The failure of inflation targeting

Joseph E. Stiglitz
May 2008 – *Project Syndicate*

The World's central bankers are a close-knit club, given to fads and fashions. In the early 1980's, they fell under the spell of monetarism, a simplistic economic theory promoted by Milton Friedman. After monetarism was discredited – at great cost to those countries that succumbed to it – the quest began for a new mantra.

The answer came in the form of "inflation targeting," which says that whenever price growth exceeds a target level, interest rates should be raised. This crude recipe is based on little economic theory or empirical evidence; there is no reason to expect that *regardless of the source of inflation,* the best response is to increase interest rates. One hopes that most countries will have the good sense not to implement inflation targeting; my sympathies go to the unfortunate citizens of those that do. (Among the list of those who have officially adopted inflation targeting in one form or another are: Israel, the Czech Republic, Poland, Brazil, Chile, Colombia, South Africa, Thailand, Korea, Mexico, Hungary, Peru, the Philippines, Slovakia, Indonesia, Romania, New Zealand, Canada, the United Kingdom, Sweden, Australia, Iceland, and Norway.)

Today, inflation targeting is being put to the test – and it will almost certainly fail. Developing countries currently face higher rates of inflation not because of poorer macro-management, but because oil and food prices are soaring, and these items represent a much larger share of the average household budget than in rich countries. In China, for example, inflation is approaching 8% or more. In Vietnam, it is even higher and is expected to approach 18.2% this year, and in India it is 5.8%. By contrast, US inflation stands at 3%. Does that mean that these developing countries should raise their interest rates far more than the US?

Inflation in these countries is, for the most part, *imported.* Raising interest rates won't have much impact on the international price of grains or fuel. Indeed, given the size of the US economy, a slowdown there might conceivably have a far bigger effect on global prices than a slowdown in any developing country, which suggests that, from a global perspective, US interest rates, not those in developing countries, should be raised.

So long as developing countries remain integrated into the global economy – and do not take measures to restrain the impact of international prices on domestic prices – domestic prices of rice and other grains are bound to rise markedly when international prices do. For many developing countries, high oil and food prices represent a triple threat: not only do importing countries have to pay more for grain, they have to pay more to bring it to their countries and still more to deliver it to consumers who may live a long distance from ports.

Raising interest rates can reduce aggregate demand, which can slow the economy and tame increases in prices of some goods and services, especially non-traded goods and services. But, unless taken to an intolerable level, these measures by themselves cannot bring inflation down to the targeted levels. For example, even if global energy and food prices increase at a more moderate rate than now – for example, 20% per year – and get reflected in domestic prices, bringing the overall inflation rate to, say, 3% would require markedly falling prices elsewhere. That would almost surely entail a marked economic slowdown and high unemployment. The cure would be worse than the disease.

So, what should be done? First, politicians, or central bankers, should not be blamed for imported inflation, just as we should not give them credit for low inflation when the global environment is benign. Former US Federal Reserve Chairman Alan Greenspan, it is now recognized, deserves much blame for America's current economic mess. He is also sometimes given credit for America's low inflation during his tenure. But the truth is that America in the Greenspan years benefited from a period of declining commodity prices, and from deflation in China, which helped keep prices of manufactured goods in check.

Second, we must recognize that high prices can cause enormous stress, especially for lower-income individuals. Riots and protests in some developing countries are just the worst manifestation of this.

Advocates of trade liberalization touted its advantages; but they were never fully honest about its risks, against which markets typically fail to provide adequate insurance. Over a quarter-century ago, I showed that, under plausible conditions, trade liberalization *could* make everyone worse off. I was not arguing for protectionism, but rather sounding a cautionary note that we must be aware of the downside risks and be prepared to deal with them.

When it comes to agriculture, developed countries, such as the US and European Union members, insulate both consumers and farmers from these risks. But most developing countries do not have the institutional structures, or the resources, to do likewise. Many are imposing emergency measures like export taxes or bans, which help their own citizens, but at the expense of those elsewhere.

If we are to avoid an even stronger backlash against globalization, the West must respond quickly and strongly. Bio-fuel subsidies, which have encouraged the shift of land from producing food into energy, must be repealed. In addition, some of the billions spent to subsidize Western farmers should now be spent to help poorer developing countries meet their basic food and energy needs.

Most importantly, both developing and developed countries need to abandon inflation targeting. The struggle to meet rising food and energy prices is hard enough. The weaker economy and higher unemployment that inflation targeting brings won't have much impact on inflation; it will only make the task of surviving in these conditions more difficult.

Joseph E. Stiglitz, Professor of Economics at Columbia University, received the Nobel Prize in economics in 2001.