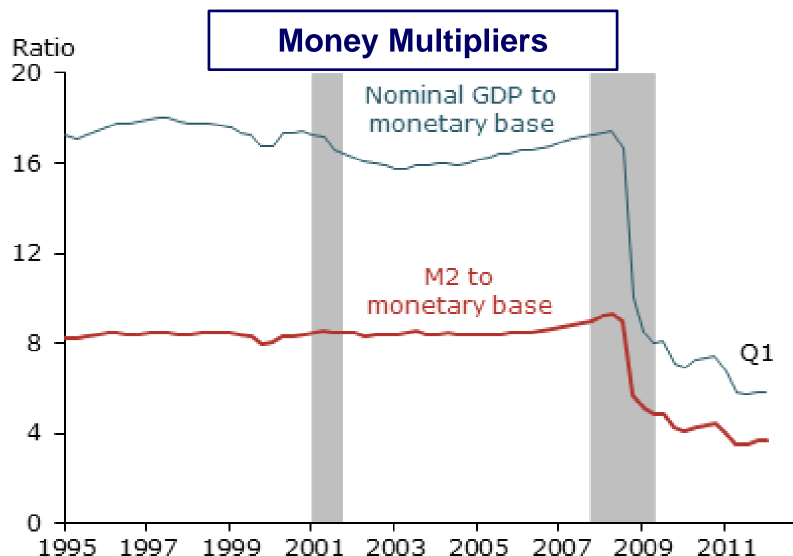

Period 2008-2012

- Average rate of inflation below 2%
- Monetary base tripled
- Money multipliers plummeted

Source: John C. Williams, "Monetary Policy, Money, and Inflation," FRBSF Economic Letter 2012-21, 9 July 2012.

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Orthodox View of Inflation

- Inflation is a ***monetary phenomenon*** and thus curbing inflation requires tight ***monetary policy*** (to reduce AD)

- The view that ***monetary policy*** should be used to curb ***inflation*** is based on three main hypotheses:
  - Central banks control the money supply
  - Money supply is an intermediate target
  - Dichotomy between ***monetary*** and ***real*** analyses

- The first hypothesis has more recently been replaced by a more realistic one:
  - Central banks cannot control the money supply
  - They control instead the short-term rate of interest

Post-Keynesian View of Inflation

- There is no relationship between money and prices, and thus ***inflation is never a monetary phenomenon***
- In addition, ***demand*** plays only a small role in the determination of prices
- There are two types of goods:
  - ***Flex-price goods*** (e.g., agricultural products) whose prices are determined by the market
  - ***Fixed-price goods*** (e.g., manufactured goods) whose prices are set by firms as a ***markup*** over production costs
- If wages increase, for instance, the firm can:
  - Reduce markup and absorb the higher cost → ***No inflation***
  - Leave the markup unchanged and pass the increase to consumers → ***Cost-push inflation***

Inflation Targeting: The New Consensus Model

- In the 1990s, the Bank of Canada officially adopted a policy of inflation targeting
- This new measure is part of the ***New Consensus*** model, which consists of three main relationships:
  - A negative relationship between interest rates and investment (an IS-curve) → ***natural rate of interest***
  - A positive relationship between the output gap and inflation (a Philips curve)
  - A Taylor rule where the central bank should change the rate of interest whenever:
    - Actual output deviates from potential output
    - Actual inflation deviates from the chosen target

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Post-Keynesian Critique of the New Consensus Model

- ***Post-Keynesians*** reject the existence of a ***natural*** rate of interest
  - Relying on the supposed existence of this rate would lead to poor ***monetary policy*** decisions
- ***Post-Keynesians*** don't believe that ***inflation*** is ***demand-determined***
  - Resting ***monetary policy*** decisions on ***demand*** would lead to poor policy decisions
- The ***New Consensus*** model does not allow a role for ***fiscal policy***
  - ***Post-Keynesians*** reject that only ***monetary policy*** can regulate cycles and tame inflationary pressures

