The more things change . . . inflation targeting and central bank policy

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Abstract: Over the past several decades, monetary theory and policy have been rather consistent, giving credence to the old adage that "the more things change, the more they stay the same." Indeed, three constants in monetary policy can be identified: (1) central banks always strive for some form of price stability, (2) inflation is always and everywhere a demand phenomenon, and (3) monetary policy is always neutral in the long run. Even the latest version of mainstream theory, under the guises of the "new consensus," is strangely consistent with this approach, despite advocating exogenous rates of interest and endogenous money. Inflation targeting is a restatement of the old doctrine, with all the traditional bells and whistles.

Key words: central bank, inflation targeting, monetary policy.

The old adage that "the more things change, the more they stay the same" is an appropriate characterization of monetary and macroeconomic policy over the past 50 years. Indeed, while mainstream economists discuss the causes of inflation, unemployment, and growth, they merely discuss subtle differences within an otherwise neoclassical framework. In the long run, we always somehow return to a stable position of equilibrium, with all the neoclassical bells and whistles.

In fact, three overall constants in central bank policy can be identified irrespective of whether central banks are governed by monetarists, mark I and mark II, or by new Keynesians, mark I or mark II: first, central banks have always strived to achieve some degree of price stability. Today, in many cases, inflation is the primary, if not only, objective of central banks. And, although central banks may claim that they are also concerned about output stability and financial stability, it is clear that mainstream economists believe that these objectives can only be met...
Once price stability has been achieved (Bernanke et al., 1999); second, inflation has always been explained through excess demand forces. As Lavoie says, “In mainstream economics, inflation is mainly an excess demand phenomenon, induced by an excess supply of money” (1996, p. 535). Finally, monetary policy has always been considered neutral in the long run. In this sense, while the pursuit of price stability may have some unfortunate costs in the short run (which “sacrifice ratios” are intended to measure), in the long run, high interest rate policies are considered as having no long-run considerations.

The overall preoccupation over inflation—a concern shared by central bankers, economists, and policy makers alike—has shifted the attention away from fiscal policy toward monetary policy. Indeed, central banks have attained a level of prominence rarely seen of any public institution, which followed a period of relatively high inflation rates, renewing concern over inflation and its possible consequences for economic outcomes. At the root of this rise in inflation, some economists believe, are the large fiscal deficits of the previous decades, thereby leading to skepticism and suspicion over the usefulness of fiscal policy in controlling output.

In light of this phenomenon, we have witnessed a dramatic policy switch away from fiscal policy and toward monetary policy, where central banks have been given the quasi-exclusive policy rights to combat rising inflation: fiscal policy has been downgraded and seen as monetary policy’s poor cousin.

This modern policy switch is exemplified in the latest incarnation of mainstream economics, under the guises of the “new consensus.” Indeed, as advocates of Taylor rules and inflation targeting will admit, central banks are given a prominent role in these models, to the detriment of fiscal policy. In fact, it is specifically stated that “fiscal dominance” should be avoided at all costs. As Debelle et al. summarize, “if fiscal dominance exists, inflationary pressures of a fiscal origin will undermine the effectiveness of monetary policy by obliging the central bank to accommodate the demands of the government, say, by easing interest rates to achieve fiscal goals” (1998, p. 2). Moreover, by adhering to an inflation target, advocates believe this will inevitably force “fiscal policy to align with monetary policy” (Mishkin, 2000, p. 2).

There are two underlying notions at play here. First, as stated above, there is this idea or belief that inflation is always caused by excess demand. Second, fiscal deficits lead to inflationary pressures through artificially increasing demand or by monetizing the public debt. Public-sector
borrowing from the central bank should therefore remain low or nonexistent. Fiscal policy should never be allowed to dictate monetary policy. Mainstream economists therefore insist on disciplined fiscal policy and balanced budgets (at least over the whole business cycle).

In accordance with this philosophy, price stability or inflation targeting is increasingly the central bank’s sole objective in many countries—or what Meyer dubs the “hierarchical principle” (2001, p. 1).

Recently, a new approach has surfaced that explains the behavior of central banks and proposes a monetary policy, which, on the surface, seems to deviate from the two neoclassical constants. Indeed, new consensus models focus on two key arguments—a Taylor-type interest rate rule and inflation targeting. While the new consensus has generated considerable attention in Post Keynesian circles (among Post Keynesians who have been critical of the new consensus, see Arestis and Sawyer, 2004; Gnos and Rochon, 2005; Lavoie, 2004; Monvoisin and Rochon, 2006; Setterfield, 2005; Smithin, 2004), attention has generally centered on the Taylor rule, an overall criticism of new consensus models, or the Wicksellian roots of the model (Rochon, 2005). Little has been specifically written on inflation targeting, which has become a fashionable monetary policy strategy in a number of countries. Indeed, since the adoption of inflation targeting in New Zealand in 1990 and Canada in 1991, a number of countries have now adopted an inflation targeting regime (see Rochon and Rossi, this issue, pp. 615–638).

The popularity of inflation targeting is partly attributed to the fact that most mainstream authors consider inflation targeting an impressive success (Fraga et al., 2004; King, 2002), although for them, success is defined exclusively in terms of a reduction in the rate of inflation. Proponents of inflation targeting argue that this regime leads to “better”—more credible—monetary policy, more transparency, more accountability, and a better, more suitable anchor for inflation expectations.

Yet a number of questions need to be asked. In particular, has inflation targeting really been a successful strategy in reducing the level of inflation rates? In fact, the success of inflation targeting is usually measured in terms of its impact on inflation rates, with little or no consideration for real factors or other economic policy goals, such as the reduction of unemployment and poverty as well as the maximization of output (see Rossi, 2004). Yet inflation was on a downward trend years before any inflation targeting strategies were adopted, thereby seriously undermining the notion that inflation targeting strategies had anything to do with lowering inflation.
This then provides an opportunity for Post Keynesians to offer an alternative explanation of why inflation has come down since the mid-1970s, on one hand, and the role central banks can play in achieving other goals, such as unemployment and income distribution, on the other hand.

The task before Post Keynesians, therefore, is twofold. First, we must show that the causes of inflation are not rooted in excess demand as central bankers believe, but rather in supply; more specifically, inflation is cost induced.¹ If this is correct, then central bank policies and inflation targeting strategies are based on flawed reasoning. Second, we must show that in their attempts at controlling inflation, central bankers do not fine-tune the economy until inflation targets are reached; rather, they must raise interest rates repeatedly until the economy finally collapses and, in the process, affects income distribution, aggregate demand, output, and the wage-bargaining power of unions in demanding higher wages. Hence, the transmission mechanism of interest rate policy on prices is a long, complicated process, not particularly well understood by central bankers. In other words, the price paid by using monetary policy to control prices is too high.

To be fair, of course, new consensus theory does account for supply shocks, although these are considered transitory in nature and tend to cancel each other out. In the end, they are not given much weight. As Blanchard explains, “[c]ost shocks are present, but their effect works through the natural level of output, and so through the output gap. Put another way, the output gap is a sufficient statistic for the effect of real activity on inflation” (2005, p. 414). Arestis and Sawyer note this clearly: “The position taken by IT [inflation targeting] on cost inflation is that it should either be accommodated, or that supply shocks come and go—and on average are zero and do not affect the rate of inflation” (2003, p. 14).

Supply shocks, however, are not the same as a supply, or cost-determined, theory of inflation, as advocated by Post Keynesians. Supply shocks occur only periodically, whereas a cost-push theory of inflation emphasizes the everyday cost structure of production and how this relates to inflation. In the end, cost-push inflation cannot be incorporated within the new consensus model. Although some may claim that they could be accommodated in the stochastic term embedded in the Phillips

¹ I do not deny that inflation can be caused by demand factors (although not by excess demand). As demand increases, this may encourage firms to adjust their markup to reflect more historical levels of the rate of profit (Lavoie, 1992, p. 376).
curve, wage increases and other increases in costs that may affect inflation are not stochastic in nature. Hence, if inflation is primarily caused by costs (see Lavoie, 1992), then monetary policy based on a demand-determined approach, and whose primary goal is to fight inflation, may lead to bad monetary policy. If this is the case, then the obvious question is what constitutes a good monetary policy?

Structure of the symposium

The contributions to this symposium share an interest on inflation targeting. Some discuss the economic impact of such a strategy, whereas other contributions discuss the central bank’s ability to control inflation. In the end, a clear consensus emerges among Post Keynesians: central banks are not efficient in fighting inflation, and as a consequence, inflation targeting strategies may do more harm to the economy.

Alvaro Angeriz and Philip Arestis, for instance, discuss the relevance of inflation-targeting policies in lowering inflation. Their paper deals with the empirical relevance of the new consensus and especially its inflation-targeting monetary strategy. Applying intervention analysis to structural time series models, the authors offer new empirical evidence produced for a number of countries. The results demonstrate that in terms of its initial impact on inflation, the empirical evidence suggests that central banks that have pursued this strategy have not been successful. In other words, the authors are suspicious of the mainstream claim that inflation-targeting policies were successful in reducing inflation levels.