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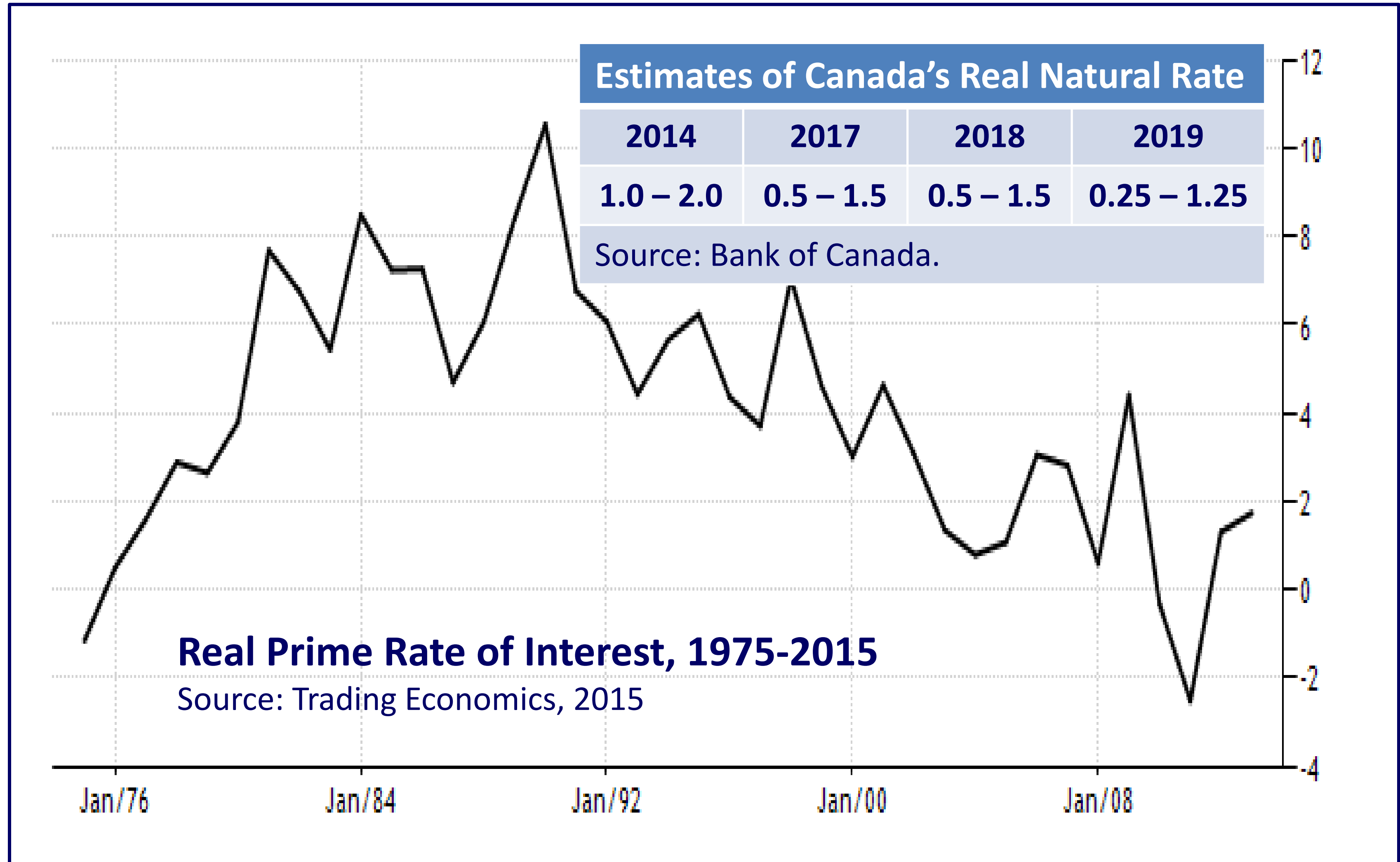
What's Canada's Natural Rate?



Estimates of the U.S. Natural Rate

Source: T. Laubach and J. Williams, *Measuring the Natural Rate of Interest Redux*, 2015.

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Post-Keynesian Critique of the New Consensus Model (cont'd)

- The money supply cannot be controlled by the central bank
  - Money supply should adjust to the needs of the banking system
    - The money supply is thus an ***endogenous*** variable
  - The central bank can control the rate of interest
    - Thus the rate of interest is an ***administered price*** and a ***distributive variable***

- There is no separation between ***money*** and ***economic activity***
  - Impossible to discuss real activity without discussing monetary conditions and the banking sector
  - Economic activity cannot be slowed down by lack of saving, but it can be affected by lack of banking lending

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Is Inflation Targeting Responsible for Bringing Down Inflation?