In his contribution, Roberto Frenkel challenges the existing Latin American consensus of fully liberalized capital accounts, a pure floating exchange rate, and inflation-targeting monetary policy as the macroeconomic setting currently recommended in Latin America by the International Monetary Fund (IMF) and the orthodoxy. Frenkel presents an alternative macroeconomic regime proposal focused on growth and employment. A competitive real exchange rate, as an intermediate target, is an essential component of the regime. The paper argues in favor of the proposed policies by showing that they are viable and manageable and also discusses some possible objections from the mainstream or orthodox approach.

In an interesting paper, Robert Pollin and Andong Zhu take a closer look at the relationship between inflation and economic growth for 80 countries over the 1961–2000 period. The paper consistently finds that higher inflation is associated with moderate gains in gross domestic
product (GDP) growth up to a roughly 15–18 percent inflation threshold. However, the findings diverge when the authors divide the countries according to income levels. In the Organization for Economic Cooperation and Development (OECD) countries, no clear pattern emerges with either the inflation coefficient or the estimated turning point. With the middle-income countries, results show a consistently positive pattern of inflation coefficients, though none are statistically significant. The turning points range within a narrow band in this sample, between 14 and 16 percent. With the low-income countries, the authors obtain positive and higher coefficient values on the inflation coefficient than with the middle-income countries. The authors then present their results by dividing the time sample into decades. Here, the results indicate that inflation and growth will be more highly correlated to the degree that macroeconomic policy is focused on demand management as a stimulus to growth. They conclude that there is no justification for inflation targeting policies as they are currently being practiced throughout the middle- and low-income countries—that is, to maintain inflation with a 3–5 percent band.

Louis-Philippe Rochon and Sergio Rossi argue that since the adoption of inflation targeting in New Zealand in 1990, a number of developed as well as developing and emerging market economies have followed suit. Often, the sole objective of central bank policies, the strategy of inflation targeting, seeks to reduce the inflation rate and, in some cases, also interest rates and output volatilities. Yet, although there is some evidence that these objectives have not been reached, the authors intend to look at the impact of inflation targeting on the distribution of income, more specifically, on the wage share. The authors present evidence for a number of inflation-targeting and non–inflation-targeting countries that inflation targeting strategies seem to worsen the wage share.

In his contribution, Malcolm Sawyer compares the ideas embedded in inflation targeting strategies and Keynes, and finds that a number of ideas advocated by inflation-targeting strategists can be found in Keynes—in particular, the notion that requires central banks to be independent. The author then asks whether this implies that we are all Keynesians now. He concludes that it does not, because the main theoretical ingredients of inflation targeting appear to be very different from Keynes’s ideas on central banking and its policy objectives. The author concludes that, regrettably, we may not be all Keynesians after all... or not yet.

With a slightly different focus, Mark Setterfield attempts to show that inflation targeting is compatible with Post Keynesian economics, but only if two very important conditions are met. Indeed, he shows that for
this conclusion to hold, central bank policies used to achieve the inflation target must explicitly acknowledge (1) the demand-determined nature of the real income generating process, and (2) the importance of conflicting claims over the distribution of income for determining the rate of inflation. That being said, the author then asks a larger question: Should policy makers engage in inflation targeting? It is shown that although there does exist a Post Keynesian case for inflation targeting, the appropriate inflation target that emerges from Post Keynesian economics suggests that far too much attention is currently being paid to inflation. Instead, Setterfield suggests that policy makers should pay more attention to output (and, by extension, employment) targeting.

Finally, in their contribution, H. Sonmez Atesoglu and John Smithin argue that an explicit inflation targeting policy is not likely to be a desirable monetary policy rule, even if it were agreed that a lower inflation rate is an important goal of policy. Inflation targeting is not neutral in the short or the long run, and a strict policy will tend to reduce the equilibrium growth rate. In terms of income distribution, a lower inflation target will tend to reduce real wages and profits and increase real interest rates—that is, the return to rentiers. In certain circumstances, it may still be possible to achieve a combination of both higher growth and lower inflation using other types of policy. However, this would actually require lower real interest rates, rather than the higher rates that are traditionally associated with anti-inflation policy.

I hope that readers of these papers will find them useful and interesting, and that these papers offer an interesting research path for those interested in central bank policies and the new consensus. I thank Paul and Louise Davidson for their continued support, and all the participants for their remarkable papers and for making this symposium a success.

REFERENCES


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