- Inflation targeting was adopted when inflation was already on the way down
  - This period corresponds to a general decrease in real wages
- What explain that inflation decreased to very low levels in both developed countries and emerging markets?
- The explanation is provided by the greater globalization of the economy:
  - Globalization of the economy facilitates the location of production in low wage countries
  - Trade liberalization allows the imports of lower price consumption and other goods

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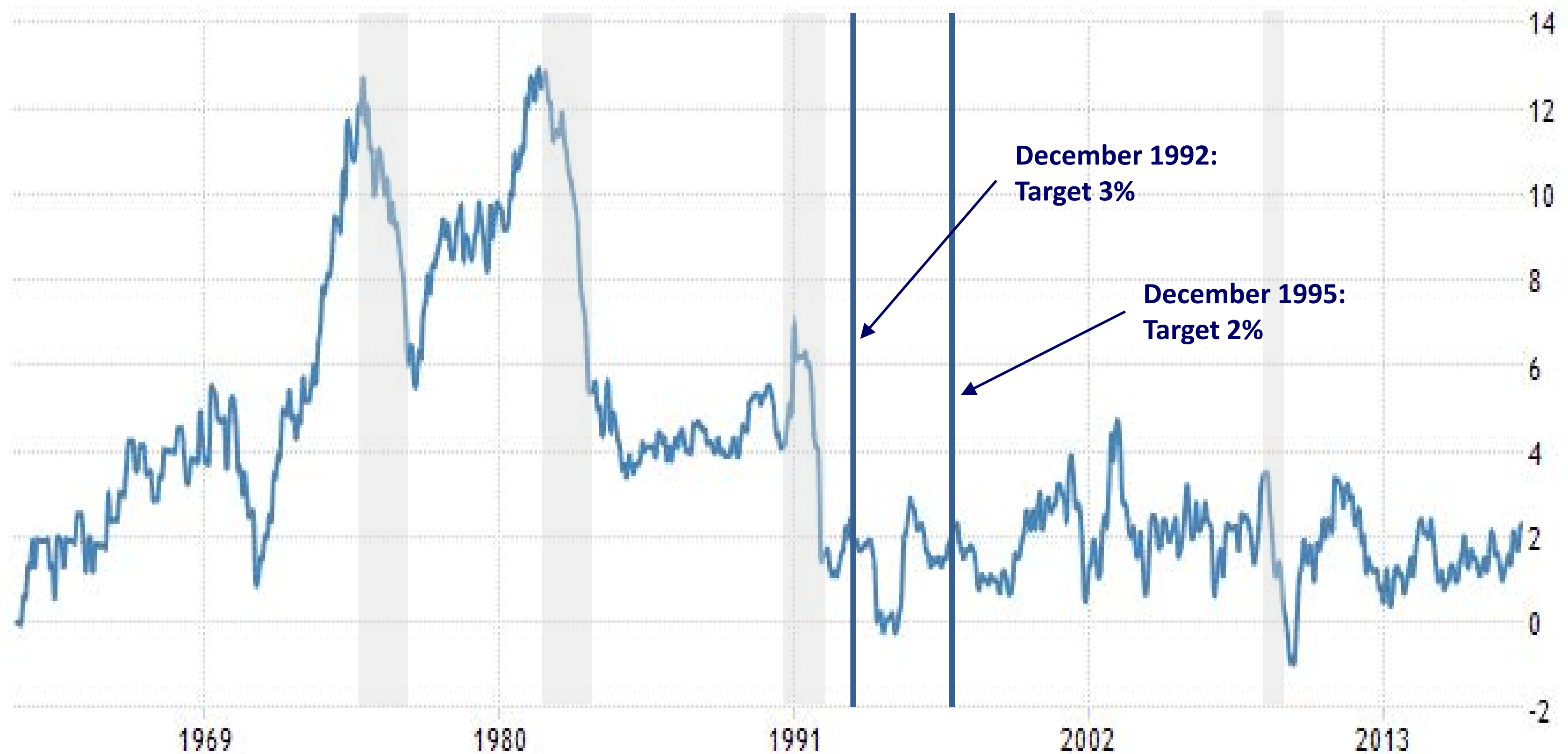
Canada: Inflation and Deflation

January 1962 to May 2018



Source: Trading Economics / Statistics Canada.

Modifications and Alternatives to Inflation Targeting

- What rate of inflation?
- Which measure of inflation?
- What time horizon to bring down inflation?
- Price-level targeting vs. inflation-targeting
- Fixed-exchange rates versus inflation targeting
- Nominal-GDP targeting
- Unemployment targeting

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Should the 2-Percent Target Be Abandoned?

- The inflation target is not appropriate when facing ***supply shocks*** or ***balance-sheet recessions***

- ***Obsession*** with inflation seems dated when inflation is ***not an issue*** anymore

- Reasons to abandon the 2-percent target
  - The 0% lower bound is too close
  - Need to reduce real wages
  - It perpetuates the feedback loop of stagnation and low inflation

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